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Delaware Courts Continue to Define Appropriate Valuation Methodologies for Statutory Appraisal

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> See page 4 for implications

Statutory appraisal actions remain one of the most closely watched areas of Delaware corporate law, and there have been significant developments in Delaware appraisal law. Recently, the Delaware Supreme Court provided additional guidance on appropriate valuation methodologies as it reversed and remanded the Delaware Court of Chancery in *DFC Global Corporation v. Muirfield Value Partners, L.P., et al.*, C.A. No. 10107 (Del. Aug. 1, 2017). The Court of Chancery has issued two opinions in the past year that did not rely on the merger price as fair value. Notably, both decisions produced a fair value determination below the merger price. Two other opinions by the Court of Chancery issued in the past year continued a trend and relied on the merger price in determining fair value. Most recently, the Delaware Supreme Court heard oral argument in the appeal of *In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016), where the Court of Chancery gave no weight to deal price and relied on a discounted cash flow analysis to produce an appraised value that was roughly 28 percent above the merger price.

Background

Statutory appraisal under Section 262 of the Delaware General Corporation Law (DGCL) provides stockholders who dissent from a merger the ability to seek a judicial determination of the "fair value" of their shares on the "effective date," or the closing date of a merger. In an appraisal action, fair value is determined "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation," such as synergies, because the appraisal seeks to value the company on a "going concern" basis. In determining fair value, the Court of Chancery is required to take into account "all relevant factors."

In re DFC Global

In its decision in *DFC Global Corporation v. Muirfield Value Partners, L.P., et al.*, C.A. No. 10107 (Del. Aug. 1, 2017), the Delaware Supreme Court reversed and remanded the fair value determination the Court of Chancery produced after giving equal weight to deal price, a comparable companies analysis and a discounted cash flow analysis. The decision contains several notable highlights:

- The Supreme Court considered and rejected DFC's argument on appeal that there should be a judicial presumption that the deal price is the best evidence of fair value when the transaction results from an open market check and contains other indicators of a competitive sale process. In doing so, the court expressly reaffirmed its prior holding in *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214 (Del. 2010), that the Court of Chancery is given broad discretion to determine the fair value of a company's shares by considering "all relevant factors." However, the Supreme Court noted that this "refusal to craft a statutory presumption in favor of the deal price when certain conditions pertain" did not "in any way signal our ignorance to the economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."
- The Supreme Court concluded that the Court of Chancery's decision to give only one-third weight to deal price was not supported by the record based on the trial court's own findings that the deal price resulted from an open process,

was informed by robust public information as well as easy access to nonpublic information and included many parties with a profit motive that had a chance to submit a bid.

- The Supreme Court explicitly rejected the theory underlying one of the Court of Chancery's reasons (the so-called "private equity carve-out") for concluding that deal price should only be given one-third weight in determining fair value. Specifically, the Supreme Court stated that it did "not understand the logic of" a finding that deal price could not be given dispositive weight because the prevailing buyer was a financial buyer focused on achieving a certain internal rate of return. The Supreme Court concluded that "the private equity carve out that the Court of Chancery seemed to recognize, in which the deal price resulting in a transaction won by a private equity buyer is not a reliable indication of fair value, is not one grounded in economic literature or this record."

The Supreme Court also concluded that the Court of Chancery's decision to upwardly adjust the company's perpetuity growth rate following a motion for reargument was not supported by the record. The Supreme Court also held that the comparable companies analysis used was supported by the record and therefore the Court of Chancery was within its discretion in affording that analysis weight in determining fair value. Finally, the Supreme Court held that the Court of Chancery's decision to give equal one-third weight to each valuation method was not explained in a manner supported by the record, particularly in light of the Court of Chancery's findings regarding the robustness of the market check and the public information available about the company. The Supreme Court stated that on remand, the Court of Chancery "should reassess the weight [it] chooses to afford various factors potentially relevant to fair value."

Court of Chancery Employs Discounted Cash Flow Valuations

While many observers have focused on recent appraisal decisions that defer to the merger price, two cases in 2017 demonstrate that the Court of Chancery continues to rely on other methods of financial valuation, in particular, a discounted cash flow analysis, especially where neither party argues for the merger price as indicative of fair value.

In one recent decision, *In re Appraisal of SWS Group Inc.*, C.A. No. 10554-VCG (Del. Ch. May 30, 2017), the court determined the fair value of a small bank holding company. The court relied exclusively on a discounted cash flow analysis because "the sale of SWS was undertaken in conditions that make the price thus derived unreliable as evidence of fair value." Specifically, Vice Chancellor Sam Glasscock III concluded that "certain structural limitations unique to SWS make the application of the merger price not the most reliable indicia of fair value." In this regard, the vice chancellor highlighted that SWS was party to a credit agreement with its would-be acquirer under which the acquirer exercised a partial veto power over competing offers.

Notably, neither party relied on deal price to demonstrate fair value. Instead, the parties turned to traditional valuation methods. The petitioners presented a comparable companies valuation and a discounted cash flow analysis. The respondent presented solely a discounted cash flow analysis. After concluding that the comparable companies analysis was not reliable, the court turned to the competing discounted cash flow analyses. The parties' experts varied widely on fair value, providing "mirror image" valuations of 50 percent above and 50 percent below the deal price. The court chose one of the discounted cash flow analyses as its starting point before adjusting several inputs and assumptions to conclude that the fair value of SWS as of the merger date was $6.38 per share, lower than the merger consideration of $6.92 per share. The court noted that this result was not surprising, as the record before it suggested that the merger was a "synergies-driven transaction."

In another recent opinion, *ACP Master, Ltd. et al. v. Sprint Corp., et al.*, C.A. No. 8508-VCL (Del. Ch. July 21, 2017), the court determined the fair value of Clearwire Corporation using exclusively a discounted cash flow analysis. Like SWS, neither party argued in favor of deal price. The court explicitly did not consider deal price while finding that the transaction generated considerable synergies, estimated at $1.95 to $2.60 per share. The parties differed widely on the fair value of Clearwire, $16.08 per share vs. $2.13 per share. The court concluded that most of the difference was driven by the parties' choice of projections. After analyzing each set of projections, the court used the projections that were prepared by Clearwire's management and determined that the fair value for Clearwire on the date of the merger was $2.13 per share, less than half the merger price of $5 per share.

Court of Chancery Gives Full Weight to Deal Price When Sufficient Indicators of a Competitive Sales Process Are Present

While the Court of Chancery will turn to other valuation methods when the merger price is not a reliable indicator of fair value, decisions by the court highlight certain transactional scenarios when the court is likely to look to deal price as an exclusive, or at least presumptive, indicator of fair value.

In one recent decision, *In re Appraisal of Petsmart, Inc.*, C.A. No. 10782-VCS (Del. Ch. May 26, 2017), the court determined that the deal price was the most reliable indicator of fair value. The respondent argued that the merger price of $83 per share was fair value for the company, while the petitioners presented a fair value of $128.78 per share, a difference of $4.5 billion overall. The court began by examining the deal price of $83 per share. The court concluded that the process employed to sell the company, "while not perfect, came close enough to perfection to produce a reliable indicator of Petsmart's fair value." Specifically, Vice Chancellor Joseph R. Slights III highlighted that the sales process included "a robust pre-signing auction." After determining that deal price was a reliable indicator of fair value, the vice chancellor moved on to the parties' discounted cash flow analyses. Ultimately, the court concluded that a reliable discounted cash flow valuation could not be produced based on any of the projections in the record.

The court then considered whether the management projections could be adjusted to bring them more in line with the company's actual expected cash flows. To do so, Vice Chancellor Slights analyzed discounted cash flow analyses submitted by the parties that made adjustments to the management projections based on specific sensitivities the board of the company had directed its financial advisor to prepare. The court concluded that the financial advisor's sensitivities were reliable and found the valuations they produced to be confirmatory of deal price, but it did not adjust its view of fair value given the court's lack of confidence in the management projections underlying the sensitivities. Finally, the court considered if there was any other basis in the record to make further adjustments to the projections to arrive at a more reliable discounted cash flow analysis and found that no such basis existed. Therefore, the court concluded that deal price was the most reliable indicator of fair value at $83 per share.

In another important case, *Merion Capital L.P. and Merion Capital II L.P. v. Lender Processing Services, Inc.*, C.A. 9320-VCL (Del. Ch. Dec. 16, 2016), Vice Chancellor J. Travis Laster gave 100 percent weight to the deal price. The court first considered the initial merger consideration — the consideration contemplated when the deal was signed — of $33.25 per share. The court determined that this initial merger consideration was a reliable indicator of fair value based on several factors, including the existence of meaningful competition during the presigning phase, the presence of different types of bidders, the availability to all parties of adequate and reliable information about the company, and the lack of collusion or favoritism toward any particular bidders.

The court then analyzed the reliability of the final merger consideration — the actual consideration paid on the effective date of the merger — of $37.14 per share, which had risen due to an increase in the stock price of the acquirer. Vice Chancellor Laster concluded that the final merger consideration was a reliable indicator of fair value. Next, the court considered the parties' discounted cash flow analyses. After adopting the projections used by both parties' experts and making certain adjustments to the assumptions and inputs, the court arrived at a valuation of $38.67 per share.

Vice Chancellor Laster then discussed how he would weigh each valuation methodology. In doing so, he recounted a series of five cases in which the Court of Chancery gave exclusive weight to deal price and five others in which the court considered deal price but either did not rely on it or gave it limited weight. Concluding that this case was most similar to those in which the court gave exclusive reliance to deal price, because as in those cases the company ran a sales process that generated reliable evidence of fair value, the court accepted the deal price of $37.14 as the fair value of the company.

Implications

For directors and officers of companies involved in a sales process, there are a number of implications from recent developments in Delaware appraisal law:

- Delaware courts appear increasingly likely to use the merger price as the basis for a determination of fair value when a "proper transactional process" is used.
  - Both *Petsmart* and *Lender Processing* highlight the benefit in an appraisal proceeding of a robust and competitive presigning process, because the merger price can be an indicator of fair value.
  - The effects of a well-run and robust sales process are exemplified by the Delaware Supreme Court's reversal and remand in *DFC*. If the Court of Chancery makes findings that indicate that a strong process was used, these findings may "suggest that the deal price was the most reliable indication of fair value."
  - The Delaware Supreme Court will soon have another opportunity to weigh in on the effects of a well-run process when it issues its decision in the *Dell* appeal. The Court of Chancery had a positive view of the sales process used by the company but ultimately appraised the fair value of the company at a price higher than the deal price because, for several reasons, it concluded that deal price was not a reliable indicator of fair value.
- A determination that the merger price is not a reliable indicator of fair value does not necessarily result in fair value determinations higher than the merger price.
  - While typically a company might be concerned that reliance on a discounted cash flow valuation based on management projections may result in fair value determinations higher than the merger price, both of the Court of Chancery opinions this year that did not rely on the merger price demonstrate that this is not always true. In both *SWS* and *Sprint*, the Court of Chancery used a discounted cash flow valuation to arrive at a fair value lower than the deal price.
  - These fair value results indicate that methodology is not outcome determinative of fair value. Specifically, if there is evidence that the merger price included significant synergies or that other factors exist to doubt the reliability of the merger price, the court may accept that the fair value of the company is actually below the price paid in the merger.
- Recent cases also suggest that a petitioner's use of a "private equity carve-out" argument is unlikely to be persuasive or successful. Prior to the Delaware Supreme Court's decision in *DFC*, the Court of Chancery in *Petsmart* noted that "while it is true that private equity firms construct their bids with desired returns in mind, it does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the best indicator of fair value for the company." Then, in *DFC*, the Supreme Court stated that it did "not understand the logic of" the argument. The Supreme Court will soon have another opportunity to address this argument in the *Dell* appeal because one factor that caused the Court of Chancery to conclude that the deal price was not an indicator of fair value was the fact that the transaction was a management buyout.