*Appraisal Practice Points Post-*SWS

As we discussed in a Fried Frank M&A Briefing last week, the Delaware Court of Chancery, in its *SWS* decision issued May 30, 2017, relying on a discounted cash flow analysis, determined that the appraised "fair value" of SWS Group, Inc. (the "Company") was 7.8% *below* the merger price paid by the acquiror, Hilltop Holdings, Inc. In our study of appraisal decisions since 2010, there have been only two other cases in which the court found fair value to be below the merger price—both of which involved unusual facts and, in one, the fair value determination was only nominally below the merger price.

In *SWS,* Vice Chancellor Glasscock explained that he relied on a DCF analysis due to the "unique facts" of the case—particularly, that the buyer had a contractual right to veto competing bids. The Vice Chancellor expressly reaffirmed the court's general preference to rely on the merger price to determine fair value when there has been a robust sales process. Notably, both the petitioning stockholders and the respondent company had agreed that the merger price was not a reliable indicator of fair value and had relied solely on their respective DCF analyses—albeit for different reasons and with different results (as is typical, the petitioners' DCF result was significantly higher than the merger price and the company's DCF result was significantly below the merger price). The Vice Chancellor wrote that the below-the-merger-price result of the court's DCF analysis was "not surprising" given that the merger price included much of the value of the significant synergies expected from the merger (while, we note, the DCF methodology does not take into account the value of merger synergies).

In our Briefing last week—*Are Below-the-Merger-Price Appraisal Results Likely to Become More Common?—The Critical Misconception Relating to the* SWS *Decision* ***(click here)***—we analyzed the *SWS* decision. In this Briefing, we discuss where we believe the court now stands with respect to appraisal cases generally, and offer practice points relating to appraisal and to situations (as in *SWS*) involving a bidder with extreme leverage over the process of selling a company.

Practice Points Relating to Appraisal

- **Consider the appraisal risk in the planning stage.** We note, as a threshold matter, that it is not possible to predict with specificity or certainty the likelihood that an appraisal case will be brought or, if it is brought, the likely exposure. This is primarily because, although the buyer will ultimately bear any appraisal liability, it is the target company (and not the buyer) that controls the sales process and other factors that may accentuate or mitigate the appraisal risk (such as the preparation of the target company's projections and the target financial advisor's valuation analyses). A bidder will not have all of the knowledge necessary to make a complete assessment of the appraisal risk upfront because, prior to executing the acquisition agreement and reviewing the target's proxy statement, it will not know the details of the nature of the sales process, the preparation of the company's projections, or the results of the target financial advisor's financial valuation analyses. However, the bidder typically will obtain at least some sense of these factors during the sales process and, as part of its final due diligence, may seek additional information pertinent to an assessment of the appraisal risk. Thus, a nuanced evaluation by a bidder and its counsel of the broad parameters of appraisal risk may be possible and should be undertaken, particularly in those cases where the appraisal risk may be greatest. Such a review can inform the bidder's planning (including, for example, with respect to ensuring adequate financing and contingency reserves for the transaction) and will permit the bidder to establish a record that should be helpful in the event an appraisal action is brought. We note that appraisal cases continue to be brought only in a minority of cases. Moreover, the court has not frequently determined (and has been moving toward even less frequently determining) appraised "fair value" to be significantly above the merger price in third-party transactions. As a result, in most cases it will be inadvisable for a bidder to structure a transaction, or to make decisions with respect to a sales process, based primarily on appraisal risk considerations. (The Delaware Supreme Court is expected to issue decisions soon in the appeals of *DFC Global* and *Dell*, which may in some respects increase the predictability of appraisal results going forward.)

- **When the appraisal risk is greatest.** The risk of an appraisal action being brought, and, concomitantly, the likelihood of a significantly above-the-merger-price result, are *greatest* in the context of affiliated transactions—*i.e.*, transactions where a controller, majority stockholder, or other affiliated party stands on both sides of the transaction (such as in a controller take-private, a majority stockholder squeeze-out or a management buyout). The risk and exposure are *least* in the context of non-affiliated transactions where there has been a "robust sales process" with competitive bidding or at least a meaningful pre-signing market check—and particularly so if the target company's projections are viewed by the court as unreliable for appraisal purposes (*i.e.*, that the result of a DCF analysis would not be reliable).

- **The court's recent trend of increasing reliance on the merger price to determine fair value.** Historically, the court relied primarily on the DCF methodology to determine "fair value" (which is the going concern value of the company as of immediately prior to the merger). In the last couple of years, the court has relied primarily on the merger price as the best proxy for "fair value" when (a) there has been a robust sales process (making the merger price particularly reliable as an indicator of fair value) and (b) the court has viewed the target's projections as unreliable (making a DCF analysis particularly unreliable as an indicator of fair value). In the court's most recent decisions over the last several months, the court has suggested a preference for the merger price in non-affiliated transactions where there has been a robust sales process *even if* a DCF analysis would be reliable. At the same time, however, the court continues to be mindful of the statutory requirement that it must consider "all relevant factors" in determining fair value—thus, even when relying solely on the merger price, the court generally still considers a DCF analysis (and, when relying on a DCF analysis, still often considers the merger price) at least as a "double-check."

- **When does the court view a sales process as "robust"?** Whether the court will view a sales process as having been robust will be highly dependent on the specific facts and circumstances. The court has emphasized that the critical factor is whether the process produced "meaningful competition" or at least exposed the company to a meaningful market check. In this regard, the court has expressed that:

- pre-signing market checks are preferable to post-signing go-shops;
- solicitation of *both* financial and strategic buyers is preferable to solicitation of financial buyers only (notably, however, the court has viewed the sales process as robust in certain cases even when only financial buyers submitted bids or even when there was only one bidder, but the market was reasonably canvassed); and
- in the case of a financial buyer, the court will be more skeptical that the merger price is the best indicator of fair value when the court considers the transaction to be an MBO rather than an LBO.

We note that, in evaluating in appraisal cases whether a sales process was "robust," some of the factors developed in the *Revlon* series of cases will be considered; however, as has been clear from the court's appraisal jurisprudence, the focus is different. A *Revlon* inquiry is focused on the board's judgments in conducting the sale process (*i.e.*, whether the board took reasonable steps to seek to obtain the best price reasonably obtainable under the circumstances), while an appraisal inquiry is focused on the result of the board's process (i.e., whether the sales process was sufficiently market-driven that the price derived from it is likely the best indicator of fair value).

- **When does the court rely on a DCF analysis?** The court has questioned whether a DCF analysis would be the best indicator of appraised fair value when:
  - the projections (which are the primary input to the analysis) were not prepared in the ordinary course of business (but, rather, were prepared for purposes of the sales process or in anticipation of the appraisal proceeding);
  - the preparers were not experienced in preparing long-term projections;
  - there is evidence that the preparers did not actually believe that the projections reflected a reasonable forecast of the company's future cash flows; and/or
  - the company had a history of never or infrequently meeting its projections.

  The court has generally viewed a DCF analysis as the best indicator of fair value when the sales process was flawed or the merger is an affiliated transaction (as discussed above). In two cases, the court has relied on a DCF analysis when, in a non-affiliated transaction, although there was an apparently robust sales process, there was, in the court's view, an *unusual factor* that rendered the market unreliable as an indicator of fair value. The court viewed the market as having been disrupted in *SWS* because the buyer had a contractual veto right over competing bids; and, in *DFC Global*, because the company faced extreme regulatory uncertainty (due to a wholly unpredictable, significant regulatory overhaul of its industry that was underway).

- **Possibility of below-the-merger-price appraisal results.** Stockholders should keep in mind that there have now been three cases in which the court has determined fair value to be *below* the merger price—by more than 14% in the 2012 *JustCare* decision, almost 8% in the 2017 *SWS* decision, and less than 1% in the 2015 *Ramtron* decision. In our view, appraisal results below the merger price—particularly appraisal results significantly below the merger price—are likely to remain rare. However, this conclusion could change if the court becomes more willing, when relying on the merger price, to make a downward adjustment to meet the statutory mandate that the court must exclude from fair value "any value arising from the merger itself" (*i.e.*, merger synergies). The court has suggested in at least one very recent decision that it is becoming more sensitive to the statutory mandate; however, the court has not actually made any such adjustment except in three cases involving unusual facts (based on our study of appraisal decisions since 2010). We discuss this issue in depth in last week's Briefing.

- **Potential positions to be taken by respondent companies in appraisal proceedings.**
  - ***Argue that the court should rely solely on the merger price.*** When possible, a respondent company should argue that, because the sales process was robust, the merger price represents the best proxy for fair value. In addition, to the extent that the proxy statement discloses facts that the court generally has viewed as indicating that company projections may not produce a reliable DCF result (such as that the projections were not prepared in the ordinary course of business or that the company has a history of not meeting its projections), the company should argue that a DCF analysis would *not* be reliable.
  - ***Argue that, if the court relies on the merger price, it should make a downward adjustment to satisfy the statutory mandate to exclude any value "arising from the merger itself."*** The court has explained its reluctance to make any such adjustment based on the practical difficulties involved in determining the appropriate amount given uncertainties about what type of synergies are properly excluded under the statute, how to value them, and how to determine to what extent they were reflected in the merger price. In this regard, the company should endeavor to establish as strong a record as possible that establishes (i) the value of the expected merger synergies; (ii) to what extent the value from synergies was reflected in the buyer's merger price; (iii) whether any *additional* element of the merger price should be considered to be value that arises from the merger itself—such as, arguably, any portion of the merger price that is attributable to a "control premium" unrelated to synergies; and (iv) that there are no, or only limited, "negative synergies" (*i.e*., expected decreases in revenue from, and costs of, the transaction) that would offset the adjustment for the expected merger synergies.
  - ***Argue that there are* unique *merger synergies, the value of which must be excluded from fair value.*** The court has expressed uncertainty as to which types of merger synergies are properly excludable under the statutory mandate that "any value arising from the merger itself" must be excluded from fair value. The court has suggested that it may be only synergies that are *unique* to the transaction at issue that may be excludable—as other synergies (such as generic cost-savings), which may be available to the company on a standalone basis or available in any merger (not just the merger at issue), possibly should be considered to be part of the "inherent value" of the company. Thus, when arguing for a downward adjustment to the merger price to exclude the value of merger synergies generally, the company also should, separately, identify and value those synergies that arguably are unique to the transaction. We note also that, while the concept has not arisen in any appraisal cases to date, a respondent company could consider whether a *special relationship* with the buyer arguably gives rise to unique value that should be excluded. For example,

where the buyer is a substantial creditor of a company that is failing, the sole supplier for a company that produces a unique product, or the sole distributor in a company's primary market, there may be unique value to that buyer that should be excluded from fair value.

- ***In determining the value of "unique" synergies, argue that the "cover" bid establishes a floor on their possible value.*** In the context of a robust sales process, the "cover bid" (*i.e.*, if the highest bid was chosen, then the next-highest bid submitted) arguably may provide a "double-check" as to the minimum value of unique synergies arising from the merger. As the cover bid, roughly speaking, would have included, *at a maximum*, *all* of the value of generic synergies and of synergies unique to the cover bidder, then, arguably, any amount by which the winning bid exceeded the cover bid would represent, *at a minimum*, the value of the synergies unique to the winning bidder—establishing a floor on the possible value of unique synergies associated with the winning bid.

- ***In a financial buyer situation, argue that there are expected synergies.*** We note that, in financial buyer situations, if the buyer intends to combine the company with another portfolio company, the deal would be strategic and the buyer should argue for exclusion of the value of the expected merger synergies from fair value.

- ***Argue, where appropriate, that the result of a DCF analysis is confirmatory of the merger price (and vice versa).***

  - It should be noted that the DCF methodology itself excludes the value of expected merger synergies (and any other element of a control premium). Thus, a below-the-merger-price DCF result could be explained (as the court did in *SWS*) by the fact that the DCF analysis did not take into account the value of merger synergies, while the merger price did.

  - Further, it should be noted that both a DCF analysis and an analysis of expected synergies result in *a range of values*, while the merger price and appraised fair value are both *a specific number*. Furthermore, the extent to which value from expected synergies is included in a merger price varies. Thus, a below-the-merger-price DCF result could be explained (as might be expected where there has been a robust sales process) by the merger price and shared synergies being at the *high end* of the ranges of DCF values and synergies values; and an above-the-merger-price DCF result could be explained (as might be the case when there has been a controller transaction or MBO or not a robust sales process) by the merger price and shared synergies being at the *low end* of the ranges of DCF values and synergies values.

Structuring Possibilities that Could Be Considered to Eliminate or Reduce Appraisal Risk

Below, we outline certain structural alternatives that could be considered to eliminate or reduce appraisal risk in appropriate circumstances. The desirability of any of these alternatives will depend on the degree of appraisal risk perceived and the buyer's sensitivity to that risk as compared to the costs and benefits of the structural alternative. ***In most cases, it is likely inadvisable to structure a transaction or a process based primarily on appraisal risk***—given that, as noted, appraisal is sought in a relatively low percentage of transactions, an appraisal result significantly above the merger price is rare other than in affiliated transactions, and it may be difficult to predict with a reasonable degree of certainty the likelihood of an appraisal action being brought or the ultimate likely result. We note that, in a competitive bidding situation, some of these structural alternatives would disadvantage the bidder proposing them. It is also to be noted that, in connection with each of the structural alternatives, a prospective buyer (and a target company in response), together with legal counsel, would have to carefully consider a number of legal, business and practical issues in light of the specific facts and circumstances involved. To narrow the issues, a buyer could consider crafting certain of these alternatives (a) to limit any restriction on appraisal rights solely to stockholders who purchase their shares after announcement of the transaction (*i.e.*, appraisal arbitrageurs) and/or (b) to be triggered only if at least a specified percentage of the outstanding shares seek appraisal. While we believe that all of these structural alternatives should be valid under Delaware law, any novel arrangement could prompt legal challenges (including potentially on a class action basis). As noted, appraisal risk is highest in affiliated transactions and, of course, the legal risk associated with any structural alternative would also be higher in that context.

- **Offering a choice of cash or listed stock of a different company.** In Delaware, appraisal rights are not available to target company stockholders who hold listed shares if the target stockholders are given the opportunity to elect to receive listed shares in the merger. Thus, a buyer considering an all-cash merger could, instead, consider structuring the merger to provide target stockholders with the right *to elect* to receive either (a) $X in cash or (b) $X in value at closing of listed stock of a specified different company (less commissions and fees to acquire the stock). (The different company should be a corporation with broadly traded, liquid stock that could be acquired by the buyer in the market at closing.) Moreover, under (b), the value offered could be lower than the cash value under (a). While the stock option could be expected to be less desirable to most (or even all) stockholders, and any disparate value between the two options could be expected to influence a stockholder's election of cash or stock, offering the choice of same- or lower-valued stock should *not* influence (*i.e.*, would not be "coercive" of) a stockholder's consideration of the transaction itself—and the stockholder would not be in the "coercive" situation of having to choose a "bad" alternative to avoid a worse alternative (as every stockholder would be free to choose cash based on the economic merits of that choice).

- **Reincorporating the target company to a jurisdiction where appraisal rights are not available (in a merger that itself is not subject to appraisal rights).** We note, for example, that Maryland expressly permits a corporation to eliminate appraisal rights in its charter (and certain states do not provide appraisal rights for cash mergers). A transaction could be structured so that a Delaware target company is first reincorporated as, say, a Maryland company whose charter does not provide for appraisal rights, and then is acquired in a cash merger. The reincorporation could be accomplished without triggering appraisal rights by having the Delaware company merge into a wholly owned Maryland subsidiary under Section 253 of the DGCL.

- **All-stock deal followed by a partial cash buyback.** In Delaware, appraisal rights are not available to target company stockholders who hold listed shares if the target stockholders receive merger consideration consisting solely of listed shares. We note that in *SWS*, where 75% of the merger consideration was paid in the buyer's stock, the buyer might have considered structuring the transaction instead as an all-stock deal, which then could have been followed at some point by a post-closing buyback of shares of the buyer for cash in the market or in a tender offer—in which case the target stockholders would not have had a right to appraisal. (We note that this approach would not be feasible for a buyer that is a private company unless it was prepared to issue either common or preferred stock that would be listed.)

- **Merger price adjustment based on appraisal petitions.** Appraisal conditions (*i.e.*, conditioning consummation of a merger on no more than a specified percentage of the outstanding shares seeking appraisal) are infrequently used because they create significant closing uncertainty for the target company. Instead of an appraisal condition (which affects deal certainty), a buyer might consider requiring that the merger agreement provide for a price adjustment based on the number of shares seeking appraisal. One challenge, of course, would be determining the formula for the price adjustment, as the number of shares seeking appraisal would be known soon after closing but the cost, if any, of the appraisal claims would not be known until well after the closing.

- **Drag-along right in private deals.** In private deals, a drag-along right—*i.e.*, an agreement by minority stockholders that they will participate in a merger if requested to do so by the majority stockholder—will not itself necessarily constitute a waiver of appraisal rights with respect to the merger. A drag-along right should (as is typical) explicitly provide that the stockholder will vote in favor of the merger and is waiving appraisal rights.

- **Possibility of amending the charter to impose conditions on the exercise of appraisal rights that would limit appraisal arbitrage.** A company may wish to consider whether to seek a charter amendment to impose conditions on the exercise of appraisal rights that would eliminate or discourage appraisal arbitrage—such as a requirement that a stockholder has held its shares for at least a specified period of time. The company's consideration might be undertaken in connection with a specific proposed transaction or in anticipation of future possible transactions—and could be part of a broader consideration (possibly with advice from its financial advisor and an economist) of the potential adverse impact of appraisal arbitrage on the company's stockholders (*i.e.,* increasing risk and decreasing the purchase price with respect to a transaction). We are unaware of any company having attempted to restrict (or eliminate) appraisal rights in its charter. It is uncertain whether the Delaware courts would view appraisal rights—particularly as applicable only to appraisal arbitrageurs—as part of the set of mandatory terms in the DGCL that guarantee core qualities of Delaware corporations that cannot be changed by charter amendment. It is also unclear what position ISS and institutions that do not participate in appraisal arbitrage would take with respect to such an amendment.

Practice Points Relating to Situations Where a Bidder Has "Extreme Leverage" Over the Sales Process

- **Sales process where a potential merger partner has extreme leverage.** Where a sales process is conducted in the context of one of the bidders having extreme leverage over the process (such as in the case of a take-private bid by a controller or, as in *SWS,* a bidder with a contractual veto right over competing bids), the target company should consider the following:

  - ***Conduct a sales process within the constraints of the specific circumstances.*** It is recognized that, as a practical matter, where a party has extreme leverage or a special right, and has expressed its intention to exercise the leverage or not waive the right, it may be very difficult for a board to obtain any expressions of interest from third parties, as potentially interested parties will not want to engage in what they would expect to be a costly and timeintensive, yet likely fruitless, exercise. However, a board *should consider* whether there would nonetheless be any benefit to soliciting expressions of interest from other parties. In this regard, the board also should consider whether the party with leverage could change its view during the process. Also, the board should consider whether, if any expressions of interest were received, even if conditioned (as they presumably would have to be) on a change in the position of the party with leverage, they might establish guideposts for the company's value, or might pressure the party with leverage to change its position or to pay more.

- ***Request that the leverage be waived.*** The board should request that a controller would be willing to consent to, or to consider, a sale of its shares in a transaction deemed by the board to be superior to the controller's proposed transaction, and should request that a holder of a veto or other contractual right that limits a sales process waive the right. If the answer is no, the board should periodically check to determine whether there is any avenue on which it can bring to bear any leverage, or provide incentives, to achieve a waiver.

- ***Just say no.*** Ultimately, the board's only leverage to pressure a controller or a bidder with a veto right to negotiate may be to "just say no" to the proposed transaction.

- ***The bidder with extreme leverage.*** A controller or holder of a special right should consider whether it would or would not sell its shares in any other transaction and should advise the target company of its decision and (if appropriate) that the decision is final and will not change. If the controller or special right holder thought it possible that it might agree to a sales process or to an alternative transaction, it should consider what to negotiate for in return for such agreement.

- **Avoiding creating extreme leverage situations.** In *SWS*, the buyer had extreme leverage due to the terms of the credit agreement the company entered into when the company faced a dire financial situation and no alternative financing was available to it. We note that in two cases in recent years—*Comverge* (2015) and *Calesa* (2014)—a significant stockholder acquired an extreme degree of leverage over a sale of the company through a purchase of outstanding debt of the company at a time that the company was in difficult financial straits. To avoid a purchase by a significant stockholder (or any other party) of outstanding debt that would provide extreme leverage, a company should consider, when issuing debt, whether the debt could include restrictions on sale or transfer of the debt, such as prohibiting sale or transfer to stockholders with more than a specified percentage of equity ownership or who have held the equity for less than a specified period or to named parties or specified types of parties. Of course, the impact on the marketability of the debt would have to be considered.

- **How is it explainable that the buyer in *SWS,* although it had extreme leverage, paid more than "fair value"?** In *SWS*, the court explained that the determination that fair value was below the merger price resulted from the buyer (Hilltop) having shared a significant portion of the value of expected merger synergies with the target stockholders. The court did not address, however, why the buyer would have done so given its position of extreme leverage in the sales process. Possible explanations include (i) Hilltop's focus may have been on the expansion opportunities associated with the acquisition and it may not have been particularly price sensitive—as there was a high level of expected synergies from the deal (given that Hilltop had just recently become a bank holding company) and, Hilltop, as a substantial creditor of SWS, had substantial knowledge about the company; (ii) with SWS failing and facing increasing pressure from regulators, Hilltop may have decided that it was important to complete the process quickly (even if that required paying a higher price) to prevent continued deterioration of the business; and (iii) the two expressions of interest that were submitted in the sales process (both of which were significantly higher than the merger price), even though they were viewed as illusory due to lack of financing and regulatory concerns, may have influenced Hilltop's view of what the company was worth and/or what it would take for the SWS special committee to agree to Hilltop's transaction.

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