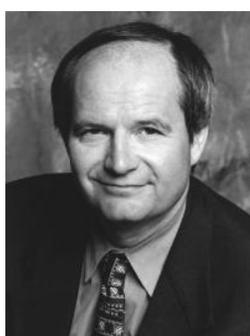


## A Study Of Recent Delaware Appraisal Decisions: Part 1

*Law360, New York (July 28, 2015, 4:38 PM ET) --*



Philip Richter



Robert C. Schwenkel

There has been much ado about the Delaware Chancery Court's recent reliance on the merger price to determine fair value in appraisal cases.

The Delaware statute defines fair value of a company as its going-concern value immediately prior to the merger, excluding value arising from the merger itself. In the past, the court has relied on standard financial analyses of going-concern value (primarily discounted cash flow (DCF) and comparable companies or transactions analyses). In a break with past practice, however, several times in recent months, the court has relied primarily or exclusively on the merger price to determine fair value.

### **The Court's Reliance on the Merger Price is Still Limited**

***Narrow Set of Circumstances (Two-Prong Test).*** The court has emphasized that it will rely primarily on the merger price only when both (1) the merger price is particularly reliable as an indication of value because an effective market check was part of the sale process and (2) the financial valuation methodologies are particularly unreliable because the available inputs — projections and comparable companies or transactions — are unreliable.

***Small Number of Cases.*** There have been only four cases in which the court has relied primarily on the merger price.

***Factual Context.*** The factual context in each of these cases included (1) an especially strong sale process — a public auction with competing bids in three of the four cases and, in the fourth case, a thorough public shopping of the company to obtain a white knight bidder (although no competing bid emerged);

(2) no competing bid being made after announcement of the merger; and (3) a merger price that represented a significant premium above the unaffected stock price.

### **The Court's Approach Has Been Consistent in the Appraisal Decisions This Quarter**

The court's appraisal decisions this past quarter have produced varying outcomes — with the court determining fair value to be:

- equal to the merger price — in *Merlin v. Autoinfo* (Apr. 30, 2015);
- slightly below the merger price — in *Longpath v. Ramtron* (June 30, 2015); and
- significantly above the merger price — in *Owen v. Cannon* (June 17, 2015).

The court's approach has been consistent, however. In *AutoInfo* and *Ramtron*, both of which involved arm's length transactions with an effective market check and with unreliable valuation analysis inputs (as well as a merger price that represented a significant premium to the unaffected stock price), the court relied primarily on the merger price — and found fair value to be equal (or very close) to the merger price.

In *Cannon*, which involved an interested transaction (a squeeze-out merger) with no market check (as well as a merger price well below the value indicated by third-party valuations received by the company), the court relied on a DCF analysis — and its fair-value determination represented a 60 percent premium over the merger price. It remains to be seen to what extent the court may expand its use of the merger price as the primary factor in determining fair value.

Before the court ever expressly used the merger price to determine fair value, the court, stating that it was relying on DCF analyses, consistently determined fair value to be equal or close to the merger price in disinterested transactions in which there had been an effective market check (and often determined fair value to be significantly higher than the merger price in interested transactions without a market check). Thus, while not expressly relying on the merger price, the actual results of the court's past appraisal decisions clearly suggest that, when there has been an effective market check, the merger price has always been a strong (albeit unacknowledged) factor in the court's considerations.

### **Open Issues**

***Will the court's increased inclination to use the merger price to determine fair value expand to include any transaction with an effective market check, whether or not there are reliable inputs for a financial analysis?***

So far, the court has used the merger price as the primary or exclusive basis for determining fair value only in those cases involving transactions that meet both prongs of the test noted above (an effective market check and unavailability of reliable inputs for financial analyses). Yet, reliance on the merger price whenever there has been an effective market check — thus, even if, for example, the company projections are reliable — no doubt holds allure. That approach would short-cut the considerable difficulties inherent in a DCF analysis.

A DCF analysis can yield widely varying results depending on the selection of the numerous required inputs for the analysis. These inputs are often uncertain or subjective (including, for example, the company's long-term projections and the appropriate discount rate). Moreover, a small change in any

of them can yield a significant change in the result. Even when a DCF analysis is conducted in a cooperative, nonlitigation context, there may be considerable uncertainty about the reliability of the result — and the court has often expressed frustration, most recently in *Ramtron*, with “litigation-driven valuations” submitted by the parties’ experts. Moreover, as noted, the results, as a practical matter, would not necessarily differ from those that now pertain.

***How strong would the market check have to be for the court to use the merger price to determine fair value in a case involving an interested transaction?***

To date, the appraisal cases involving interested transactions have included, in the court’s view, no (or weak) market checks. Moreover, the amount by which the court’s fair value determinations (using financial valuation analyses) have exceeded the merger price has generally corresponded to the apparent strength of the sale process (even though the process is logically irrelevant to a DCF or other financial analysis of going-concern value). It remains to be seen whether the court would accord to an interested transaction with an effective market check the same treatment as a disinterested transaction with an effective market check.

***Would the merger price or the financial valuation take precedence in the case of a transaction in which there had been an effective market check but also reliable financial analyses — and the financial valuation exceeds the merger price?***

If the court were to expand its use of the merger price to all transactions with an effective market check, how would the court respond if the financial valuations — if based on reliable company projections and sufficiently comparable companies and transactions — lead to values materially in excess of the merger price? Clearly, in such a case, either the “effective market check” would not in fact have been effective or there would have been a “market failure” for some reason. Presumably, the course the court would choose in these circumstances would depend on the court’s view of the reason for the discrepancy between the merger price and the financial valuations.

**Key Points**

- ***Consistency of Results in Appraisal Cases.*** The court has been, and continues to be, consistent in awarding appraisal amounts equal (or close) to the merger price in disinterested transactions in which the sale process included an effective market check — whether the court has utilized the merger price or a DCF analysis as the basis for determining fair value. The court continues to be consistent in awarding appraisal amounts that significantly exceed the merger price only in interested transactions without an effective market check.
- ***Use of the Merger Price Under Narrow Circumstances.*** Although the court has now relied on the merger price as the sole or primary basis for determining value in four recent cases, in each of these cases there was not only (1) an effective market check, but also (2) the court viewed the standard financial analyses (DCF and comparables analyses) as being particularly unreliable because management projections were deemed to be unreliable for a variety of reasons and there were not sufficiently comparable companies or transactions.

- ***Effect of Increased Use of the Merger Price.*** As noted, the court’s increased use of the merger price in disinterested transactions with an effective market check may not change the results in these cases. Further, in our view, the increased use of the merger price may or may not discourage appraisal arbitrage overall but, in any event, should tend to drive appraisal claims away from disinterested transactions with an effective market check (unless accompanied by indications that the market check was not in fact effective) and to those transactions with the most potential for an award significantly above the merger price.
- ***Effectiveness of Market Check When There is a Single Bidder.*** The court has viewed a public auction process with competitive bidding as an effective market check that supports the court’s use of the merger price to determine appraised fair value. In Ramtron, even though no competing bid emerged during the company’s search for a white knight buyer after the company had received an unsolicited bid, the court viewed the company’s “lengthy” and “public” shopping of the company (during which it contacted every party that the company believed might be interested) to have been an effective market check.
- ***Continued Confusion About Adjustments to Exclude Merger-Specific Value.*** The court’s more frequent use of the merger price to determine fair value necessarily focuses more attention on the long-neglected issue of adjustments to the merger price to exclude merger-specific value from the appraisal award (as is statutorily mandated). In AutoInfo, the court articulated a new burden of proof that has the potential to provide effective guidance to parties seeking to establish the need for an adjustment. Although inconsistent with the general approach in appraisal cases of both parties and the court itself having a burden to establish fair value, the court stated that the party arguing for an adjustment to exclude value arising from merger-specific synergies would have the burden of establishing the merger-specific nature of the synergies and their value. We note that, nonetheless, the next appraisal decision, Ramtron, indicates that, where both parties propose an adjustment amount, the court may select the amount it considers to be more reasonable (which the court in Ramtron did without analysis or much explanation), even if the burden of proof has not been met. We note that the court still has not addressed (and parties to appraisal actions still have not raised) the issue of whether all or part of a control premium included in the merger price is merger-specific value that should be excluded.
- ***Reliability of Projections — No Change in the Court’s Approach.*** The court continues to find projections to be unreliable when they are not prepared by management in the ordinary course of business.

Please see below our charts summarizing the outcome of each appraisal case since 2010 and a list of our other articles on appraisal.

Parts 2 and 3 of this article will be published here in the coming days, covering additional explanation and discussion of the key points noted above; summaries of AutoInfo, Cannon and Ramtron; and

practice points relating to adjustments to the merger price, projections and other appraisal-related issues arising out of these decisions.

### Delaware Appraisal Decisions 2010 – June 2015: Premium Over Merger Price

Date	Case	Appraisal amount higher than merger price	Premium over merger price represented by appraisal amount	Estimated additional premium over merger price represented by statutory interest	Number of years from merger date to appraisal decision	Sale process included market check and minority shareholder protections
<b>INTERESTED TRANSACTIONS:</b>						
6/17/15	<i>Owen v. Cannon</i>	Yes	60%	17.6%	2.1	None
5/12/14, 6/25/14	<i>Laidler v. Hesco</i>	Yes	86.6%	24.7%	2.5	None
9/18/13	<i>In re Orchard Enterprises</i>	Yes	127.8%	36.1%	2.0	-
6/28/13	<i>Towerview v. Cox Radio</i>	Yes	19.8%	26.9%	3.9	Weak
4/23/10	<i>Global v. Golden Telecom</i>	Yes	19.5%	14.7%	2.2	Weak
2/15/10	<i>In re Sunbelt Beverage</i>	Yes	148.8%	213.8%	12.4	None
<b>DISINTERESTED TRANSACTIONS:</b>						
6/30/15	<i>Longpath v. Ramtron</i>	No	0%	13.7%	2.6	Yes—strong
4/26/15	<i>Merlin v. AutoInfo</i>	No	0%	10.5%	2.0	Yes—strong
1/30/15	<i>In re Ancestry</i>	No	0%	11%	2.1	Yes—strong
11/1/13, 5/19/14, 2/12/15	<i>Huff v. CKx</i>	No	0%	12.7%	2.3	Yes—strong
7/8/13	<i>Merion v. 3M Cogent</i>	Yes	8.5%	14.3%	2.6	*
3/18/13	<i>IQ v. Am. Commercial Lines</i>	Yes	15.6%	13.7%	2.3	*
4/30/12	<i>Gearhead v. Just Care</i>	No	(14.4%)	11.7%	2.6	*

\* In these cases, the court did not reach a conclusion about the strength of the market check or other protections. The court did not primarily utilize the merger price to determine the appraisal amount, but conducted a DCF analysis (see Chart below) that (as reflected above), in each case, yielded a result that was within about 15 percent of the merger price.

### Delaware Appraisal Decisions 2010 – June 2015: Valuation Methodologies Used

Date	Case	Merger consideration (per share)	Court's valuation method/ appraised amount	Petitioner's valuation method/ proposed value	Respondent's valuation method/ proposed value
<b>INTERESTED TRANSACTIONS:</b>					
6/17/15	<i>Owen v. Cannon</i>	\$26.33M (shareholder's whole interest)	\$42.17M DCF	\$53.46M DCF	\$21.5M DCF
6/25/14	<i>Laidler v. Hesco</i>	\$207.50	\$387.24 DDCF	\$515 DDCF	\$205.30 DCCF (Primary) Comparable Companies Comparable Merger Price Transactions
7/18/13	<i>In re Orchard Enterprises</i>	\$2.05	\$4.67 DCF	\$5.42 DCF	\$1.53 DCF (1/3) Comparable Companies (1/3) Comparable Transactions (1/3)
6/28/13	<i>Towerview v. Cox Radio</i>	\$4.80	\$5.75 DCF	\$12.12 DCF	\$4.28 DCF (Primary) Comparable Companies Merger Price

Date	Case	Merger consideration (per share)	Court's valuation method/ appraised amount	Petitioner's valuation method/ proposed value	Respondent's valuation method/ proposed value
4/23/10	<i>Global v. Golden Telecom</i>	\$105	\$125.49 DCF	\$139 DCF	\$88 DCF
2/15/10	<i>In re Sunbelt Beverage</i>	\$45.83	\$114.04 DCF (\$104.16) Comparable Companies Comparable Transactions	\$114.04 DCF	\$36.30 DCF (\$42.12) Asset Based (\$45.83) Earlier Sunbelt Transaction
<b>DISINTERESTED TRANSACTIONS:</b>					
6/30/15	<i>Longpath v. Ramtron</i>	\$3.10	\$3.10 Merger Price  \$0.03— Adjustment for merger synergies	\$4.96 DCF: \$5.20 (80%) Comparable Companies: \$3.99 (20%)  \$0.03— Adjustment for merger synergies	\$3.10 Merger price  \$0.34— Adjustment for merger synergies
4/30/15	<i>Merlin v. AutoInfo</i>	\$1.05	\$1.05 Merger Price	\$2.60 DCF (1/3) Comparable Companies (historical-based multiple) (1/3) Comparable Companies (forward-looking multiple) (1/3)	\$0.97 Merger price—adjusted to exclude merger synergies
1/30/15	<i>In re Ancestry</i>	\$32.00	\$32.00 Merger Price (\$31.79) DCF	\$43.05 DCF	\$30.63 DCF
11/1/13, 5/19/14, 2/12/15	<i>Huff v. CKx</i>	\$5.50	\$5.50 Merger Price	\$11.02 DCF (60%) Comparable Companies/ Comparable Transactions (40%)	\$4.41 DCF
7/8/13	<i>Merion v. 3M Cogent</i>	\$10.50	\$10.87 DCF	\$16.26 DCF	\$10.12 DCF (1/3) Comparable Companies (1/3) Comparable Transactions (1/3)
3/18/13	<i>IQ v. Am. Commercial Lines</i>	\$33.00	\$38.16 DCF	\$45.01 DCF Comparable Companies Comparable Transactions	\$25.97 DCF Comparable Companies Comparable Transactions
4/30/12	<i>Gearreid v. Just Care</i>	\$40M (whole company)	\$34.24M DCF	\$55.2M DCF	\$33.6M DCF (2/3) Comparable Companies (1/3)

In addition, please see our previous articles relating to appraisal, including:

- "Why Delaware Appraisal Awards Exceed the Merger Price," posted on The Harvard Law School Forum on Corporate Governance and Financial Regulation (Sept. 23, 2014)
- "Fried Frank Discusses Proposed Appraisal Statute Amendments, Which Would Permit Companies to Reduce Their Interest Cost," posted on Columbia Law School Blue Sky blog (March 30, 2015)
- "Over-Reaction to Use of Merger Price to Determine Fair Value," posted in *The M&A Lawyer* (May 2015) and posted on The Harvard Law School Forum on Corporate Governance and Financial Regulation (May 1, 2015)
- "New Activist Weapon—A Look At Appraisal Arbitrage Cases," posted on Law360 (August 07, 2014)
- "The Rise of Appraisal Arbitrage," published in *Insights: The Corporate & Securities Law Advisor* (July 2014) ■

—By Steven Epstein, Arthur Fleischer Jr., Peter S. Golden, Brian T. Mangino, Philip Richter, Robert C. Schwenkel, John E. Sorkin and Gail Weinstein, Fried Frank Harris Shriver & Jacobson LLP

*Steven Epstein, Peter Golden, Philip Richter, Robert Schwenkel and John Sorkin are partners in Fried Frank's New York office.*

*Brian Mangino is a partner in Washington, D.C.*

*Arthur Fleischer and Gail Weinstein are senior counsel in New York.*

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