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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

A Study Of Recent Delaware Appraisal Decisions: Part 2

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Steven Epstein John E. Sorkin

In part 1 of this article, we outlined the key points relating to the latest Delaware appraisal decisions: Merlin v. Autoinfo (Apr. 30, 2015), Owen v. Cannon (June 17, 2015), and Longpath v. Ramtron (June 30, 2015). Specifically, we noted that, although the Chancery Court in recent months has expanded its use of the merger price in the underlying transaction as a basis for determining appraised "fair value," the court's reliance on the merger price has been expressly limited to a narrow set of circumstances. We noted further that, at the same time, while the most recent appraisal decisions have resulted in varying outcomes — with the court determining fair value to be equal to the merger price (in Merlin), significantly above the merger price (in Cannon), and slightly below the merger price (in Ramtron) — the court's approach has been consistent.

In this article, we provide further explanation and discussion of the key points arising out of AutoInfo, Cannon and Ramtron. Part 3 of this article will be published here in the coming days, covering practice points arising out of these decisions.

Consistency of the Chancery Court's Results in Appraisal Awards

Interested Transactions Without an Effective Market Check

The court has been consistent in determining fair value to be significantly above the merger price only in interested transactions (i.e., transactions involving, for example, a controller or a parent-subsidiary or squeeze-out merger) without an effective market check. Moreover, the amount of the premium above the merger price represented by the fair-value determination in these cases has corresponded with the extent of the market check. The premiums in cases involving interested transactions that included no market check ranged from 60 percent to 150 percent, while the premiums in cases involving transactions that included some (albeit, in each case, a weak) market check were just under 20 percent.

Disinterested Transactions with a Market Check

Irrespective of the valuation methodology utilized by the court, the court has been consistent in determining fair value to be not significantly above the merger price in disinterested transactions with a market check. In the disinterested transactions that have included an effective market check, the court has determined fair value to be equal (or close) to the merger price. In the disinterested transactions in which the court did not comment on the sale process (although, we note, in each of these there appeared to be no, or only a weak, market check), the court has determined fair value to be above, but not significantly above, the merger price (specifically, premiums of 9 percent and 16 percent above the merger price, and, in one case with an unusual fact situation, 14 percent below the merger price).

Methodology to Determine Fair Value

The Delaware appraisal statute defines fair value for appraisal purposes as going-concern value of a company immediately preceding the merger, excluding any value arising from the merger itself.

Use of the Merger Price

The court now primarily or exclusively relies on the merger price to determine fair value when (1) the merger price is a particularly reliable indication of value because it has been established through a sale process that included an effective market check and (2) the standard financial valuation analyses (discounted cash flow (DCF) and comparables analyses) are particularly unreliable because (a) the available company projections (the primary input for a DCF analysis) are unreliable and (b) there are not sufficiently comparable transactions or companies (for meaningful input to a comparables analysis). All of the recent cases meeting these parameters have involved disinterested transactions.

Use of DCF Analysis

In the case of interested transactions, and in the case of disinterested transactions in which either prong of the two-part test has not been satisfied, the court has relied primarily or exclusively on a DCF analysis to determine appraised fair value. As noted, in these cases, notwithstanding the potential inherent in a DCF analysis for wide variability of the results, and notwithstanding the logical irrelevance to a DCF analysis of the nature of the transaction or the sale process, the court's results have been significantly above the merger price in the case of interested transactions and not significantly above the merger price in the case of disinterested transactions (with the amount of any premium above the merger price corresponding to the apparent strength of the sale process).

Open Issues

We note that key open issues remaining include: 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? 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? 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?

Effectiveness of Market Check

Prior to Ramtron, each case in which the court utilized the merger price to determine fair value after finding that there had been an effective market check involved a public auction with competing bids. In Ramtron, the court viewed the company's aggressive public shopping of the company to find a white knight buyer to be an effective market check — even though no competing bidder emerged. Notably, the $3.10 merger price the company ultimately agreed with the unsolicited bidder, after five separate price increases, represented a 71 percent premium over the unaffected stock price and a 25 percent increase over the unsolicited bidder's initial offer price. The court found that the nonemergence of competing bids was a result of the company's "operative reality" rather than "any shortcomings of the process." The court noted that no party made a competing bid even at the time that the unsolicited bidder's offer was 42 cents below the final merger price.

Continued Uncertainty About Adjustments to the Merger Price to Exclude Merger-Specific Value

The Delaware appraisal statute mandates that any value arising from the merger itself be excluded from appraised fair value. In the cases in which the court has utilized the merger price as a basis for fair value, the court has acknowledged that merger-specific value must be "backed out." However, the court invariably has not made adjustments — sometimes simply ignoring the issue and sometimes indicating that the parties had not argued for or established a sufficient basis for an adjustment.

There are difficulties inherent in determining what is a merger-specific synergy and how to calculate the value it represents. These difficulties, as a practical matter, may account for the court's reluctance to make adjustments to exclude merger-specific value when the merger price is used as the primary or sole basis for determining fair value.

Further, the court has not addressed (and the parties to appraisal actions have not raised) the complicated issue of whether all or part of a control premium is merger-specific value that should be excluded from a determination of fair value.

AutoInfo: Court Establishes a New Burden on the Party Advocating an Adjustment for Merger Synergies

In AutoInfo, the court has provided what appears to be new, albeit limited, guidance on this issue. The court placed on the party arguing for an adjustment a burden to establish the need for, and amount of, the adjustment. We note that, generally, the court has characterized the appraisal statute as placing a burden on both parties and on the court to determine fair value. Thus, no presumptions have been applied by the court based on one or the other party's failing to provide convincing evidence with respect to one or more parts of the determination of fair value. Rather, the court has viewed itself as having the burden of determining whether to rely on one party's view or the other's or, if it finds neither persuasive, than to form its own view. In AutoInfo, the court appears to have departed from that approach in connection with the issue of adjustments to the merger price when it is used as the basis for fair value.

In AutoInfo, the respondent company's expert had argued that a downward adjustment should be made to the merger price to exclude the cost savings the acquiror anticipated from eliminating public company costs and reducing executive compensation. These savings were reflected in the base case projections the acquiror had developed and used internally. Following its usual course, the court did not make any adjustment to exclude merger-specific synergies. The court stated that the record had not established precisely the nature of the anticipated cost savings (thus, according to the court, it could not be determined whether they were merger-specific) or the reliability of the estimated amount of the savings. The court, in effect, established a presumption against an adjustment for anticipated cost savings unless the company demonstrates that the anticipated savings are merger-specific and that the court can have confidence in the amount.

It remains to be seen how rigorous a standard the court will apply in determining whether a record sufficiently supports an adjustment being made to the merger price. Given the court's strong reluctance to date to make any adjustments when the merger price has been used to determine fair value, and given that the court rejected any adjustment in AutoInfo even though the record (while not fully developed) appeared to be sufficient to indicate that some adjustment would be required, we expect that the court may continue to apply a restrictive standard.

Ramtron: Court Chooses Between Parties' Proposed Adjustments (Selecting Only a Nominal Adjustment)

In Ramtron, the court rejected the respondent's two proposed methods of determining an adjustment to exclude merger-specific synergies (both of which indicated a 34 cents per share adjustment of the $3.10 merger price). We note that, if the company had the benefit of the court's discussion of adjustments in AutoInfo, it may have been possible for the company to have developed a more acceptable methodology. With little discussion, the court characterized the petitioner's proposed nominal adjustment (3 cents per share) as "better conform[ing] to the evidence adduced at trial" — even though, the court stated, that adjustment "may understate" the merger-specific synergies.

The court noted the petitioner's testimony that, in addition to "positive synergies" anticipated from the merger (such as cost savings), significant "negative synergies" (i.e., negative effects on revenue, as well as transaction costs in the range of 10-15 percent of revenue) were also expected. Therefore, the court appeared to believe that the petitioner's nominal adjustment (although likely too low) made more sense than the respondent's proposed significant adjustment (which, the court noted, represented more than 10 percent of the merger price).

Notwithstanding the burden of proof established in AutoInfo, the court in Ramtron simply selected what it viewed as the more reasonable of the two proposals, without regard to the burden of proof. In our view, it may be that the court will take this approach only in limited situations — such as where, as was the case in Ramtron, significant negative synergies are anticipated, both parties propose adjustment amounts, one amount does not take into account the negative synergies, and the other amount is nominal.

Reliability of Projections — No Change in the Court's Approach

The court generally views as reliable projections that are prepared by management in the ordinary course of business. These are viewed as reliable because management ordinarily has the best first-hand knowledge of a company's operations and, when prepared in the ordinary course, the projections typically reflect management's best estimate of the company's future performance and are not tainted by distorting influences or post-merger hindsight.

The court has viewed management projections as unreliable when they:

- were prepared outside the ordinary course of business;
- were prepared by a management team that never before prepared similar projections;
- were prepared in anticipation of litigation or an appraisal action, or with some other motive (for example, to protect their jobs or to increase the apparent value of the company in a sale process);
- were viewed by management itself as unreliable; and/or
- were based on unusual company or industry factors that were so speculative as to make forecasting nearly impossible.

AutoInfo and Ramtron: Unreliable Projections

In Ramtron and AutoInfo, the court rejected use of a DCF analysis to determine fair value in part because the court deemed the management's projections to be unreliable.

In Ramtron, the court deemed the projections to be unreliable because they were prepared by a new management team (with the CEO, chief financial officer and all other senior management having been at the company for less than two years); the team used a new methodology (that the team appeared to view, without confidence, as a "new and unfamiliar process"); and the company had previously only ever prepared short-term forecasts (which the company itself had recently characterized as having limited reliability).

Further, the court found that the projections, prepared while the company was in the process of trying to defend against a hostile takeover bid, were prepared in anticipation of possible future disputes and seeking white knights; in addition, the projections did not accord with the reality of the business in numerous respects. Moreover, the company itself did not rely on the projections in the ordinary course of its business (having prepared other projections for managing the company's finances, including providing information to the company's bank). Importantly, the court criticized the parties' "litigation-driven" valuations, including the petitioner's "eyebrow-raising DCF," which relied on projections the expert had presumed were overly optimistic and yet still yielded a result 2 cents below the merger price.

In AutoInfo, the court found that the company's projections were unreliable because management had been specifically directed to "paint an 'aggressively optimistic' picture" for the purpose of generating more interest in, and a better price for, the company in its sale process. In addition, management had never before prepared projections, "had no confidence in its ability to forecast" the company's future performance, and "perceived its attempt [to forecast] as 'a bit of a chuckle and a joke.'"

Cannon: High Bar for Company to Disavow Its Projections

In Cannon (an interested transaction), the court and both of the parties utilized a DCF analysis to determine fair value. The court rejected the company's attempt to disavow the projections that had been prepared by the company's president in favor of projections later created by the company's expert. The expert's projections, which had been prepared in anticipation of a mediation of the parties' dispute with respect to the forced buyback of the petitioner's shares, projected less growth in the company than the projections that the company had prepared earlier in anticipation of offering to buy back the petitioner's shares. The court deemed the expert's projections to be unreliable because they were prepared in anticipation of litigation.

While the president's projections had been prepared for the purpose of determining the offer price for the contemplated forced buyback of the petitioner's shares (either through his agreement or a squeeze-out merger), the petitioner did not argue that they were unreliable on this basis, but argued instead that the president's projections were more reliable than the expert's revised projections.

The court agreed, finding that the following factors supported the reliability of the president's projections: (1) although the projections had not been prepared by a management team but by the president alone, the president had a thorough knowledge of the company and its prospects, and other management input was obtained through weekly discussions with the president about results, developments and prospects; (2) the president had, over a three-year period, updated and revised the projections to reflect actual results and new developments; (3) the president had submitted the projections to financing sources (here, the court emphasized that it will place great weight on projections that have been provided to financing sources, as it is a federal felony to knowingly obtain funds from a financial institution by false or fraudulent pretenses or representations); and (4) it was unlikely that the president's projections were too high, as he had an incentive to make the projections as low as possible since they were prepared for the purpose of setting the price for the buyback of the petitioner's shares.

The court rejected the respondent's arguments that, based on principles discussed in previous Chancery Court decisions, the projections prepared by its president were unreliable. The court distinguished the previous decisions as follows:

- *CKx.* In Huff v. CKx (2013), the court viewed the company's projections as unreliable because a projected increase in licensing fees under a material, to-be-negotiated contract was so speculative and the initial estimates of those revenues had been markedly lower than the projections provided to potential buyers and lenders. By contrast, the court noted, in Cannon, although Cannon had argued that its prospects had dimmed, it had not identified any particular line item or line of business in the projections that was so uncertain as to undermine the integrity of the overall projections.

- *JustCare.* In Gearreald v. Just Care (2012), the court viewed the company's projections as unreliable because the company had never before prepared multiyear projections. The court distinguished the situation in ESG by noting that, even though the company had not generally prepared projections in the ordinary course of business, the president's projections had been prepared (and updated and revised) over three years; that he had been confident enough in them to provide them to banks in connection with financing the buyout; and that they had been created in part with the assistance of a financial adviser with whom the president had reviewed the revenue growth assumptions.

- *Nine Systems.* In In re Nine Systems (2014), the court viewed a set of one-year projections as unreliable because the projections were inconsistent with the company's recent performance (specifically, management had "overestimated ... revenues even two months away ... by more than a factor of three"). By contrast, in Cannon, the court noted, the company's performance in the months just preceding the merger was in line with the projections.

Summary of Most Recent Cases: AutoInfo, Cannon and Ramtron

AutoInfo — In this disinterested transaction involving a competitive public auction, the court:

- used the merger price to determine fair value (with a DCF analysis as a double-check);
- found the sale process to have been thorough;
- found the management projections unreliable because they were prepared with a view to marketing the company;
- imposed a new burden with respect to adjustments to the merger price to exclude merger-specific synergies; and
- determined fair value to be equal to the merger price.

In AutoInfo, the merger price, $1.05 per share, had been established through a public auction process conducted at arm's length by a special committee with an independent financial adviser. The company and its financial adviser had aggressively shopped the company; the merger agreement was entered into with the bidder that had by far the highest indication of interest (although, after that bidder uncovered alleged accounting, financial and other irregularities during due diligence, the price was renegotiated to an amount slightly below the amount at which some of the other indications of interest had been); and no competing bid emerged during the almost two-month post-signing period. The court rejected the company's projections as unreliable because management had been instructed to prepare aggressively optimistic projections as they would be used to market the company. The court rejected the petitioner's comparable companies analysis because of the much larger size of the companies included and their different business model (store-based as opposed to the company's agent-based model).

The petitioner's expert had argued that fair value was $2.60 per share, based one-third each on a DCF analysis, comparable company analysis using a historical-based multiple, and a comparable company analysis using a forward-looking multiple. The respondent's expert had argued that fair value was 97 cents, based on the merger price, adjusted downward to exclude cost savings arising from the merger. The court based fair value on the merger price — and also conducted its own DCF analysis as a double-check on the merger price (which yielded a result slightly below the merger price: 93 cents). The court rejected any adjustment to the merger price to exclude merger-specific synergies, reasoning that the party arguing for those adjustments (the company) had a burden (that it had not met) to establish the nature and amount of the synergies alleged to be merger-specific before any adjustment could be made.

Cannon — In this interested transaction involving a squeeze-out merger at a price far below the value indicated in third-party valuations received by the company (and with no market check), the court:

- used a DCF analysis to determine fair value (as had both parties);
- rejected the company's attempt to disavow (and lower) its projections; and
- determined fair value to be significantly higher than the merger price.

In Cannon, two stockholder-directors of a Subchapter S corporation forcibly removed the third stockholder-director (the petitioner) as president and, after several failed attempts at repurchasing his shares, effected a squeeze-out merger in which his shares were canceled. At the merger price, the petitioner would have received $26.33 million for his interest. The repurchase offers and the merger price for his interest were all far below the value indicated in third-party valuations received by the company throughout the relevant periods. The court utilized a DCF analysis to determine fair value, yielding a result of $42.17 million — representing a 60 percent premium over the merger price. The result of the DCF analysis conducted by the petitioner's expert was $53.46 million, while the respondents' expert's DCF result was $21.50 million. The difference in results in the DCF analyses was primarily attributable to the different projections utilized.

In addition, the petitioner had tax-affected the company's earnings in the analysis to compensate the petitioner for the loss of the tax advantage in being a stockholder of a Subchapter S corporation. The court utilized the projections prepared by the company's new president (one of the two stockholder-directors who planned the merger), rejecting the respondents' arguments that their expert's more conservative projections should be used instead, and agreed with the petitioner that the Subchapter S corporation earnings should be tax-affected.

Ramtron — In this disinterested transaction involving a hostile takeover bid and a thorough search for a white knight buyer (with no competing bidder having emerged), the court:

- used the merger price to determine fair value;
- found the management projections unreliable for a variety of reasons;
- made a nominal adjustment to the merger price for merger-specific synergies (without much discussion); and
- based on the nominal adjustment, determined fair value to be just below the merger price.

In Ramtron, the company, after receiving an unsolicited bid, aggressively shopped the company to find a white knight buyer, while rejecting the unsolicited bid. No competing bids emerged over the three-month period and the company ultimately agreed to a merger with the unsolicited bidder. The merger price, $3.10 per share, represented a 75 percent premium over the unaffected stock price and, after five separate increases in the bid price, a 25 percent increase from the initial offer. The court rejected the management projections as unreliable because, among other things, the entire senior management team had been in place for a very short time; the projections were prepared using a new methodology; the management expressed uncertainty about the reliability of the projections and used different projections to manage the company's finances and provide information to its bank; and the projections were prepared in anticipation of potential litigation (including an appraisal action). The court rejected the petitioner's comparables analysis because it was comprised of only two comparable companies and the multiples for each differed significantly, making the average of the data points unreliable.

The petitioner's expert had argued that fair value was $4.96 per share (which was 274 percent of the unaffected stock price, the court noted), based 80 percent on its DCF analysis (which yielded a result of $5.20) and 20 percent on its comparables analysis (which yielded a result of $3.99). The respondents' expert had argued that fair value was $2.76, based on the merger price, adjusted downward to exclude cost savings arising from the merger. The respondent's expert argued, in the alternative, that fair value, based on a DCF analysis utilizing management's projections, was $3.08. The court based fair value solely on the merger price and, with little analysis or explanation, adjusted the merger price downward by the 3 cents that the petitioner proposed represented the merger-synergy savings less the merger-synergy costs.

Please see part 1 of the article for our charts summarizing the outcome of each appraisal case since 2010 and a list of our other articles on appraisal. Part 3 of this article, to be published here in the coming days, will cover practice points relating to adjustments to the merger price, projections and other appraisal-related issues arising from AutoInfo, Cannon and Ramtron.

—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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