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A Study Of Recent Delaware Appraisal Decisions: Part 3

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In part 1 of this article (published July 28), 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 AutoInfo), significantly above the merger price (in Cannon), and slightly below the merger price (in Ramtron) — the court's approach has been consistent. In part 2 of this article (published July 29), we provided further explanation and discussion of the key points arising out of, as well as summaries of, AutoInfo, Cannon and Ramtron. In this part 3, we provide practice points arising out of these decisions.

Key Practice Points for Acquirors Relating to Adjustment of the Merger Price

Establish the Amount and Nature of the Expected Cost Savings

An acquiror should outline in some detail the cost savings expected from the merger. References to anticipated savings embedded, for example, in assumptions for projections or in an investment memorandum may not be sufficient. The acquiror should identify what portion of the expected savings is attributable to the merger itself.

For example, executive compensation reductions that are anticipated due to the overlaps of executive positions at both companies (i.e., the merged company will not need two CEOs, two chief financial officers, etc.) would appear to be merger-specific. Reductions that are anticipated due to the target's already having implemented compensation reductions would not be merger-specific. Reductions anticipated because the target's compensation scale is above market (so reductions could be achieved by the target itself without the merger, but the target might not have thought of or wanted to make those reductions) are more difficult to classify as merger-specific or not.

The acquiror should consider identifying what part of its offer price is based on expected merger-specific cost savings. Internal documents, and those prepared by the company's investment banker, should be carefully reviewed so as to be consistent with the acquiror's views of merger-related cost savings.

Consider Establishing the Amount of the Control Premium

The merger price typically includes a control premium, all or part of which logically is merger-specific and should be excluded from the court's determination of fair value. An acquiror should consider establishing a foundation to support a determination as to what part of the merger price is represented by a control premium. If the merger price is used to determine fair value in an appraisal proceeding, the respondent company should argue for a downward adjustment to exclude that amount. We are not aware of parties to appraisal proceedings having made this argument and the court has not addressed the issue. (Of course, the calculation of the control premium amount could be complex because, for example, part of a control premium may be attributable to merger synergies (and cannot be counted twice in determining reductions).

Seek to Understand the Target Company's Sale Process

The acquiror will have a better sense of the likely appraisal risk if it understands the target's sale process, including whether there was an effective market check. The acquiror should consider requesting information about the sale process from the target company's general counsel and seeking to review a draft of the target's description of the background of the transaction in its proxy statement or tender offer statement.

Seek to Establish the Nature and Reliability of the Target's Projections

The acquiror will have a better sense of the likely appraisal risk if it understands the target's process in developing its projections. For example, the acquiror should seek to understand: Does the company prepare annual projections on a regular basis? What is the nature of those projections (one-, three- or five-year)? Are the projections subject to review by the board and what is the extent of the review? Were the projections utilized in the sale process prepared in the ordinary course? Are there any factors indicating that the projections utilized in the sale process were prepared other than in the ordinary course? Are there any factors indicating that the projections were modeled to be "aggressively optimistic," were prepared in anticipation of the sale process, or do not reflect the management's best view of the company's future? What has management said about its confidence in the projections and how has management used the projections? Have the projections been provided to the company's banks or other financial institutions?

We note that, if a court utilizes the merger price to determine fair value and requests adjustment proposals from the parties, the petitioner and the company may wish to consider the game theory involved in proposing a lower proposed adjustment (in the case of the company) or a nominal proposed adjustment (in the case of the petitioner) insofar as it may affect the court's decision whether to reject both proposals as not satisfying the burden of proof or to select what it views as the more reasonable between the two proposals.

Key Practice Points From Cannon

Stockholders Agreement Should Have Prevented the Squeeze-Out Merger

The petitioner argued that the merger violated the stockholders agreement among the petitioner and the other two stockholders. That agreement required that all three stockholders approve any "agreements or transactions valued in excess of [$10,000]" and "any material changes in the business of the Company." The court declined to resolve the issue for various reasons. We note, however, that the stockholders agreement could have been drafted more clearly to prevent a squeeze-out merger or other forced buyout of any of the stockholders by the other two (or to provide certain protections in that event).

Valuations and Offers to Purchase Prior to a Squeeze-Out

The company's credibility was damaged by its several offers to purchase the petitioner's stock at prices, in each instance, significantly below the value of the petitioner's shares indicated by third-party valuations the company had received.

Key Practice Point for Bankers Relating to DCF Analysis

No Liquidity Discount to Cost of Capital Size Premium

In AutoInfo, the court indicated that, in a DCF analysis for appraisal purposes, the weighted average capital cost (WACC) component of the capital asset pricing model (CAPM) should generally be calculated without applying any "marketability" or "illiquidity" discount to the equity size premium derived from the Ibbotson tables. The court indicated agreement with the position, taken in Gearreald v. JustCare (2012), that, as "the 'liquidity effect' contained within the size premium" relates to the company's ability to obtain capital at a certain cost, it is therefore related to the company's intrinsic value as a going concern, and should therefore be included in the calculation of its cost of capital in a DCF analysis for appraisal purposes.

Hypothetical Corporate-Level Tax Rate for Subchapter S Corporation

According to the court in Cannon, determining the corporate-level tax rate to calculate the company's projected free cash flows, a hypothetical rate must be determined for an S corporation that "treats the S corporation shareholder ... as receiving the full benefit of untaxed dividends, by equating [his] after-tax return to the after-dividend return to a C shareholder."

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