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Are Below-the-Merger-Price Appraisal Results Likely To Become More Common?—The Critical Misconception Relating to the SWS Decision

In *In re Appraisal of SWS Group Inc.* (May 30, 2017), the Delaware Court of Chancery, relying on a discounted cash flow analysis, determined that the appraised "fair value" of SWS Group, Inc. (the "Company") was *below* the merger price paid by acquiror Hilltop Holdings, Inc. The court's determination of fair value was 7.8% below the value of the merger consideration at closing (about 19% below the value of the merger consideration at the time the merger agreement was announced and the hedge-fund petitioners decided to acquire their SWS shares).

In our study of all appraisal decisions since 2010, we found that the court determined appraised "fair value" to be below the merger price in only two other cases—in both cases, there were unusual facts and, in one, the fair value determination was just nominally below the merger price. *SWS* raises the question whether below-the-merger-price appraisal results will now become more common. If the answer is yes—or even if the court more frequently finds "fair value" to be *equal to* the merger price—then, appraisal litigation generally, and in particular "appraisal arbitrage," would slow dramatically.

A number of commentators have suggested that the answer is yes, based on *SWS*. Their conclusion follows from what we believe to be a *misconception* that, in *SWS,* in determining fair value, the court "excluded" the value of merger synergies based on the statutory requirement that value arising from the merger itself must be excluded. In fact, contrary to the commentary, in our view, the court did not treat merger synergies differently in *SWS* than it has in any appraisal case. The court simply noted that a below-the-merger-price result from a DCF analysis could be explained by the fact that the DCF methodology—which is designed to determine the going concern value of a company on a standalone basis—does not take into account the value of merger synergies (while, we note, a merger price often reflects some of the value of expected synergies). This result *could* obtain in *any* case where merger synergies are expected, but, importantly, it has not. Every appraisal case (since 2010) in which the court has utilized a DCF analysis has resulted in a fair value determination *above* (sometimes significantly above) the merger price, notwithstanding that merger synergies were expected. In the two prior cases where the court found fair value to be below the merger price, only one was based on a DCF analysis—and the result was attributable not to merger synergies but to the court's revision of the company's projections that were used for the analysis.

Below, we discuss that, in our view, much of the commentary on the decision conflates (a) the effect of the statutory requirement to exclude value arising from the merger itself when the court relies on the merger price to determine fair value with (b) its effect when (as in *SWS*) the court relies on a DCF analysis—and that that misconception has led some to the view that *SWS* signals a new approach to the treatment of merger synergies in determining fair value. We believe that the decision does *not* reflect a new approach—whether the court relies on the merger price (where the court could, but has almost invariably not, made adjustments based on the statutory requirement) *or* a DCF analysis (where, based on the methodology itself, merger synergies are always excluded).

The Delaware statute. The statute provides the Court of Chancery with wide discretion in how to determine "fair value" in appraisal proceedings, imposing only two requirements. Under the statute, the court must (i) "take into account all relevant factors"; and (ii) "exclude any value that arises in anticipation of the merger or in contemplation of its consummation."

The court's appraisal jurisprudence. In recent years, the court has expressed a strong preference for reliance on the merger price to determine "fair value" when (i) the merger price would be a particularly reliable indicator of fair value because it was derived through a robust sales process that "created meaningful competition" or "exposed the company to the market" and (ii) a DCF result was a particularly *un*reliable indicator of fair value because the company's projections (the key input to a DCF analysis) were unreliable. In some recent cases, the court has expressed a preference for the merger price where the sales process was robust, *even though* the projections also were reliable. Where neither the merger price nor the projections are reliable, the court generally has relied on a DCF analysis (sometimes making adjustments to the projections or taking a discount to reflect their unreliability). The court has usually found other valuation methodologies (such as comparables analyses) to not be reliable indicators of fair value. The court's approach to each appraisal case has been intensively facts-based, with the court generally weighing the relative reliability of the merger price and a DCF analysis in determining which to use or how much weight to give to each. Most often, even when the court has relied "solely" on the merger price or solely on the DCF, the court takes the other into consideration, in one form or another, as a "double-check" on, or "confirmation" of, the court's result.

The role of merger synergies. As noted, the Delaware statute requires the exclusion from a fair value determination of value that arises from the merger itself (the "Statutory Requirement"). With respect to merger synergies, the Statutory Requirement plays out in two different ways depending on whether the court is relying on a DCF analysis or on the merger price.

- ***Where the court relies on a DCF analysis*** to determine fair value, as noted, the DCF methodology itself, by definition, excludes the value of *all merger synergies*. A DCF analysis determines the going concern value of a company, based on expected future cash flows, as of (in appraisal cases) the time just preceding the merger. Merger synergies are thus irrelevant to the analysis; there is no input into the calculation that includes their value; and a DCF result by its very nature meets the Statutory Requirement without the court paying any attention to synergies.

  In our view, SWS has been widely misconceived as an example of the court affirmatively determining to exclude synergies from fair value based on the Statutory Requirement. This, in our view, was not the case. Rather, *consistent with* the court's general appraisal jurisprudence, the court, having found the sales process to be unreliable because the buyer had a contractual veto power over competing bids, chose to rely on a DCF analysis—and then simply commented that the fact that there was evidence that this was a highly "synergies-driven" deal, and that some of the value of significant expected merger synergies was included in the merger price, was "confirmatory" of the below-the-merger-price result from the DCF analysis.

- ***Where the court relies on the merger price***, the Statutory Requirement conceptually requires judicial attention to merger synergies because a merger price typically includes some portion of the value of expected merger synergies. The court has long acknowledged that the Statutory Requirement mandates a downward adjustment to the merger price to exclude the value of merger synergies—*but the court has not actually made such an adjustment in any case* (with only one exception, where the adjustment was nominal). In a number of appraisal decisions, the court has noted the practical difficulties involved in determining the appropriate amount of such an adjustment. These difficulties include the issue of precisely *what type* of synergies are to be considered as "arising from the merger itself." Certain synergies, the court has stated, such as many generic cost-saving synergies, depending on the circumstances, could be considered to be part of the "inherent value" of the company (rather than as arising from the merger itself) because the company could achieve those cost-savings on its own without a merger. Also, the court has stated that it may be that synergies should not be viewed as arising from the merger itself if they could be achieved in *any* merger, as opposed to being achievable only in the particular merger at issue due to something unique that the buyer brings to the deal. The court has also expressed concerns about how any excluded synergies should be valued and how the court could determine to what extent (if any) those synergies had been included in the merger price. There is also the further complexity that the court has indicated that positive synergies would have to offset by "negative synergies" (the expected negative effects or costs of the merger).

Why merger synergies do not generally result in fair value being below the merger price. The question arises why fair value determined in appraisal cases is not *always below* the merger price—given that, (i) where the court relies on a DCF analysis, the DCF result does not include the value of *any* merger synergies while the merger price typically does; and (ii) where the court relies on the merger price, the Statutory Requirement mandates that the merger price be adjusted for the value of merger synergies. As noted, the court has only *twice* before (at least since 2010) found fair value to be below the merger price. Moreover, when the court has relied on a DCF analysis, the results have sometimes been *significantly* above the merger price.

- ***In the context of the court relying on <u>the</u> <u>merger</u> <u>price</u> to determine fair value***, as noted, the court has explained that it has not made adjustment to the merger price to reflect the value of synergies because of the practical difficulties involved in determining the appropriate amount of such an adjustment. In a recent decision, Vice Chancellor Laster commented that respondent companies in appraisal cases have rarely argued for a downward adjustment and that, when they have, they have not produced a record that would permit the court to determine the appropriate amount.

- ***In the context of the court relying on <u>a</u> <u>DCF</u> <u>analysis</u> to determine fair value***, the fact that fair value is almost invariably determined to be above (and sometimes significantly above) the merger price, is, in our view, attributable to the fact that the court generally utilizes the DCF analysis when the merger at issue involves a controller or a flawed sales process. In those situations, the court does not rely on the merger price to determine fair value *because* the merger price is likely to *undervalue* the company. Thus, it is not surprising that the DCF result reflects a value above the merger price. We note that, while an appraisal determination and a merger price are both fixed numbers, buyers and their financial advisors determine *a range* of DCF values for the company and of synergy values in the deal to determine the merger price. In the context of a controller transaction or weak sales process, the buyer is likely to choose a merger price toward the low end of the range (and to share synergies with the stockholders at the low end of the synergies value range)—while the number determined by the court's DCF analysis may be in the middle of the range or higher. In addition, it is to be noted that the key input to a DCF analysis is the company's projections—and these may be unreliable or even have been designed to reflect an overly optimistic view.

Will below-the-merger-price appraisal results become more common? The answer, of course, is uncertain. On the one hand, conceivably they may become more common. In that respect, we note that:

- ***The court just reached a below-the-merger-price result in* SWS*.*** While the court characterized the decision as based on the "unique facts" of the case, the unique facts *related to the sales process* and the court's decision to rely on a DCF analysis rather than the merger price. There were no unique facts relating to the DCF analysis. While the court commented that the deal was "heavily synergies-driven," that has been the case in many other appraisal cases where the court determined fair value to be above the merger price.

- ***The Delaware courts have transformed the law in several areas to reduce M&A-related litigation.*** The seminal *Corwin* and *Trulia* decisions have sharply reduced M&A fiduciary duty litigation in Delaware. One result has been an *increase* in appraisal litigation. The Delaware legislature recently adopted amendments to the appraisal statute (to bar petitions for appraisal of de minimis amounts of shares), in an effort to reduce appraisal litigation. Moreover, the court has suggested some degree of skepticism about the practice of appraisal arbitrage. It may be that these developments portend a change in appraisal jurisprudence as well.

- ***There are readily available tools for reaching a below-the-merger-price result.*** When the court relies on the merger price to determine fair value, implementation of the Statutory Requirement would in most cases result in fair value being below the merger price (the only exception would be cases where no merger synergies were included in the merger price—an unlikely scenario in the context of a case where the court has determined to rely on the merger price). When the court relies on a DCF analysis, the methodology is highly susceptible of widely varying results—as there are myriad inputs, the key input is the company's projections (which often present issues of unreliability), all of the other inputs involve subjective determinations (as to which reasonable minds easily can, and typically do, differ—even in a non-litigation context); and just a small change in one input typically produces a significant difference in the DCF result.

- ***In a recent decision, Vice Chancellor Laster appeared to encourage respondent companies in appraisal proceedings to argue for excluding the value of merger synergies from a merger price.*** In *Lender Processing* (May 15, 2017), Vice Chancellor Laster reiterated the practical difficulties involved in making such an adjustment, but appeared to encourage respondent companies to develop an appropriate record with respect to these issues and to argue that, if the court relies on the merger price, it should make a downward adjustment to exclude the value of expected merger synergies. Notably, Vice Chancellor Laster did not offer guidance as to what record would be appropriate nor which synergies would be properly excluded.

On the other hand, the following factors militate *against* a likelihood of increased prevalence of court determinations of fair value below the merger price. We note that:

- ***The court did not appear to intend in* SWS *to announce a major shift in its treatment of merger synergies.*** The court commented on the unusual result of a below-the-merger-price fair value determination with one sentence in the "Conclusion" section of the opinion: "I note that the fact that my DCF analysis resulted in a value below the merger price is not surprising: the record suggests that this was a heavily synergies-driven deal." It may be unlikely that the court would have announced or signaled a major shift in approach in appraisal with a brief comment.

- ***Contrary to commentary on SWS, the court did <u>not</u> act affirmatively to exclude merger synergies, resulting in fair value below the merger price.*** Much of the commentary on *SWS* states that the court excluded the value of merger synergies pursuant to the Statutory Requirement. As discussed, this misstates the decision, in our view. The resulting misconception is that the court in future cases may also exclude the value of merger synergies and reach below-the-merger-price results. However, in *SWS,* the court simply conducted a DCF analysis (which itself does not take merger synergies into account)—and the result of that analysis, *without the court paying any attention to merger synergies,* was below the merger price. While the court commented that the inclusion of the value of expected synergies in the merger price was confirmatory of a below-the-merger-price DCF result, importantly, the court did not *do anything* to exclude merger synergies. In our view, this decision should not give rise to any expectation that the court will now be treating synergies in some new way.

- ***The court has only determined fair value to be below the merger price twice before.*** The court has reached a below-the-merger-price result in only two previous case (at least since 2010)—despite the fact that may cases, like *SWS*, involved significant expected synergies. As noted, these two cases (discussed below) both involved unusual facts and, in one, the fair value determination was only nominally different from the merger price.

- ***Finally, and most critically, a move toward below-the-merger-price results would be inconsistent with the court's strong recent emphasis on the reliability of the merger price when there has been a robust sales process.*** The court's jurisprudence over the past several years, and particularly in the last couple of years, has emphasized that a merger price derived through a robust sales process is the best proxy for fair value. Notably, in *SWS*, the court expressly reaffirmed its preference for basing fair value on the merger price when there has been a robust sales process and attributed its decision to rely on a DCF analysis to the "unique facts" of the case.

The court now has found fair value to be below the merger price in the following three cases:

- In ***In re Appraisal of SWS***, as discussed in this Briefing, the court found the merger price to be unreliable based on the "unique fact" that the buyer had the right to veto all competing bids in the sales process; the court relied on a DCF analysis; the DCF result was 7.8% below the merger price; and the court viewed as "confirmatory" of the below-the-merger-price result could be the fact that the value of the significant expected synergies was not taken into account under the DCF methodology but was included in the merger price.

- In ***Longpath v. Ramtron* (2015)**, the court found the public sales process to have been robust and relied on the merger price to determine fair value; the respondent company proposed that the court make a downward adjustment to the merger price of $0.34 (more than 10% of the merger price) to exclude expected synergies; the petitioners argued that, due to significant "negative synergies" (*i.e.,* the negative effects of the merger on revenue, in the range of 10-15%, as well as transaction costs), any adjustment to exclude the value of merger synergies, on a net basis, would not be more than $0.03; and the court, without discussion, chose the petitioner's suggested nominal adjustment, stating only that, while it may have "understated" the value of expected synergies, it properly gave effect to the significant negative synergies that were expected.

- In ***Gearrald v. JustCare* (2012)**, which involved a majority stockholder squeeze-out of the two minority stockholders, the court relied on a DCF analysis to determine fair value; the DCF result was 14.4% below the merger price; and the court explained the below-the-merger-price result as being based on unusual circumstances relating to the company's projections, which the court had adjusted downward for the DCF analysis. (The projections had been prepared by the former CEO and the former CFO of the company, who *themselves were the petitioners* in the appraisal trial and had testified that the projections had been prepared for the purpose of attracting the highest possible price for the company in a sale and did not reflect their realistic opinion.)

Conclusion. It is uncertain whether below-the-merger-price fair value determinations will become more common in appraisal cases. While some have opined that they will become more likely based on the *SWS* decision, we do not believe that *SWS* suggests this result. There have now been only three cases (at least since 2010) with below-the-merger-price results—each involving unusual facts and one involving only a nominal difference from the merger price). Moreover, all of the court's recent jurisprudence has emphasized the logic of viewing the merger price itself as the best proxy for fair value when there has been a robust sales process. The countervailing considerations are that the court has been developing its jurisprudence in other areas to reduce M&A-related litigation, there are readily available tools to get below-the-merger-price results if the court seeks to move in that direction, and, in one recent case, one Vice Chancellor called for respondent companies to argue for a downward adjustment to the merger price when the court relies on the merger price (albeit without providing guidance relating to the practical difficulties the court has cited as the reason it has virtually never made a downward adjustment to the merger price).

We will be issuing a separate Fried Frank M&A Briefing on "Practice Points Arising from the SWS Appraisal Decision."

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<u>Authors</u>:

Warren S. de Wied

Steven Epstein

Arthur Fleischer, Jr.

David J. Greenwald

Scott B. Luftglass

Philip Richter

Robert C. Schwenkel

Peter L. Simmons

Gail Weinstein

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<u>Contacts</u>:

New York

Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com

Washington, D.C.

Jerald S. Howe, Jr.	+1.202.639.7080	jerry.howe@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com
Brian Miner	+1.202.639.7340	brian.miner@friedfrank.com

*Senior Counsel