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Appraisal Decision Sole Reliance on Merger Price: PetSmart

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In *In re Appraisal of PetSmart, Inc.* (May 26, 2017), which related to the acquisition of PetSmart, Inc. (the "Company") by funds managed by private equity firm BC Partners, Inc., the Delaware Court of Chancery determined "fair value" for appraisal purposes to be equal to the merger price.

Key Points

- **The decision reaffirms the court's recent trend of increased reliance on the merger price to determine appraised "fair value" when the sales process involved "meaningful competition" and the target company projections available for a discounted cash flow analysis were unreliable**. Moreover, in our view, commentary in the opinion suggests that the court may be more likely than in the past to rely on the merger price where there has been a sales process involving "meaningful competition," *even if* the company projections available for a DCF analysis were reliable.
- **We note that, in the *SWS* appraisal decision issued just after *PetSmart*, the court did *not rely* on the merger price**. *SWS* is not likely to have broad precedential applicability, however, as it was based on what the court characterized as the "unique facts" of the case—a failing company that was acquired by its substantial creditor, who therefore derived unique value from the transaction itself, which was reflected in the merger price. Although the *SWS* sale process had included a market check, both the petitioners and the company (albeit for different reasons) argued that the merger price did not reflect fair value. The court agreed, and determined the fair value of SWS to be 8% *below* the merger price. We will be distributing a separate Private Equity Briefing on the *SWS* decision. (We note also that the Delaware Supreme Court is currently considering the issue of reliance on the merger price in the appeals of the *Dell* and *DFC Global* appraisal decisions.)
- **In the context of an arm's length transaction for a company that has been shopped in a reasonable sales process, the court will likely view with skepticism a financial analysis that indicates that there was a "massive market failure."** The sales process undertaken by PetSmart provides a roadmap for a process that maximizes the likelihood of judicial reliance on the merger price to determine appraised "fair value." Notably, the

court relied on the merger price notwithstanding that (i) only financial sponsors (and no strategic buyers) submitted bids for the Company and (ii) the Company experienced improved post-signing financial performance—to the point that the Company declared an $800 million dividend at year-end after the closing, representing a 38% return on equity invested.

- **The court rejected the contention that a financial buyer's price, which is based on an "LBO pricing model," cannot reflect "fair value" for appraisal purposes**. Skepticism about whether an "LBO pricing model" would reflect "fair value," even in the context of a competitive auction among financial bidders, not only was asserted by the Petitioners in this case but had been expressed by the court, in dicta, in two recent appraisal decisions.

Background

After over a decade of consistent growth, PetSmart's growth began to stall in 2012; its quarterly forecasts were then "often off by large margins"; there was significant management turnover; following the announcement of 1Q 2014 results, the stock price dropped 8% (to $57.02); an activist stockholder announced that it had acquired a 9.9% stake in the Company; and both the activist and the Company's largest stockholder agitated for the Company to seek strategic alternatives, including a sale of the Company. In April 2014, the Company, which had already begun the process of considering strategic alternatives, engaged independent advisors and formed a committee of independent, non-executive directors. The committee instructed management to create long-term projections for use in a sale process (the "Management Projections"), as previously the Company had prepared only one-year budgets; and directed JP Morgan Securities ("JPM") to conduct an auction of the Company. The board publicly announced the auction and continued to evaluate strategic alternatives, including a standalone option with new initiatives for revenue and cost savings or a leveraged recapitalization.

JPM expected that financial sponsors, rather than strategics, would be more interested in participating in the auction. JPM contacted a large number of potential financial buyers and the three strategic parties most likely to be interested (other than the Company's main competitor, Petco). No strategic buyers expressed interest, but there were competing bids by a number of financial buyers, with four final bids ultimately submitted after a four-month process that included extensive due diligence and negotiation. After receiving the final bids, the board determined to sell the Company rather than pursue other strategic alternatives or remain independent. In early January 2015, the Company accepted BC Partners' final offer of $83 per share. The offer was $1.50 higher than the next highest offer the Company received and represented a 39% premium over the unaffected stock price. After the merger agreement was signed, notwithstanding disclosure in the proxy statement of trends in improvement in the Company's financial performance, no topping bid was received. Over 99% of the shares voting approved the merger (which represented over 77% of the outstanding shares), and the merger closed in March 2015.

Six groups of investors (the "Petitioners"), who owned 10.7 million shares (9.5 million of which were purchased after the record date for the merger), dissented and sought appraisal of their shares. During a four-day trial, the Petitioners' expert opined that "fair value" for appraisal purposes was $127.78 per share, based on a DCF analysis. The Company's expert opined that "fair value" was equal to the $83 per share merger price—resulting in a gap of $4.5 billion between the parties' respective valuations. After months of post-trial briefing, as well as oral argument, Vice Chancellor Slights relied solely on the merger price and decided that "fair value" was equal to the merger price.

Discussion

The court's commentary suggests that the court may be more likely than in the past to rely on the merger price where there has been a strong sales process, *even if* the target company projections available for a DCF analysis were reliable. The court's appraisal jurisprudence over the past few years has been to rely on the merger price to determine fair value when *both* (i) the merger price is a particularly reliable indicator of fair value because it was derived through an arm's length sale process that involved meaningful competition *and* (ii) a DCF analysis is particularly *un*reliable because the company's projections (the key input to the analysis) were not reliable (generally because they were not prepared by experienced managers in the ordinary course of the company's business or did not reflect management's actual expectations about future cash flows). In *PetSmart*, the court viewed the sales process as very strong and the projections as very weak, and therefore relied solely on the merger price.

We note that *Lender Processing* (Dec. 16, 2016)—the court's last appraisal decision before *PetSmart* (which also involved a very favorable fact situation for the respondent company relating to the sales process)—was the first in which the court suggested that, when both the merger price and a DCF analysis would be reliable, the court would prefer reliance on the merger price. The court, in *PetSmart*, without addressing specifically the approach taken by Vice Chancellor Laster in *Lender Processing*, clearly reiterated the previous approach of *not* relying solely on the merger price unless *both* the sale process rendered the merger price reliable *and* the projections were unreliable. This approach is required, Vice Chancellor Slights wrote in *PetSmart*, because the appraisal statute requires that the court, in determining fair value, must take into account "all relevant factors"—which, the Vice Chancellor reasoned, would include the value derived from a DCF analysis.

However, Vice Chancellor Slights' commentary in *PetSmart* appears to indicate a preference for the merger price over a DCF analysis *as a general matter* where there has been a strong sales process— suggesting that the court may well be more likely than in the past to rely on the merger price in those circumstances even when there are reliable projections. In the "Conclusion" to the opinion, the Vice Chancellor wrote:

Accepting Petitioners' contention that the fair value of PetSmart was $128.78 per share would be tantamount to declaring that a massive market failure occurred here that caused PetSmart to leave nearly $4.5 billion on the table. In the wake of a robust pre- signing auction among informed, motivated bidders, and in the absence of any evidence that market conditions impeded the auction, I can find no basis to accept Petitioners' flawed, post-hoc valuation and ignore the deal price. Nor can I find a path in the evidence to reach a fair value somewhere between the values proffered by the parties. And so I "defer" to deal price, not to restore balance after some perceived disruption in the doctrinal Force, but because that is what the evidence presented in this case requires.

In a notable footnote, the Vice Chancellor continued:

I cannot help but observe, however, that reliance upon the deal price as a reliable indicator of fair value in this case, where the paid experts have offered such wildly different opinions on the subject, does project a certain elegance that is very appealing. In an arm's length transaction like the one here, the buyer and seller are both incented to value the company as accurately as they can knowing that they will be penalized in the marketplace for failing to do so. Paid experts in litigation who testify about values derived from analyzing comparables or discounting future cash flows to present value, on the other hand, have very different incentives. Given this dynamic, Delaware courts must remain mindful that the DCF method is subject to manipulation and guesswork and that the valuation results that it generates in the setting of a litigation can be volatile. The Merger Price, negotiated at arm's-length, in real time, after a well-run pre-signing auction that takes place in the midst of a fully functioning market, is not burdened by such litigation-driven confounding influences. (Internal quotation marks and citations have been omitted.)

In our view, as a practical matter, the court, in appraisal cases, essentially weighs all of the factors relating to the reliability of the merger price as an indicator of fair value. Vice Chancellor Slights suggested as much in *PetSmart*, while evidencing antipathy to any one formulaic approach to appraisal. "Every company is different; every merger is different. These differences are enriched with 'relevant factors' that must be accounted for in the search for fair value," the Vice Chancellor wrote. In our view, whether or not the court expressly adopts the approach that was taken in *Lender Processing* and is suggested by Vice Chancellor's footnote in *PetSmart*, the court will likely increasingly rely on the merger price in cases where the sales process justifies doing so.

The court found that the DCF analysis results were *not* a reliable indication of "fair value" because the Company's projections were unreliable. The Petitioners argued that their DCF analysis, utilizing the Company's own projections of future cash flow, supported a fair value determination far above the merger price. Vice Chancellor found that the Management Projections were "at best, fanciful" and that their preparation had been "saddled with nearly all of [the] telltale indicators of unreliability." The results of a DCF analysis relying on them would be "meaningless," the Vice Chancellor stated. The court found:

- ***The projections were not prepared in the ordinary course of business but for use in the auction process.*** Because the Company had never prepared long-term projections before, the board directed management to prepare them for use in the sales process. "To fulfill this purpose, the projections were created to be aggressive and extra-optimistic about the future of the Company." In fact, they projected a reversal of several downward trends, including with respect to the important metric of comparable store sales growth estimates. The management testified that there was "intense pressure from the Board to be aggressive," and the committee members testified that the projections were "designed to be aggressive because [the board and JPM] were convinced that potential bidders would discount whatever projections were put in front of them"—which, the court stated, "makes perfect sense when the projections are being prepared not in the ordinary course of business but to facilitate a sale of the Company."
- ***Management had "virtually no experience" with long-term projections.*** The Company's forecasting practice had been limited to the creation of annual budgets after "summer strategy meetings." These budgets were one-year forecasts prepared to support particular proposed initiatives with the anticipation that they would be revised

throughout the year as events unfolded and were "nothing like" the five-year projections management was directed to prepare when the board decided to explore a sale of the Company. In addition, senior management was "new to their jobs," having been hired only one to two years before this effort. Moreover, "the projections were rush jobs," with the board requiring that they be prepared "in a matter of weeks" so that they could be used in the sales process.

- ***Management did not believe the projections offered reliable predictions of future performance.*** Management was told that their jobs "depended on" the projections being aggressive. The board sent management "back to the drawing board" numerous times with instructions to be "more aggressive." According to testimony, the projections reflected what management viewed as "hoped for" (rather than "expected") cash flows.
- ***There was a history of management's short-term projections not accurately predicting performance.*** Even management's short-term projections, and even the "reforecasts" of those projections, frequently had "missed the mark…by large margins."

The court considers the reliability of each of the sales process and the company's projections on a continuum. We note that it would be the unusual case where the sales process or the projections are "perfect." When determining whether, and to what extent, to rely on the sales process or the projections (and thus the merger price or a DCF analysis), the court considers their reliability on a continuum and weighs how reliable one is as compared to the other. In *PetSmart*, the court viewed the sales process as very reliable and the projections as very unreliable; and found no evidence of "any confounding factors that would have caused the massive market failure—to the tune of $4.5 billion (a 45% discrepancy), that Petitioners allege occurred here."

***PetSmart* provides a roadmap for a sales process that supports an appraisal award close to the merger price.** The court characterized the PetSmart sales process as "a robust pre-signing auction in which adequately informed bidders were given every

The court viewed the auction as having produced meaningful competition even though only financial buyers submitted bids for the Company. The Petitioners argued that "the lack of strategic bidders left PetSmart at the mercy of financial sponsors and their 'LBO models.'" The court emphasized that the auction had been publicly announced and was "open to all"; that "JPM made every effort to entice potential strategic bidders and none were interested"; and that the process had been designed so that the financial bidders did not know whether they were competing against strategic buyers or not (a nd so were incentivized to provide their best offers).

The court rejected the contention that a financial buyer's price cannot reflect fair value for appraisal purposes because it is based on an "LBO pricing model." The Petitioners argued that a price derived from an LBO pricing model cannot be a reliable indicator of fair value because the model is driven by "a required internal rate of return that will always leave some portion of the company's going concern value unrealized." Vice Chancellor Laster had expressed similar skepticism of financial buyer pricing in both the *Dell* and *Lender Processing* appraisal decisions. Vice Chancellor Slights wrote in *PetSmart*: "Taken to its logical conclusion, this position…suggest[s] that all private equity bidders employing the same model (assuming they strive for the same IRR as Petitioners contend they do) should have bid the same amount for PetSmart"—which was not the case, as there was a $5 spread between the lowest final bid received and the merger price. While acknowledging that PE firms construct their bids "with desired returns in mind," the Vice Chancellor wrote: "[I]t does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the *best* indicator of fair value for the company."

Thus, to the extent that the court in any case does consider use of an LBO model as a negative factor, it is likely to be considered as just one fact among many (and would generally be of far less importance than in *Dell*, where the merger was a management buyout, in the court's view there was no countervailing evidence of the merger price being reliable, and there were numerous other significant aggravating factors). In addition, it should be possible, where appropriate, for a financial buyer to establish that its merger price did not reflect formulaic pricing, but was buyer- and/or deal-specific, reflecting variation from other financial buyers in, for example, the degree of leverage the firm could obtain or was willing to use, the exit multiples it projected, and/or what improvements it expects to make to the business. It should also be possible, where appropriate, for a financial buyer to demonstrate (as in *PetSmart*) that its winning bid was the result of a process involving meaningful competition.

The court found that the board's decision not to contact the Company's main competitor to participate in the sale process was a "reasoned decision." The Petitioners argued that the merger price was "depressed" because the Company's main competitor was not included in the auction process. Although the Company viewed Petco as the most likely strategic buyer, the board decided not to contact them to participate. The court viewed the Company as having made a "reasoned decision" that the risks of providing Petco with unfettered access to the Company's information, as well as antitrust concerns, likely "outweighed any potential reward" when Petco had not expressed any serious interest in acquiring the Company. Moreover, the court noted, the auction was public and the Company "would have been receptive to a deal with Petco if only it would have expressed a serious indication of interest" (which it never did). Also, the court noted that the bidders did not know who else was bidding.

Improved financial performance between the signing of the merger agreement and the closing typically would not affect "fair value." The appraisal statute requires that fair value be measured as of the time immediately preceding closing of the merger. As a result, post-signing, pre-closing developments can affect the determination of fair value. In *PetSmart,* after the merger agreement was signed, 4Q 2014 results suggested that the Company was outperforming the forecasts in the Management Projections. The Petitioners contended that these results indicated that the merger price, which had been agreed three months before the closing, had undervalued the Company's going concern value as of the date of the closing. However, the court rejected what it characterized as the Petitioners' argument that there had been "a turnaround miracle" between signing and closing. The court noted that the directors on the committee had testified that the 4Q 2014 results had not changed their view about the long-term prospects of the Company. The board believed the results were temporary and, the court stated, "these perceptions were borne out in 1Q 2015 during which comparable store sales dropped" and, at year end, the Company's reported comparable store sales growth was a "40% miss from the Management Projections in just the first projection year."

We note that post-signing changes that would be likely to render the merger price "stale" might be the discovery of valuable natural resources on the property or an unexpected technological breakthrough. However, short-term changes in financial performance will rarely reflect a miraculous change in the long- term value of a well-established business.

The Petitioners' argument that the improved performance post-signing supported a view that the merger price no longer reflected the Company's fair value appeared to be bolstered by the post-closing financial performance of the Company (although the post-closing period would have no legal relevance, as fair value is to be determined as of the time immediately before the merger). PetSmart's post-closing performance enabled it to declare an $800 million dividend at year-end of the year in which the merger closed (which represented a 38% return on equity to the buyer). The court noted, however, that the post- closing improvements occurred after a new CEO was installed, who "quickly brought in a new management team, changed [the] organizational structure and created a new strategy…based on his own cost and revenue initiatives." Moreover, the court noted, the Company's post-closing success was "mixed." While EBITDA increased and permitted the dividend, in both 2015 and 2016 (as of the date of trial) comparable store sales growth was "massively underperforming" the projections.

Practice Points

The decision underscores the importance of a process that, at each step, is thoughtful, careful and well-documented. The following features of the PetSmart sales process were viewed by the court as leading to a process that supported the reliability of the merger price as an indicator of "fair value":

- The Company had a reasonable basis for exploring strategic alternatives (the Company's stock had experienced a steep decline from historical levels, "the Company was unhappy, and shareholders were speaking up");
- When the Company decided to consider a sale, it engaged an independent financial advisor; and it formed a special committee of experienced directors as to whom there was no issue as to independence and disinterestedness ;
- From the outset, the board's "orientation was to view a sale of the Company not as an inevitable outcome, but rather as one of several strategic alternatives that also included remaining standalone while pursuing new revenue and cost saving initiatives or pursuing a significant leveraged recapitalization";
- The board "was prepared to walk away" from the sale process and pursue other alternatives if the price achieved in the auction was unsatisfactory (and it was "only after engaging in an analysis of all options [that] the Board conclude[d] that accepting the $83 per share offer provided the best opportunity to maximize value for PetSmart stockholders");
- If the "more active" stockholders were unhappy with the board's ultimate decision, the board was "prepared to deal with the consequences of the reaction, including to take on a proxy fight if necessary";
- The auction was "announced to the world…, so the whole universe of potential bidders was put on notice";
- The board "did not rush the sale"—with the announcement of the auction in August 2014, the Company continuing to consider strategic alternatives throughout the auction process, and the final decision to sell the Company made in December 2014, after the final bids were received;
- Although it had been determined that only financial buyers likely would be interested, in addition to contacting financial buyers, the three potential strategic buyers considered most likely to be interested (other than the Company's main competitor) were also contacted;

- The board's decision not to invite its main competitor to participate in the auction was a "reasoned decision" (based on business and antitrust concerns) and the board remained receptive to including it in the process it expressed "serious interest" in making a bid;
- Twenty-seven potential bidders were contacted; fifteen parties signed nondisclosure agreements and conducted due diligence; and management made in-person presentations to thirteen parties;
- Indications of interest were received from five bidding groups, three of which then conducted additional due diligence and received from management "further presentations" and "constant updates" regarding the Company's financials and operations (including progress on the Company's newly adopted cost-reduction program);
- There was no credible evidence presented that management, the committee, the board or JPM "colluded with" or favored any bidder at any point in the process;
- None of the bidders knew which other bidders they were competing with;
- The board received a fairness opinion from its independent financial advisor; and
- The board not only chose the highest of the final offers but succeeded in "prodding" BC Partners "to bid against its own initial final bid" and raise its price.

Importance of the overall factual context. It should be kept in mind that the outcome in an appraisal case will depend on the specific facts and circumstances of the case, as reflected in the record. In *PetSmart*, the careful work of the board and its advisors, which was well established in the record, supported the reliability of the merger price as the best indicator of fair value. Given the overall positive factual context, the court viewed the Petitioners' claims as "nitpicking." As just one example, the Petitioners argued that JPM had "manipulated its analysis" to arrive at its fairness opinion by "stretching" to reach a high weighted average cost of capital (WACC) for the Company in order to deflate the DCF results. The court acknowledged that there had been internal discussions among the JPM team about whether double-digit WACC could be defended. "But," the court wrote, "the evidence also demonstrates that JPM approached its work without preconception or designs to reach a desired result." In addition, and importantly, "JPM walked the Board through that analysis in detail," making it "no secret" how it arrived at the number it did. The court stated that "the JPM analysis was thorough and the results were objectively rendered." Another example is that, while the court viewed the Management Projections as unreliable, it was able to rely on the Company's DCF analysis as "confirmatory" of the merger price reflecting fair value because the Company's expert had adjusted the projections ("starting with" the downward sensitivities that had been prepared by JPM for the board when certain directors expressed skepticism whether management's forecasts were accurate) and had adjusted the DCF model in various ways (by discounting free cash flow by the Company's unlevered cost of equity, adding the benefit of a tax shield obtained from the Company's debt, and then subtracting the value of the debt to determine equity value).

Post-signing/pre-closing performance improvement. It is to be remembered that an appraisal is of fair value as of the time immediately prior to closing of the merger, and that post-signing/pre-closing improvements in performance arguably may reflect value that was not taken into account in the merger price. With respect to any significant developments between signing and closing, the target company should confirm and contemporaneously memorialize that they do not reflect on the company's long-term prospects. Improvements post-*closing* (which will be known at the time of trial) should be legally irrelevant, but may provide coloration. In addition, the court has permitted discovery of the company's post-closing performance to evaluate the reasonableness of the company's projections prepared pre- closing.

Banker conflicts alleged. The court characterized a number of conflicts of interest of JPM alleged by the Petitioners as "hardly striking and, in any event, [ ] fully disclosed" to the board and the committee." The court rejected the Petitioners' claim that JPM had not adequately disclosed its previous relationships with potential equity bidders. Citing testimony of a committee member, the court stated that, the board assumed that JPM, as a large institutional bank, had relationships with PE firms.