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Recent Appraisal Decision Relies Solely on Merger Price to Determine "Fair Value"—And May Suggest Greater Receptivity to Downward Adjustments to Exclude Value of Synergies — Merion v. Lender Processing

In a noteworthy appraisal decision, *Merion Capital v. Lender Processing Services, Inc.* (Dec. 16, 2016), the Delaware Court of Chancery relied entirely on the merger price to determine "fair value" and issued an appraisal award equal to the merger price.

Key Points

- **The decision confirms that an appraisal award likely will not exceed the merger price in a non-affiliated transaction where there was a pre-signing market check with "meaningful competition"—particularly if, as in *Lender Processing*, there are also additional factors supporting the reliability of the merger price as an indicator of fair value.**

- **The decision is the first in which the court has relied solely on the merger price when it has viewed *both* the merger price *and* the inputs available for a financial valuation analysis as reliable indicators of "fair value."** Previously, the court has stated that it would rely solely on the merger price only when *both* (i) the merger price was particularly reliable *and* (ii) a financial valuation would be particularly *un*reliable. In *Lender Processing*, Vice Chancellor Laster expressed a preference (when either approach would be reliable) for reliance on the merger price because of the numerous assumptions inherent in a financial analysis.

- **The decision confirms that a market check may be viewed as having included "meaningful competition" even where there was ultimately only one bidder.** The Vice Chancellor emphasized that, in the context of a pre-signing market check crafted to create competition, the "threat" of potential competition can be "meaningful competition" even if actual competition does not materialize.

- **The decision encourages respondent companies to make timely arguments, supported by a sufficient record, for the court to make *downward adjustments* to the merger price to exclude the value of expected merger-specific synergies.** The tone of the discussion on this issue in *Lender Processing* suggests that the court, when it relies on the merger price

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to determine fair value, may be more amenable than in the past to making such adjustments, despite the practical difficulties involved. We note that an increased risk of an appraisal award *below* the merger price could discourage appraisal demands in cases where there are significant expected synergies and a reasonable possibility that the court would rely on the merger price.

- **Other notable aspects of the decision** include that the Vice Chancellor (i) emphasizes the importance of the pre-signing period, as compared to a post-signing go-shop, in establishing whether there was "meaningful competition"; and (ii) reiterates his previously expressed skepticism (in *Dell*) as to whether a *financial buyer's* merger price, which is based on an "LBO pricing model," would be a reliable indicator of "fair value."

Background

Fidelity National Financial ("Fidelity") acquired Lender Processing Services, Inc. (the "company") in 2014. During the pre-signing period, a number of financial and strategic potential bidders were contacted, but only the ultimate buyer made a bid. During the post-signing go-shop period, many financial and strategic buyers were contacted, but none submitted an indication of interest. Merion Capital purchased 5.7 million shares of the Company after the merger was announced and then sought appraisal.

The merger price was $37.14. In the appraisal proceeding, the petitioner-shareholder's expert opined that fair value was $50.46 per share, based on a DCF analysis. The respondent company's expert opined that fair value was $33.57, based on a DCF analysis, and that the merger price "set a cap" on the maximum possible fair value. The court's DCF analysis (conducted as a double-check on the reliability of the merger price as a basis for "fair value") yielded a result of $38.67. The court gave "100% weight" to the merger price and determined "fair value" to be equal to the merger price.

Discussion

The court did not consider unreliability of a DCF valuation to be a prerequisite to the court's sole or primary reliance on the merger price to determine "fair value." Previously, the court has emphasized the importance of the DCF (discounted cash flow) value and has indicated that it would rely solely or primarily on the merger price when *both* (i) the merger price would be a particularly reliable indicator of fair value (due, primarily, to "meaningful competition" in the sale process) *and* (ii) a DCF (or other financial valuation analysis) would be particularly *un*reliable (for example, because the court viewed the company's projections as being unreliable). While the court may have viewed these two prongs as functional equivalents, *Lender Processing* is the first case in which the court has stated expressly that, when both the merger price and a DCF analysis would be reliable, the court will prefer reliance on the merger price. Notably, *Lender Processing* involved a very favorable fact pattern for the respondent company, with all of the factors that the court has previously indicated would militate toward reliability of the merger price present. The merger was a wholly arms-length non-affiliated transaction; there was a pre-signing market check with "meaningful competition"; the court's DCF analysis (conducted as a double-check) was close to the merger price; the merger price represented a substantial premium over the unaffected market price of the company's stock; and there was evidence of significant anticipated merger synergies, indicating that the merger price likely was even higher than "fair value."

The court may view a process as having included "meaningful competition" even if there was ultimately only one bidder. The court found that the sale process involved "meaningful competition"—even though Fidelity was ultimately the sole bidder—because the market check was crafted to create

actual competition and, when actual competition did not materialize, the process was crafted to create the "threat" of potential competition. In the pre-signing phase, the board received five unsolicited indications of interest, with three from strategic buyers (including Fidelity) and two from financial buyers. After obtaining input from its consultant, financial advisors and management, "the Board was well-positioned to solicit bids for the Company…and to evaluate those bids against other possibilities, including remaining a standalone entity." The company then contacted three additional strategic buyers. All of the potential bidders were contacted "on equal terms, and all knew that the Board was conducting a sale process and so [the potential bidders] faced the prospect of competition when formulating their offers." No strategic buyer other than Fidelity ultimately decided to bid. "Importantly, however," the court wrote, "if bidders perceive a sale process to be relatively open, then a credible threat of competition can be as effective as actual competition." The court noted that Fidelity (i) did not know that the strategic buyer that was its main competitor in the process had dropped out; (ii) knew that the merger agreement likely would contain a go-shop, which would create a path for post-signing competition by a strategic buyer; and (iii) knew that the company might reject the Fidelity bid and pursue a different alternative (as the company had rejected numerous proposals made by Fidelity in the previous years, including three premium bids made in a recent year).

The court emphasized that reliable information about the company was provided to the potential bidders. The validity of a sale process may be called into question when reliable information about the company is unavailable. The court noted a number of factors that could indicate an unreliable process in this respect, none of which it viewed as being present in this case:

- Significant regulatory uncertainty (as was the case in *DFC Global*);
- "Persistent misperceptions about the corporation's value" (as in *Dell*);
- The size of the company or the nature of its business makes it difficult to understand and assess the company (as in *Dell*);
- "Indications of irrational or exaggerated pessimism, whether driven by short-termism or otherwise, that could have anchored the price negotiations at levels below fair value" (as in *Dell*).

The court rejected the argument advanced by the dissenting shareholder that the settlement (soon before the sale process began) of regulatory investigations into the company's involvement with robo-signing, and related shareholder litigation, led to confusion about the company's value. The court acknowledged that the investigations "created a regulatory overhang," but concluded that "the settlements cleared up those issues… [and] made the Company easier to understand…." The court also noted that analysts "had established a pattern of accurately predicting the Company's performance" and that the valuation ranges generated by the company's advisors using DCF analyses "were also generally consistent with market indicators."

The court emphasized that there was no collusion or unjustified favoritism toward particular bidders. The court found an "absence of any explicit or implicit collusion, whether among bidders or between the seller and a particular bidder or subset of bidders." The court stated: "This was not an MBO." Thus, the management had no incentive to favor Fidelity over other bidders or to "deliver the Company to Fidelity at an advantageous price." The court acknowledged certain ties among Fidelity (and its co-bidder) and members of the company's board, but found that, although they "warranted close examination," they "did not compromise the sale process." The court noted that the CEO interacted with Fidelity and other

bidders in his capacity as CEO but recused himself from deliberating as a director during the sale process; another director recused himself completely; and another director participated only after the board determined that he did not have a conflict. None of the directors expected to retain their positions after the merger and all of the directors were "net sellers in the deal" and so had an incentive to maximize the value of their shares, the court stated.

The court rejected the dissenting shareholders' argument that a director with ties to Fidelity effectively set the price when, during a call, he committed to a price. The court noted that the board had the bankers "push back" on that price twice thereafter and, "more importantly," that the price that he committed to "included a portion of the synergies that Fidelity…hoped to achieve from the transaction…." Thus, even if a higher price might have been extracted in further negotiations, "the additional amount would have represented a portion of the combinatorial value of the Company to Fidelity, not increased going concern value to which the petitioners would be entitled in an appraisal," the court wrote. A merger price resulting from arms-length negotiations is a strong indication of fair value only if "accompanied by evidence tending to show that it represents the going concern value of the company rather than just the value of the company to one specific buyer," the court stated. Thus, the fact that a board has extracted the highest price a particular buyer will pay does not mean that the result constitutes "fair value" (as the court found was the case in *Dell*), and the fact that a board has failed to extract the highest price that a particular buyer will pay does not mean that the result obtained did not already exceed "fair value" (as the court found to be true in this case).

The court did not view the post-signing go-shop as supporting the reliability of the sale process. The target company conducted a go-shop for forty days after the merger agreement was signed. During the seven-month period between signing and closing, no other bidder submitted an indication of interest or made a competing proposal. The court commented that the following factors undermined the efficacy of the go-shop (and the court therefore gave it no weight):

- **In the court's view, the go-shop was not part of the bankers' plan for the sale process**, but was "a lawyer-driven add-on" to help mitigate the risk of shareholder litigation.
- **In the court's view, the "quality of the contacts" during the go-shop was "suspect."** Although there were many potential strategic and financial buyers contacted, "the bulk of those companies…already had demonstrated that they were not interested in acquiring the Company, had been ruled out by the Board and its bankers as unlikely transaction partners, or were 'the usual opportunities.'"
- **The go-shop included an unlimited match right.** While the fact that no bidders emerged during the go-shop could provide support for the proposition that the merger price equaled or exceeded fair value, here, the court found, "the most persuasive explanation is that the existence of an incumbent trade bidder holding an unlimited match right was a sufficient deterrent to prevent other parties from perceiving a realistic path to success." Given the unlimited match right, according to the court, "an overbidder could force Fidelity to pay more, but it could not ultimately prevail"—and, therefore, "it made no sense [for other bidders] to get involved."

The decision suggests potentially greater receptivity by the court to making downward adjustment of the merger price to exclude the value of merger-specific synergies. In previous cases, the court has acknowledged that, when it relies on the merger price to determine appraised fair

value, the statutory prohibition against including in "fair value" any value "arising from the merger itself" requires a downward adjustment to exclude the value of merger-specific synergies to the extent that value is reflected in the merger price. However, with only one exception (involving unique facts), the court has not made any such adjustments in any case—apparently due to the difficulty in establishing which expected synergies are merger-specific (as opposed to being part of the "inherent value" of the company as a going concern); how to value the expected synergies; and how to determine how much of that value (if any) was included in the merger price. In *Lender Processing*, however, the court strongly suggested that it would have been open to making a downward adjustment if the respondent company had argued for it during the litigation (rather than after the court had determined "fair value"). The court stated that it has not previously made such adjustments because respondent companies have rarely argued for the adjustments, and, when they have so argued, they have not produced a sufficiently supportive record to prevail.

The decision indicates the court's continued skepticism of a financial buyer's "LBO pricing model" when considering whether the merger price reflects fair value for appraisal purposes. In the 2016 *Dell* appraisal decision, Vice Chancellor Laster expressed skepticism that a financial buyer's merger price would be as reliable as a strategic buyer's price as a basis for determining fair value. The court reasoned that a financial buyer's "LBO pricing model" solves for what a buyer is willing to pay (determined by the requirements that financial buyers have for a certain rate of return and for sufficient leverage capacity to support financing of the transaction), rather than what the company's fair value is. The Vice Chancellor's reiteration of that discussion in *Lender Processing* reduces the likelihood that the skepticism expressed in *Dell* was intended to be limited to a situation (like *Dell*) involving a management buyout (and not intended to extend to all financial buyer situations). We continue to believe, however, that, even in the non-MBO context, when the court considers use of an LBO pricing model as a negative factor, it is likely to be considered as just one factor among many—and would generally be of far less importance than in *Dell*, where, in the court's view, there was no countervailing evidence of the merger price being reliable (as well as numerous other significant aggravating factors). Further, in our view, 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 that its winning bid was the result of a process involving meaning competition.

Notably, in *Dell*, there was almost no variation because all of the financial buyers that considered a potential transaction intended simply to execute the company's existing plan and not to add value. Further, the very large gap in *Dell* between the stock market price and management's view of going concern value (which provided the opportunity for a deal at a price far below the DCF-based price) is rare—and, as the court noted, it "anchored" the deal price to a low number. In most cases, so long as there is actual or perceived competition, a buyer whose LBO model-driven price is far below going concern value simply would not submit a bid, as it would be unlikely to be successful. Certainly, in the context of an adequate sale process, where there is actual, or a realistic potential for, competition by strategic buyers, and there is no evidence of self-interested reasons for choosing a financial buyer, the court should view a financial buyer's price as a reliable indicator of fair value.

Practice Points

Based on *Lender Processing* and other recent appraisal decisions:

- **A respondent company should argue that, if the court determines to rely on the merger price to determine fair value, the court should make a downward adjustment to exclude the value of merger-specific synergies.** A record should be established as to what synergies arise from the merger (and would not be achieved by the company on a standalone basis nor are part of what the court may view as the "inherent value" of the company); how the synergies are valued; and the extent to which their value was included in the merger price. The arguments for adjustment should *not* be made "post-trial" (as they were in *Lender Processing*). We note that, even in financial buyer situations, there may be merger synergies that are excludable from the merger price (for instance, if the buyer intends to combine the company with another portfolio company, making the deal more strategic).

- **The following factors may undermine the reliability of the merger price, in the court's view, as an indicator of "fair value," even in non-"interested" transactions:**

  - The process was not designed to create actual competition, including both financial and strategic buyers—or, if actual competition did not materialize, the process going forward was not crafted to create the "threat" of competition (which can be fostered, for example, by not letting bidders know when other potential bidders drop out of the process);

  - The timing of the purchase was particularly opportune, permitting the buyer to take advantage of temporary weakness in the company's valuation;

  - The target company favored a particular buyer or subset of buyers for reasons of self-interest (as, for example, may occur in the case of a management buyout);

  - The only solicitation occurred in the post-signing go-shop period; the go-shop was "window dressing" and not part of the strategy to maximize value; and/or the terms of the go-shop undermined its effectiveness (such as by providing an unreasonable termination fee or unreasonable matching right);

  - Valuation of the company was especially problematic (for example, due to extreme uncertainty about the company's future or due to there being very few possible buyers given the company's extremely large size);

  - Post-announcement, pre-closing developments significantly affected the value of the company (note that "fair value" is decided as of the date the merger closes, not as of the date it is announced); or,

  - As a practical matter (although not legally relevant), *post*-closing developments suggest that the merger price severely undervalued the company.

- **The following factors may undermine the reliability, in the court's view, of a DCF analysis:**
  - The target company's projections were not prepared in the ordinary course of business, were modeled to be aggressively optimistic or pessimistic, or otherwise may not reflect the management's best view of the company's future;
  - There was unusual, extreme uncertainty regarding the company's future; and/or
  - The company has a poor historical track record of being able to project its performance accurately.
- **In a financial buyer situation, the respondent company should seek to establish a record to overcome the court's skepticism as to whether an "LBO pricing model" reflects fair value.** The company should seek to establish to what extent the financial buyer's price was based on deal-specific and buyer-specific factors (rather than standard IRR targets)—such as the buyer's unique leverage or risk profile or non-standard IRR target; the exit multiples it projects; and how it intends to add value to the company.
- **It should be kept in mind that appraisal cases are particularly facts and circumstances sensitive.** While we have identified what we view as the particularly salient variables, the outcome of any given appraisal case will depend on the specific facts and circumstances of the case.

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