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

Risk Of 'Below Deal Price' Appraisal Post-Dell: Part 1

By **Gail Weinstein, Steven Epstein, Robert Schwenkel and Brian Mangino**
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Gail Weinstein


Steven Epstein


Robert Schwenkel


Brian Mangino

Since the Delaware Supreme Court issued its landmark Dell appraisal decision in December 2017, the Delaware courts have issued three appraisal decisions — Verition Partners v. Aruba Networks on Feb. 15, In re Appraisal of AOL Inc. on Feb. 23, and In re Appraisal of SWS Group, affirmed by the Delaware Supreme Court on Feb. 23. In Dell, the Supreme Court held that, in the case of an arm's-length merger with a "robust" sale process, the deal price is generally the best "proxy" for appraised fair value and should be given "heavy, if not determinative weight" in determining fair value. The Supreme Court also directed that, even if the deal price were not fully reliable for determining fair value (for example, because the sale process was not fully robust), the Court of Chancery still should consider the deal price and accord it an appropriate weight. However, in Aruba and AOL, as well as previously in SWS, the Court of Chancery ascribed zero weight to the deal price and determined that fair value was below the deal price.

In the first part of this article, we outline and discuss the key points arising from these post-Dell decisions, review the background of the decisions, and offer related practice points.

Key Points

Aruba, AOL and SWS indicate that there is now a meaningful risk of a below-the-deal-price appraisal result in most cases involving arm's-length mergers.

These decisions indicate that a below-the-deal-price result may be reached, in the context of an arm's-length merger case, whether the court deems the sale process to have been fully robust (as in Aruba) or not (as in AOL and SWS). However, the court is likely to continue to reach above-the-deal-price results in arm's-length merger cases involving a seriously flawed sale process (as well as in non-arm's-length merger cases — such as controller transactions, squeeze-outs and certain management buyouts).

A below-the-deal-price result leads to an actual economic loss for the appraisal claimants.

In recent years, appraisal claimants had a realistic worst-case scenario of an at-the-deal-price appraisal result, which meant that no return would be achieved on the "investment" in the appraisal action (and, with the high rate of statutory interest payable on an award even at the deal price, costs of the action typically would be recouped). Appraisal claimants also had a realistic expectation of extracting a quick settlement. Now, however, the new trend of below-the-deal-price results in arm's-length merger cases creates a meaningful risk of a potentially significant loss from seeking appraisal (as compared to having taken the merger consideration) — which, no doubt, will accelerate the trend already underway of appraisal claims becoming rarer in the context of arm's-length mergers.

Likelihood of appeals.

Given the inconsistency of the approaches taken in Aruba and AOL with the directional approach prescribed in Dell, it is unclear whether the other members of the Court of Chancery will follow these decisions, and it seems likely that they will be appealed and may not be upheld. Nonetheless, given the new, strong focus in the opinions on the statutory mandate to exclude the value of merger synergies in the context of reliance on either the deal price or a discounted cash flow analysis, we expect that the risk of below-the-deal-price results in arm's-length merger cases (without serious sale process flaws) is likely to continue absent further clarification from the Supreme Court or legislative change. It should be noted, however, that if below-the-deal-price results in arm's-length merger cases do not continue, the results likely would be at the deal price instead — which would in any event continue to discourage appraisal claims in this type of cases.

Background

Aruba

Hewlett-Packard Co. acquired Aruba Networks Inc. in an arm's-length cash transaction. The deal price represented an almost 49 percent premium to Aruba's 30-day average unaffected market price. With 81 percent of the outstanding shares voting, the merger was approved by a 98 percent vote. Vice Chancellor J. Travis Laster relied solely on the unaffected market price (a metric never before used to determine fair value for appraisal purposes) and determined fair value to be about 31 percent below the deal price.

AOL

Verizon Communications Inc. acquired AOL Inc. in an arm's-length tender offer followed by a cash merger. More than 60 percent of the outstanding shares were tendered. Vice Chancellor Sam Glasscock relied solely on a DCF analysis (after finding that the sale process was not sufficiently robust for full reliance on the deal price — although, we note, that the process apparently was far more robust than the process in Aruba). The DCF result was about 3 percent below the deal price (and the vice chancellor stated that he would have had to "revisit [his] assumptions" if the DCF result had "grossly deviated" from the deal price). The vice chancellor attributed the below-the-deal-price result to the fact that the DCF methodology does not take into account the value of merger synergies. (The vice chancellor stated in a footnote that he had not considered the unaffected market price as the parties had not argued for reliance on it.)

SWS

Hilltop Holdings Inc., a substantial creditor of SWS Group Inc., acquired SWS in a cash-and-stock merger. Although SWS was sold in a public auction, Vice Chancellor Glasscock held that the deal price was not a reliable indicator of fair value, primarily because of the "probable influence" of the veto power that the buyer, under its credit agreement with SWS, had over competing bids. Relying solely on a DCF analysis, the vice chancellor determined fair value to be about 19 percent below the deal price as valued at the time the deal was announced (and appraisal arbitrageurs bought up approximately 15 percent of the company's shares) and 9 percent below at closing. The vice chancellor attributed the below-the-deal-price result to the fact that merger synergies are not taken into account in a DCF analysis.

Discussion

Aruba and AOL appear to reject (or at least to substantially call into question) the directional approach — set by the Court of Chancery in recent years and strongly endorsed by the Delaware Supreme Court in Dell — for reliance on the deal price itself in the context of an arm's-length merger with a robust sale process. While the Aruba and AOL opinions were framed as being consistent with Dell, they appear to have rejected what, by our reading, was the essential thrust of Dell that, in the context of an arm's-length merger: (a) the most reliable factor in determining fair value is the deal price itself (absent a nonrobust sale process, misconduct or highly unusual circumstances); (b) even when the sale process is not fully robust, the court should rely on the deal price to some extent; and (c) the DCF methodology is inherently unreliable for appraisal purposes and is generally not preferable to reliable market-based factors.

In Aruba, Vice Chancellor Laster found that the sale process was robust but relied solely on the unaffected market price to determine fair value. The vice chancellor reasoned that the two reliable factors for determining fair value were (1) the "deal-price-less-synergies" (rather than the deal price itself, which ignored the statutory mandate to exclude value arising from the merger itself) and (2) the unaffected market price. He viewed the latter as more reliable because it better comports with (a) the Supreme Court's emphasis in Dell on the efficient market hypothesis (given that the unaffected market price reflects the "consensus view" of the "mass of market investors" rather than the view of a single buyer) and (b) the statutory mandate to exclude any value arising from the merger itself (given that the unaffected market price automatically excludes such value, without any of the "uncertainty," "judgments," and potential for "human error" involved in a downward adjustment to the deal price to exclude it).

In AOL, Vice Chancellor Glasscock found that the sale process was not sufficiently robust to support full reliance on the deal price (although, we note, the process appeared to be far more robust than the process in Aruba or many other cases in which the court has relied on the deal price) and relied solely on a DCF analysis. The vice chancellor stated that there was no "principled way" that he could ascribe any weight to the deal price once it could not be relied on fully.

The trend of below-the-deal-price results in arm's-length merger cases (whether the court relies on the deal price or a DCF analysis) is based primarily on a new focus on the statutory mandate to exclude value arising from the merger itself. As noted, the Delaware appraisal statute states that "fair value" for appraisal purposes excludes any value arising from the merger itself. Historically, the Court of Chancery, when relying on the deal price, has acknowledged the statutory mandate but has not made any downward adjustment to exclude the value of merger synergies or other value arising from the merger itself. The court has cited the practical difficulties involved in calculating an adjustment to satisfy the statutory mandate, given the uncertainty as to how to value the expected synergies and how to determine to what extent that value was reflected in the deal price. Notably, the Supreme Court, in Dell,

also acknowledged the statutory mandate but did not make any adjustment to the deal price to exclude the value of merger synergies.

By contrast, in Aruba, where the parties addressed the statutory mandate in their briefs to the court, Vice Chancellor Laster held that the deal price with a downward adjustment to exclude the value of merger synergies (not the deal price itself) would be a reliable measure of fair value (although he chose to rely on the unaffected market price, finding it more reliable as it avoided the uncertainties involved in calculating the adjustment). Moreover, in AOL and SWS, although the court relied in these cases on a DCF analysis, the court attributed the below-the-deal-price results to the fact that the DCF methodology (on which the court relied) automatically excludes the value of merger synergies, while the deal price typically includes some portion of that value.

The appraisal result may, however, still be above the deal price in some arm's-length merger cases. Given the new emphasis by practitioners and the Court of Chancery on the statutory mandate to exclude value arising from the merger itself, we expect that, absent legislative change with respect to the mandate or clarification by the Supreme Court, below-the-deal-price results will continue to be seen in arm's-length merger cases — whether the court (a) views the sale process as having been robust (and thus relies on the deal-price-less-synergies) (or even if the court relies on the unaffected market price) or (b) views the sale process as not having been robust (and thus relies on a DCF analysis).

We note that the below-the-deal-price result in the case of (b) is potentially "incongruous" (as Vice Chancellor Glasscock characterized the result in AOL) — because, intuitively, an appraisal result should be higher than a deal price that resulted from a deficient sale process. For this reason, when the court relies on a DCF analysis due to the sale process for an arm's-length merger having been less than fully robust (but not seriously flawed), we expect that the result typically will be reasonably close to the deal price (as it was in AOL); however, we expect that, when the court views the sale process as having been seriously flawed, the appraisal result may well be above (even significantly above) the deal price. Importantly, the DCF methodology can produce a very wide range of results depending on the inputs selected — and should produce a result above the deal price if the deal price undervalues the company by more than the value of the merger synergies, which the DCF methodology excludes. (The variability of possible DCF results also explains why appraisal results in non-arm's-length merger cases generally would be above the deal price, notwithstanding that the deal may be synergistic and the DCF methodology would not take the synergies value into account.)

In the second part of this article, we discuss whether Aruba indicates that reliance on the unaffected market price or the deal-price-less-synergies is likely to replace reliance on the deal price itself, as apparently prescribed by Dell; the standard for "robust"-ness of the sale process that was applied in AOL; and how SWS stands apart from the other two decisions and offers a different lesson.

Practice Points

Settlement discussions. Parties involved in pending appraisal cases should consider whether it is now a favorable time to try to settle the case, prior to possible review of Aruba and/or AOL by the Delaware Supreme Court.

Appraisal claimants. Parties considering whether to make appraisal claims should consider that, in the case of an arm's-length merger, based on Dell, Aruba, AOL and SWS, there is a high likelihood of an appraisal result either at or below the deal price. In addition, potential claimants should recognize that, although they may view a transaction as not having been at arm's-length or as not having involved a

robust sale process (and that, therefore, they may expect that the court would determine fair value based on a DCF analysis, with the potential for an above-the-merger-price result), (a) it is not entirely predictable what the court's view of the nature of the transaction and the sale process will be and (b) in any event, there is now a significant risk that a DCF result may be below (rather than above) the deal price.

Finally, claimants and respondents should consider the new explication of appraisal by Vice Chancellor Laster in Aruba as being a process designed not to ensure that dissenters receive the best price but only that they were not "exploited" — and that a premium above market price could indicate that they were not exploited.

Valuations. A respondent company should argue for reliance on (1) the deal price, with a downward adjustment to exclude value arising from the merger itself, and (2) the unaffected market price. Respondents should argue that any DCF result that is significantly above the deal price likely overstates fair value for appraisal purposes, as the DCF methodology excludes the value of merger synergies and the value "created by the buyer in reducing agency costs." Respondents should emphasize the skepticism relating to the DCF methodology for appraisal purposes that the Supreme Court expressed in Dell and DFC Global and that the Court of Chancery expressed in a number of pre-Dell decisions. A respondent should maintain an adequate record with respect to the buyer's anticipated synergies and negotiations with respect to sharing the value of synergies with the target stockholders. Petitioners should consider whether there are "negative synergies" (i.e., costs of the merger) that might mitigate any downward adjustment of the deal price. As fair value is measured as of the time immediately preceding the merger closing, petitioners and respondents should consider whether there were positive or negative developments at the target company between signing and closing that affect fair value.

DCF analyses. First, based on the courts' recent skepticism about DCF results that diverge widely from the deal price, a petitioner should consider presenting a DCF result that is not significantly above the deal price; and a respondent should consider whether its below-the-deal-price DCF result is consistent with an exclusion of the value of the expected synergies (and consistent with the DCF value ranges produced by the target's bankers in connection with their fairness opinion). Second, as discussed, it is to be emphasized that a DCF analysis is susceptible to widely varying results and that, when the court relies on a DCF analysis, the result could be above or below the deal price. We expect that, generally, in the context of an arm's-length merger, the court's DCF result is likely to be significantly above the deal price only when there is strong evidence of a seriously flawed sale process (or of highly unusual circumstances or misconduct). In this connection, while the proxy statement description of the sale process is available before the stockholder vote, detailed information about the sale process typically is not obtainable until after the deadline for filing an appraisal petition and even until after the deadline for withdrawing an appraisal petition without the respondent's consent.

Market inefficiency. Based on Dell, in the context of an arm's-length merger, the sole potential route to nonreliance on the deal price based on market inefficiency is the petitioner's establishing the unavailability to the market of information that typically is available for public companies that are widely held, traded and followed in the market. Thus, for example, an argument for market inefficiency could be successful if a private company is involved, there are few stockholders or limited trading, the company is not generally followed by analysts, the company is late in making public filings, or the company has withheld or misstated material information. Otherwise, the court generally would be unlikely to conclude that the deal price was unreliable based on factors such as a trough in the target company's market price, an inopportune time to sell, significant uncertainty as to prospects, and the like.

Gail Weinstein is a senior counsel at Fried Frank Harris Shriver & Jacobson LLP in the firm's New York office. Steven Epstein and Robert C. Schwenkel are partners in the firm's New York office. Brian T. Mangino is a partner in the firm's Washington, D.C., office.

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