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Risk Of 'Below Deal Price' Appraisal Post-Dell: Part 2

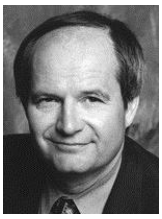
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In the first part of this article, we discussed the key points arising from three post-Dell appraisal decisions — Verition Partners v. Aruba Networks on Feb. 15, In re Appraisal of AOL Inc. on Feb. 23, and In re Appraisal of SWS Group, affirmed by the Delaware Supreme Court on Feb. 23, reviewed the background of the decisions, and offered related practice points. In part two, we analyze whether Aruba indicates that reliance on the unaffected market price or on 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.

It is unlikely that the unaffected market price will replace the deal price (or deal-price-less-synergies) as the most reliable indicator of fair value in arm's-length merger cases.

Vice Chancellor J. Travis Laster stated in Aruba that the Delaware Supreme Court, in Dell, had "endorsed" reliance on both the deal price and the unaffected market price. The vice chancellor concluded that the unaffected market price was the more reliable of the two because (1) it better comports with the efficient market hypothesis championed by the Supreme Court in Dell (as it reflects the "consensus view" of the "mass of market investors" rather than the view of a single buyer); and (2) it avoids the "uncertainty," "judgments," and potential for "human error" involved in calculating a deduction from the deal price for value arising from the merger itself (such as merger synergies and the value "created by the buyer in reducing agency costs").

We note, first, that the unaffected market price has never before been used to determine fair value in appraisal cases. Second, the Supreme Court's commentary in Dell relating to reliance on the unaffected market price was primarily directed at refuting the Dell petitioners' argument that there had been a significant gap between the market's and management's view of the value of Dell, which had "anchored" the deal price to the "artificially low" market price of the stock. The Supreme Court rejected the concept of a "valuation gap" based on its confidence in the efficient market hypothesis (i.e., the capability of the market to take all factors into account). While the Supreme Court mentioned that the unaffected market price is "likely a possible proxy for fair value," the clear thrust of the opinion is that, in the context of an arm's-length merger with a robust

sale process, the deal price is the best proxy for fair value.

Third, we note that the unaffected market price arguably reflects an inherent minority discount (attributable to the noncontrol status of shares trading in the market). It is well-established under the common law that the dissenting stockholders are entitled to their proportionate share of the going concern value of the company as a whole and that, therefore, fair value is to be determined exclusive of any minority discount. Presumably, an upward adjustment to the unaffected market price to take into account the minority discount would be as fraught with "uncertainty," "judgments" and the potential for "human error" as a downward adjustment to the deal price to exclude value arising from the merger itself. Finally, we note the difficulty in determining the unaffected market price itself — as what the appropriate reference date (the day preceding the merger announcement or preceding the beginning of market rumors?) or period (the 30-day average, as was used in Aruba?) is, in each case, will depend on the specific facts and circumstances and will involve a subjective judgment.

It remains uncertain whether the court, when it determines to rely on the deal price to determine fair value, will now make a downward adjustment to exclude value arising from the merger itself.

As noted, the Delaware Court of Chancery almost invariably has not made any downward adjustment to the deal price based on the statutory mandate — and the Supreme Court in Dell did not direct that the Court of Chancery do so, did not itself make an adjustment to the Dell deal price, and did not provide guidance as to how an adjustment would be made. Rather, the Supreme Court appeared to emphasize that the deal price itself is the best proxy for fair value (in what we would call a rough justice kind of way). However, as discussed in part one of this article, Aruba — and, to a lesser extent, AOL and a number of pre-Dell Court of Chancery appraisal decisions — indicate that practitioners and the Court of Chancery are now more focused on the statutory mandate. Based on this increased focus, and the results in this trio of post-Dell cases, we believe that there is a significantly greater likelihood of below-the-deal-price results going forward. As noted in part one of this article, the difference between an appraisal result at the deal price and one below it is the difference between the appraisal claimant achieving no return from the appraisal action versus realizing an actual economic loss (either of which discourages appraisal claims).

Aruba represents one of the few times that the court has actually calculated an adjustment to exclude value arising from the merger itself based on the statutory mandate.

Vice Chancellor Laster used the buyer's planning estimates for the value of all revenue and cost synergies — that is, (a) he did not distinguish between synergies that arose from the merger itself and those that could be characterized as not arising from the merger itself because they could be achieved in any merger or by the company on a stand-alone basis, and (b) he did not undertake a judicial valuation of the synergies but accepted the buyer's view of value. To determine to what extent the synergies value had been reflected in the deal price, the vice chancellor took the midpoint of data that a study of deals (presented by the respondent) indicated as the percentage of expected merger synergies that targets had "extracted" from buyers to be shared with the target stockholders.

The vice chancellor noted that, even with the exclusion of merger synergies from the deal price, the statutory mandate still was not satisfied as the deal price would also include "value created by the buyer in reducing agency costs" (in other words, as we read it, the amount of the control premium attributable to obtaining sufficient shares for control, or, put another way, the portion of the control premium beyond the value of merger synergies). We note that the reduction-in-agency-costs amount is so uncertain that the vice chancellor did not attempt to calculate it — and the court has not before even

mentioned it as value to be excluded based on the statutory mandate even though it clearly arises from the merger itself.

Although Vice Chancellor Laster took a relatively broad-brush approach to calculating the "deal-price-less-synergies" amount, the calculated amount will almost invariably still understate the adjustment that would fully satisfy the statutory mandate, because it does not exclude the control premium-related value beyond the synergies value. As appraisal actions involving arm's-length mergers are likely to become increasingly rare, the issues relating to the statutory mandate may effectively become moot, without resolution by the court.

What constitutes a "robust" sale process for appraisal purposes?

As discussed in part one, if the court views the sale process as having been sufficiently robust, the court may rely (a) on the deal price — in which case the result will be equal to the deal price (in accordance with Dell), or below the deal price (if a downward adjustment is made based on the statutory mandate to exclude value arising from the merger itself) (as the court related in Aruba); or (b) possibly, on the unaffected market price — in which case fair value will be below the deal price (in accordance with Aruba).

If the court views the sale process as not sufficiently robust for reliance on "market-based" factors, then the court generally will rely on a discounted cash flow analysis — in which case fair value could be above or below the deal price. We note that there is a significant degree of subjectivity in any determination as to whether a particular process was "sufficiently robust" for reliance on the deal price — a challenge that the Delaware Supreme Court underscored in Dell as one of the several reasons why the Supreme Court declined to adopt a formal judicial presumption that "deal price" was the best indicator of fair value.

While the Court of Chancery has emphasized "meaningful competition" in the sale process, it has found the deal price to be fully reliable even in the context of some quite limited sale processes (including where there was not any actual competition so long as the sale process was designed to promote or not be prohibitive of competition). Consistent with this approach, in Aruba, Vice Chancellor Laster found the targeted, nonpublic sale process there, with no competing bidder, to have been sufficiently robust. Six parties (all of them strategic buyers) were contacted presigning and none expressed any interest; the merger agreement prohibited a post-signing go-shop (although there was a fiduciary out and a nonprohibitive termination fee in the event of a superior offer); HP's internal analyses estimated the pro forma value of Aruba to be potentially as high as $32.50 per share, based on expected synergies from the merger, while the deal price was $24.65; the negotiations were conducted against a backdrop of conflicts of interest involving Aruba's management and bankers (as, the court found, HP had engaged the CEO in discussions about post-merger employment and the bankers likely were currying favor with HP for future business); and the stock was experiencing a 52-week low (according to Aruba's bankers, due to a "misperception in the market" that the company was going to miss quarterly estimates, which the company actually was on track to meet and then did meet).

Importantly, however, Vice Chancellor Laster stated that the purpose of appraisal is not to ensure that dissenting stockholders receive the best price that would have been obtainable in the merger — in other words, "robust" does not necessarily suggest a Revlon-like standard. Rather, Vice Chancellor Laster stated, the purpose of appraisal is only to ensure that the stockholders were not "exploited" in the merger — and the significant premium of the Aruba deal price over the unaffected market price established that the stockholders had not been exploited.

By contrast, in AOL, Vice Chancellor Glasscock found that the AOL sale process was not sufficient to support reliance on the deal price (other than as a "check" on the DCF result). Vice Chancellor Glasscock compared the sale process to the process in Dell and found it less robust (although the court did not address that the process was apparently more robust than the process in Aruba and other decisions where the court has relied solely on the deal price). Although AOL declined to conduct a formal auction, the vice chancellor concluded that it was widely known in the market that AOL was considering a sale, and that, pre-signing, AOL had contacted "numerous" strategic and financial potential buyers and had "engaged with anyone that indicated a serious interest in doing a deal."

In finding the sale process not reliable, the vice chancellor emphasized the comments made by AOL's CEO, after signing, which the court characterized as "unusually preclusive" in their likely effect on the emergence of potential topping bids. The CEO's statements were to the effect that "the deal was 'done,'" that a deal with Verizon was the culmination of "a natural process" for AOL, that AOL was fully "committed" to the deal, and that AOL "intended to see [the deal] to closing." The vice chancellor reasoned that, although the AOL directors had "fulfilled their fiduciary duties," because of the CEO's statements — combined with the CEO's "prospect of post-closing employment" that the CEO had discussed with Verizon (as well as the post-signing prohibition on a go-shop, the "unlimited three-day matching rights" for unsolicited superior offers, and "the fact that Verizon "already had ninety days between expressing interest in acquiring the entire company and signing the Merger Agreement, including seventy-one days of data room access") — the court "[could] not be assured that a less restrictive environment was unlikely to have resulted in a higher price for AOL." Arguably, the CEO's statements were not substantially different from the types of statements that parties often make after signing with respect to their commitment to the deal. We also note that, unlike Vice Chancellor Laster's approach in Aruba, Vice Chancellor Glasscock's focus on whether a higher price might have been obtained suggests a Revlon-like approach to robustness for appraisal purposes.

The lesson from SWS.

SWS involved an arm's-length merger and a sale process that included a number of competing bids. However, Vice Chancellor Glasscock relied on a DCF analysis because he viewed the sale process as likely having been "influenced" by the unusual circumstance that the third-party buyer had effective veto power over competing bids. In that respect, the decision is not inconsistent with Dell, which prescribed reliance on the deal price only in arm's-length mergers with a robust sale process. What appears to be anomalous, however, is that the court's DCF result was significantly below fair value when the sale process was apparently significantly flawed (indeed, one could argue, that a buyer with a veto power is effectively like a controller). As we read the opinion, the incongruous result of a significantly below-the-deal-price determination of fair value may be explained by the fact that the court seemed to be not fully convinced that the buyer's veto power actually negatively affected the sale process. As discussed, in most cases where the sale process was significantly deficient, we expect that the court would find fair value to be above the deal price. SWS highlights, however, the possibility in any highly synergistic case that the court's DCF result could be significantly below the deal price.

In Aruba, Vice Chancellor Laster reasoned that, although the sale process was robust and the deal price was reliable, the unaffected market price was a more reliable indicator of fair value 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 that any value arising from the merger itself be excluded (given that the unaffected market price does not include such value, without any of the

"uncertainty," "judgements," and potential for "human error" involved in a downward adjustment to the deal price to exclude such value). In AOL, Vice Chancellor Glasscock relied solely on a DCF analysis and found fair value to be below the deal price. The vice chancellor found the sale process to be not sufficiently robust to support full reliance on the deal price (although the sale 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, further, the vice chancellor stated that there was no "principled" way to ascribe any weight to the deal price once it could not be relied on fully.

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