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The Changing Landscape of Delaware Appraisal Rights

BY GARDNER DAVIS AND JOHN WOLFEL

Appraisal rights historically have been a sleepy backwater of Delaware corporate jurisprudence with little practical impact on M&A transactions. Stockholders traditionally did not exercise appraisal rights because of the delay, expense and uncertainty inherent in the litigation. Recently, however, Delaware courts have been flooded with appraisal litigation. The Delaware courts and legislature have responded with a series of rulings and statutory amendments which should make appraisal less attractive to speculators and return these actions to more traditional levels.

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Appraisal rights, also known as dissenter's rights, are a statutory right available to a stockholder who objects to a cash-out merger, to require the corporation to purchase their shares for fair value, as determined by the Chancery Court. In determining fair value, the court must take into account all relevant factors. (*See Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-713 (Del. 1983); *Owen v. Cannon*, 2015 WL 3819201 (Del. Ch. June 17, 2015).)

Stockholders are generally entitled to interest on an appraisal award at a rate equal to the Federal Reserve discount rate plus 5% (compounded quarterly) from the date of the merger until the day of payment. (DGCL Section 262(h).) This interest is paid regardless of whether the final appraised value exceeds the deal price.

Appraisal was intended to be remedial in nature, to balance majority stockholder rule against the need to protect the minority stockholder forced to sell shares in a transaction he or she deemed unfair. The dissenting stockholder is compensated for the intrinsic value of what is taken in the merger. Therefore, the value of the stock is determined on a going-concern basis without consideration of any benefits that result from the merger or any minority or illiquidity discounts.

Unlike traditional lawsuits, the burden of proof is not specifically allocated to a party – rather the Chancery Court, via statute, has the duty to determine the fair value of the shares. Therefore, both sides ultimately bear the burden of establishing fair value by a preponderance of the evidence. (*Laidler v. Hesco Bastion Envtl*, 2014 WL 1877536 at * 6 (Del Ch. May 12, 2014).) Furthermore, the Chancery Court places substantial weight on discounted cash flow analysis as the most reliable indicator of going-concern value. (*In re PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017); *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del Ch. Apr. 30, 2015).)

In the past few years, sophisticated investors, including hedge funds, developed an arbitrage strategy of buying a target company's stock after the merger is announced and bringing an appraisal action contending the fair value of their shares based on discounted cash flow or other valuation methodologies exceeds the deal price.

The fundamental disconnect fueling the current wave of appraisal litigation is that the theoretical valuation derived from a discounted cash flow analysis is separate and usually greater than ''fair market value'' – the price at which M&A buyers and sellers with reasonable knowledge of pertinent facts and not acting under any compulsion are willing to do a deal. Most M&A transactions require a price which represents a premium over the trading price in the stock market but which also leaves the buyer with some potential upside.

An investor presumably will not undertake a new capital project if the return on a present value basis is only equal to the cost. Similarly, a potential buyer will not make a bid for a target company if the discounted cash flow generated from the acquisition is only equal to the deal price. In both cases, the investor wants to make a profit.

A second disconnect is the concept that fair value can be distilled into a precise number. Many believe the final deal price, representing the collective view of sophisticated potential buyers with adequate information, must equal the exact fair value of the company. However, M&A professionals understand that the sale of every company involves a substantial amount of good or bad luck. Therefore, it is more appropriate to view fair value as a range rather than a precise number. Accordingly, the deal price, following a robust sale process, is only a reliable indicator of fair value, not necessarily the exact fair value number.

The Delaware courts' historical reliance on discounted cash flow for purposes of appraisal rights resulted in a classic market failure, similar to the ''free rider'' problem – so long as a majority of target stockholders will approve a deal, the holdouts can capture an additional, above-market profit by pursuing appraisal remedy.

In today's M&A environment, the arbitrage investors purchase their shares after the deal is announced. The stockholders selling their shares to the arbitragers generally accept a discount from the deal price, thereby suggesting the selling stockholders liked the deal price and otherwise would have voted to approve the merger.

From the potential M&A buyer's perspective, the trade-off between deal price paid to stockholders in a merger and the price paid to arbitragers in an appraisal lawsuit is a zero-sum game. The buyer has a finite amount to invest in the deal. The buyer must reduce its highest offer to target stockholders to compensate for the substantial transaction costs resulting from appraisal claims.

To compound the problem, discounted cash flow models are only as good as their inputs. Small changes in assumptions frequently result in large changes in value. In appraisal litigation, the Chancery Court is confronted with a ''battle of the experts'' presenting conflicting valuation theories and methodologies. It would stand the reasoning behind the business judgment rule on its head to suggest the Chancery Court is better equipped than the target board and the capital market following a robust, arm's length sale process to make decisions about value.

Therefore, prior to recent developments, the appraisal arbitrage strategy resembled buying a lottery ticket with a guaranteed minimum payout equal to the purchase price plus interest. Companies have a substantial incentive to settle by offering the dissenting stockholders a premium because of the cost of litigating the suits and the unpredictability of the Chancery Court's ruling based on complex and conflicting valuation testimony from expert witnesses. A recent study estimates that appraisal litigation is currently pursued in 25% of the eligible deals – and 80% of such cases settled. (Jiang, Li, Mei and Thomas, ''*Appraisal: Shareholder Remedy or Litigation Arbitrage?*'' 59 J. L. & ECON. 697 (Aug. 2016).)

A growing number of critics have expressed alarm regarding the subversion of legislative purpose and the uncertainty and deal risks created by buyers not knowing what they will have to pay. They claim arbitrage investors are inequitably extracting rents from target stockholders.

On the other hand, proponents of appraisal arbitrage, generally aligned with the hedge fund investors, describe appraisal rights as a tool to protect the value of their investment against unfair or simply ill-timed bids. Of course, the counter-argument might be that the stockholder at the time of the alleged unfair bid liked the deal price enough to sell to the arbitrage investor at a lower price. The arbitrage investor was never being oppressed but rather bought the stock after the deal was announced. Moreover, appraisal arbitrage is not limited to situations involving deficiencies in the market process. Now, many appraisal proceedings arise from cash-out mergers following robust, open and arm's length sale process.

The current appraisal arbitrage boom relates back to the Delaware Chancery Court's 2007 *Transkaryotic* decision, which permitted investors that buy target shares held in street name by Cede & Co. after the record date and pursue appraisal rights so long as the aggregate number of shares for which appraisal is being sought is less than the number of shares that either voted no on the merger or did not did not vote at all. (*In re Appraisal of Transkaryotic Therapies*, 2007 WL 1378345 (Del. Ch. 2007); *see also In re Appraisal of Ancestry.com, Inc.*, 2015 WL 66825 (Del Ch. 2015).) After Transkaryotic, arbitrage investors did not need to establish that their specific shares had either voted against the transaction or not voted at all – elements traditionally required for an appraisal claim.

With 20-20 hindsight, *Transkaryotic* facilitated champerty – the selling of a cause of action to a stranger to the situation — a practice illegal at common law. This approach is directly contrary to the Delaware law in the stockholder derivative action context, where the stock-

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holder must have owned the stock at the time the alleged injury occurred. The long-term stockholder, who believes that she is genuinely injured by sale of the company for less than fair value, is the intended beneficiary of the appraisal remedy.

Prior to 2010, the Delaware courts generally considered the deal price in an arm's length transaction free of conflicts to be indicative of fair value. However, the Delaware Supreme Court's 2010 opinion in *Golden Telecom* rejected deference to the merger price, finding that such deference was contrary to the clear language of the statute and inappropriately shifted responsibility to determine fair value from the court to the private parties. (*Golden Telecom, Inc. v. Glob, GT LP*, 11 A.3d 214, 218 (Del. 2010).)

Golden Telecom represented a simple, strict construction of the clear language of the statute: ''Section 262(h) neither dictates nor even contemplates that the Court of Chancery should consider the transactional market price of the underlying company. Rather, in determining 'fair value,' the statute instructs that the court 'shall take into account all relevant factors.' Importantly, this Court has defined 'fair value' as the value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction.'' (*Id*. at 217.) ''Section 262(h) unambiguously calls upon the Court of Chancery to perform an independent evaluation of 'fair value' at the time of a transaction. It vests the Chancellor and Vice Chancellors with significant discretion to consider 'all relevant factors' and determine the going concern value of the underlying company. Requiring the Court of Chancery to defer – conclusively or presumptively — to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent.'' (*Id*.)

Golden Telecom expressly acknowledged that discounted cash flow analysis is likely to produce a valuation greater than the negotiated deal price: ''Fair value, as used in § 262(h), is more properly described as the value of the company to the stockholder as a going concern, rather than its value to a third party as an acquisition. We have long recognized that failure to value a company as a going concern may result in an understatement of fair value.'' (*Id*. at footnote 5 (*quoting M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 795 (Del.1999)).)

Facing an upswing in appraisal litigation, in 2013 the Chancery Court pragmatically demonstrated a renewed receptiveness toward accepting the merger price as the best evidence of fair value in transactions involving an adequate sale process free from a conflict of interest. (*Huff Fund Inv. P'Ship v. CKx, Inc.*, 2013 WL 5878807, at * 11-15 (Del. Ch. Nov. 1, 2013).) A number of subsequent Chancery Court cases found the deal price to be the most reliable indicator of a corporation's fair value. (*See Merion Capital LP v. BMC Software, Inc.*, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015); *Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del. Ch. Jan. 30, 2015).) As a result of these cases, many in the corporate M&A community believed that the tide had turned against arbitrage investors and that appraisal rights would play a diminishing role in future transactions.

However, in May 2016, the Chancery Court held in an appraisal proceeding involving Dell, Inc. that the fair value of the shares was 26% higher than the deal price. (*In re Appraisal of Dell, Inc.*, 2016 WL 3186538 (Del. Ch. May 31, 2016).) In reaching the decision, Vice Chancellor Laster did not give any weight to the deal price and used a discounted cash flow exclusively to determine fair value. The *Dell* opinion acknowledged the recent cases holding that deal price was the best evidence of fair value but declined to follow them, in part, because Dell was distinguishable as a management buyout and all the other cases involved a more robust pre-signing market check or originated from an unsolicited third-party bid. The Court identified a number of factors which contributed to the finding that fair value was substantially in excess of deal value, including that leveraged buyouts typically rely on financial sponsors who demand a minimum target IRR and limitations on the amount of debt.

Although many in the M&A community assumed *Dell*'s reliance on discounted case flow rather than deal price would be limited to management buyouts and other non-arm's length transactions, in July 2016 the Chancery Court's decision in *DFC Global* again applied discounted case flow to determine fair value. (*In re Appraisal of DFC Global Corp.*, 2016 WL 3753123 (Del. Ch. July 8, 2016).)

DCF Global provided alternative consumer financial services, colloquially known as payday lending. DFC faced significant risk of potential, adverse changes to the rules and regulations governing its business that imposed substantial uncertainty on the company's future profitability, and even its viability. The company's fate rested largely in the hands of the multiple regulatory bodies that governed it.

This uncertainty impacted DFC's financial projections. During the extended marketing process for the company, DFC repeatedly adjusted its projections downward, cutting its adjusted EBITDA forecast from $200–240 million to $151–156 million in the span of a few months, while noting that regulatory uncertainty made it impractical to project earnings per share.

Chancellor Bouchard found that the DFC transaction was arm's length and involved a robust pre-signing sale process. However, appearing to follow *Dell*, Chancellor Bouchard acknowledged the limitations in the LBO financing model and the sponsor's minimum required IRR target. Chancellor Bouchard also concluded that regulatory and market uncertainties created concerns regarding the reliability of the DFC Global deal price as an indicator of intrinsic value. Unlike *Dell*, Chancellor Blanchard did not totally disregard deal price, but instead gave equal weighting to deal price, discounted cash flow and a multiples-based comparable company valuation. *DFC Global* awarded the arbitrage investors a 7.5% premium over the deal price.

In 2016, mindful of the rapid growth of appraisal litigation and believing that the relatively high statutory interest rate paid in appraisal cases regardless of the outcome may encourage arbitrage activity, the Delaware legislature amended the statute to allow the surviving corporation the right to make a voluntary cash prepayment in any amount determined solely by the surviving corporation to the stockholders exercising appraisal rights. Under the revised statute, assuming such prepayment is made, interest will only accrue on the sum of the difference, if any, between the prepayment and the fair values eventually determined by the Chancery Court. At the time of the legislation, it was anticipated that buyers were likely to elect to make the prepayments to reduce the return to the arbitrage investors. However, as a practical matter, it appears that many acquirers have not adopted that strategy in order to avoid prepaying or funding the arbitrage investors' total investment in the litigation.

The 2016 legislation also created a *de minimis* exception for public companies, which prohibits appraisal proceedings where the number of shares seeking appraisal is less than 1% of the outstanding shares entitled to appraisal and the value of the shares seeking appraisal is less than $1 million. The *de minimus* exception is not a practical deterrent to arbitrage investors.

In 2017, the Delaware courts decided a series of cases which collectively represent a serious setback for the arbitrage investors, beginning with the Chancery Court's *PetSmart* decision which held that the deal price, ''forged in the crucible of objective market reality'' is the best indicator of fair value. (*In re Appraisal of PetSmart, Inc.*, 2017 WL 2303599 at * 1 (Del. Ch. May 26, 2017).) Chancellor Slights held that a discounted cash flow analysis did not provide a reliable measure of fair value because management's projections, upon which the discounted cash flow analysis relies, were unreliable.

Later in May 2017, in *SWS Group*, the Chancery Court found for the first time, that fair value was less than the deal price. (*In re Appraisal of SWS Group, Inc.*, 2017 WL 2334852 (Del. Ch. May 30, 2017).) *SWS Group* did not involve a robust arm's length sale process. The target was in precarious financial condition and the buyer was a substantial creditor. The buyer pursued the deal based on benefits from cost-savings in reduction of overhead rather than the target's stand-alone performance. The target's special transaction committee viewed the bid as a ''very solid offer'' which reflected ''very strong synergy values.'' After preforming a discounted cash flow analysis, Chancellor Glasscock found that the standalone fair value of the target was approximately 8% less than the deal price. The practical significance of *SWS Group* cannot be underestimated – for the first time the arbitrage could lose money on the bet.

In June 2017, the Delaware Supreme Court reversed the Chancery Court's *DFC Global* decision and strongly endorsed the merger price as the best evidence of fair value in an arm's length merger with a robust sale process. Chief Justice Strine writing for the court, declined to expressly establish a presumption that in certain cases, the price of the transaction giving rise to appraisal rights is the best estimate of fair value. The Chief Justice adopted the fiction of following the Supreme Court's prior ruling in *Golden Telecom*. However, *DFC Global* is a game-changer. The practical effect of reversing a well-reasoned Chancery Court decision to equally weight three separate valuation approaches is to declare that deal price is the new king.

Chief Justice Strine's well-crafted opinion corrects the misconception that fair value is an exact number: ''Fair value is just that, 'fair.' It does not mean the highest possible price that a company might have sold for had Warren Buffett negotiated for it on his best day and the Lenape who sold Manhattan on their worst.'' He added: ''The purpose of an appraisal is not to make sure the petitioners get the highest conceivable value that might have been procured had every domino fallen out of the company's way; rather, it is to make sure that they receive fair compensation for their shares in the sense that it reflects what they deserve to receive based on what would fairly be given to them in an arm's-length transaction.''

DFC Global represents the end of Delaware's primary reliance on discounted cash flow analysis performed by experts to establish fair value in appraisal proceedings, at least where the deal price is the result of a robust and open sale process. Chief Justice Strine correctly recognizes that a discounted cash flow analysis is the proper way to value an enterprise. Companies are valuable to their equity owners because of the profits they generate. Rational participants in any sale process base their bids on a discounted cash flow analysis to determine the present value of future free cash flows. At this point in the discussion, however, the Chief Justice introduces an important new concept – the discounted cash flow analysis performed by the market during the sale process is more reliable than the valuation performed by any single expert: ''Market prices are typically superior to other valuation techniques because, unlike, e.g., a single person's discounted cash flow model, the market price should distill the collective judgement of the many based on all the publicly available information about a given company and the value of its shares.'' The discounted cash flow analysis should be reserved for those situations where the market does not establish the price following a well-run sale process. He added: ''A single person's own estimate of the cash flows is just that, a good faith estimate by a single, reasonably informed person to predict the future. Thus, a singular discounted cash flow model is often most helpful when there isn't an observable market price.''

The Delaware Supreme Court's refusal to create a judicial presumption that the deal price is the best evidence of fair value initially appears incongruous with holding that deal price is king. Upon closer examination, rejecting the creation of a new judicial presumption was the correct decision. A presumption involves an assumption of fact required by the law. A presumption is unnecessary when a fact is established. For example, no presumption is required that Delaware is a state. The Delaware Supreme Court found in *DFC Global* that the market's judgment of value based on the market's discounted cash flow analysis is more accurate than the judgment of a single individual. Having made a finding of fact with broad application to M&A transactions, there is no need for a presumption.

*DFC Globa*l also emphasizes that fair value often may be less than the deal price and therefore the arbitrage investor can lose money on the bet. Chief Justice Strine presented evidence that ''the sales price in many M&A deals includes a portion of the buyer's expected synergy gains, which is part of the premium the winning buyer must pay to prevail and obtain control.'' Under Delaware law, the stockholder seeking appraisal is not entitled to transaction synergies as part of fair value. The clear implication is that the price available to arbitrage investors in an appraisal action may be lower than the deal price.

The Chancery Court's July 2017 *Clearwire* ruling amplified the risk that arbitrate investors can lose money on their bets. (*ACP Master, Ltd. v. Sprint Corp. v. Clearwire Corp.*, 2017 WL 3421142 (Del. Ch. July 21, 2017; corrected Aug. 8, 2017).) The appraisal proceeding

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arose from Sprint Nextel's acquisition of the 49.8% of Clearwire that Sprint did not already own. The deal was part of a broader effort by Softbank, the largest telecommunications company in Japan, to enter the United States Cellular telephone market. Sprint initially offered to pay $2.97 per share for Clearwire. However, as a result of negative stockholder reaction and competing bids from DISH, Sprint eventually agreed to $5.00 per share. During the trial, the company did not argue that the court should give weight to the deal price because the merger involved a controlling stockholder.

Clearwire applied the well-established law that the company must be valued as a going concern rather than based upon its value to a third party as an acquisition and the court must exclude any synergies arising from the deal. The Chancery Court found the fair value of Clearwire to be $2.13 per share, which was 57% less than the deal price.

After the 2016 legislative changes permitting the company to cut off interest by prepaying a portion of the merger consideration and the *Clearwire*, *SWS Group* and *DFC Global* decisions, appraisal arbitrage is no longer a guaranteed bet. Sophisticated investors will need to think long and hard before pursuing the investment strategy. If the deal price resulted from a robust sale process free from conflict of interest, the company can be reasonably confident of prevailing at trial, and perhaps even paying less than the deal price if the acquirer can establish a synergistic component of the deal price. Therefore, most appraisal arbitrage will come down to a bet on whether the company will settle quickly for a modest premium to avoid the expense and delay of litigation. For M&A professionals going forward, they should expect to see a substantial reduction in appraisal litigation activity.