Transaction Price Dominates Delaware Appraisal Litigation

By **William Hrycay** (July 30, 2019)

William Hrycay

The past decade witnessed a notable increase in the number and magnitude of actions brought under Delaware's appraisal statute. Since 2013, the Delaware Chancery Court's decisions have increasingly relied on transaction prices as the best indicators of fair value. Two recent Delaware Supreme Court decisions led the Delaware Chancery Court to place greater weight on market prices, even when there are perceived flaws in the transaction process.[1]

Following the Delaware Supreme Court decisions, the Chancery Court decision in Verition Partners Master Fund Ltd. v. Aruba Networks Inc. used the preacquisition common stock price as the best indicator of value, while another decision rejected the common stock price in favor of the acquisition price.[2]

On April 16, the Delaware Supreme Court rejected the use of the unaffected stock price as the best indication of value in the Aruba Networks case, and clarified what elements of a transaction price can and cannot be properly ascribed to "fair value" as defined by Delaware appraisal law.

This article analyzes the valuation disputes between petitioners and respondents in Delaware appraisal litigation, and discusses the trend toward the use of market prices to determine fair value since 2013.

Background

After an acquisition, Delaware appraisal law allows minority shareholders to refuse the transaction proceeds and receive instead a court-determined value for their shares.[3] Petitioning shareholders also receive statutory interest from the time of the transaction.[4] Appraisal actions are generally not an option for acquisitions paid for with equity or other forms of noncash consideration.[5]

The appraisal statute dates from more than 100 years ago and was written around the same time that Delaware corporate law was amended to allow acquisitions to be approved by majority shareholder vote, rather than unanimous shareholder approval. The court appraisal option was seen as a remedy for potential transactions that take advantage of shareholders through acquisitions that could be below value.[6]

The number and value of appraisal actions have increased in recent years. One study found that in 2013, nearly 30 public company acquisitions were subject to appraisal claims, compared to fewer than 10 in 2010.[7] Approximately 5% of eligible acquisitions were subject to an appraisal claim from 2004 through 2010, while in 2013, more than 15% of such transactions were subject to appraisal claims.[8] Similarly, between 2004 and 2012, an average of less than $250 million in shares were at stake in appraisal litigation. In 2013, the dollar value of the shares at stake was close to $1.5 billion.[9]

Valuation Methodologies and Use of Market Evidence

The Delaware appraisal law does not prescribe a single methodology for determining fair value. Rather, the statute states that the court "shall take into account all relevant factors."[10] Weinberger v. UOP Inc. established that valuation methods customarily accepted among financial market participants can be used by the court.[11]

In the Huff Fund Investment Partnership v. CKx Inc. decision in 2013, the Delaware Chancery Court determined that the transaction price itself represented the best indication of fair value.[12] In subsequent decisions, the court has relied on comparable company analysis, discounted cash flow analysis, discounted net income, the stock price of the company prior to the transaction and the transaction price.

In practice, the Delaware Chancery Court has often used discounted cash flow analysis as its preferred method for estimating fair value. Discounted cash flow analysis estimates per-share value using the present value of the expected free cash flows of the business. Most often, the analysis is implemented using a set of financial projections for a few years — often three, five or 10 — and using a terminal value to estimate the value of operations after the projection period.

The value estimated using this method depends largely on the financial projections used. The projections from management are often preferred, as management often has the best perspective regarding the future of the business. However, this presumption in favor of management projections may be overcome when the projections are shown to be unreliable because of the facts and circumstances in which they were created.[13]

In the CKx decision, the court found that the transaction price itself, rather than a valuation derived from an analytical model, represented the most reliable indication of value.[14] CKx was a publicly traded company that was acquired by Apollo in 2011. It owned and managed the rights to several entertainment assets, including television programs such as "American Idol" and "So You Think You Can Dance," and to certain intellectual property associated with Elvis Presley and Muhammad Ali.[15]

CKx management did not develop financial projections in the ordinary course of its business, and the court found it particularly difficult to estimate expected future cash flows from these businesses. Projections were further complicated by the declining ratings and contract disputes with "American Idol" at the time of the transaction, resulting in earnings that were "in a state of flux."[16]

The court found that without a reliable basis for conducting an analytical valuation, the acquisition price itself is the best estimate of fair value. Several subsequent decisions have determined that the transaction price, or transaction price minus synergy value, is the best indication of fair value.[17]

The Battles of the Experts

In appraisal disputes, both the petitioner and the respondent sponsor expert testimony regarding the fair value of the shares at issue. The difference between the two estimates is often very large.

Figure 1, below, shows the difference in the estimated values of two experts in relation to the transaction price in cases where the Delaware Chancery Court decided fair value in the period between the 2013 CKx decision and March 31, 2019. The values have been normalized so that the transaction price is equal to 100%. The top end of the range represents fair value as estimated by the petitioner's expert. The low end of the bar reflects fair value estimated by the respondent's expert.

The petitioner's expert's estimated value is often 50% to 100% above the transaction price, while the respondent's expert's value is often at or slightly below the transaction price.[18] On average, the value estimated by the petitioner in these 20 cases was 98% above the transaction price.[19] The respondent's value was an average discount of 15% to the transaction price. The blue dot indicates the fair value as estimated by the Delaware Chancery Court decision.[20]

Figure 1

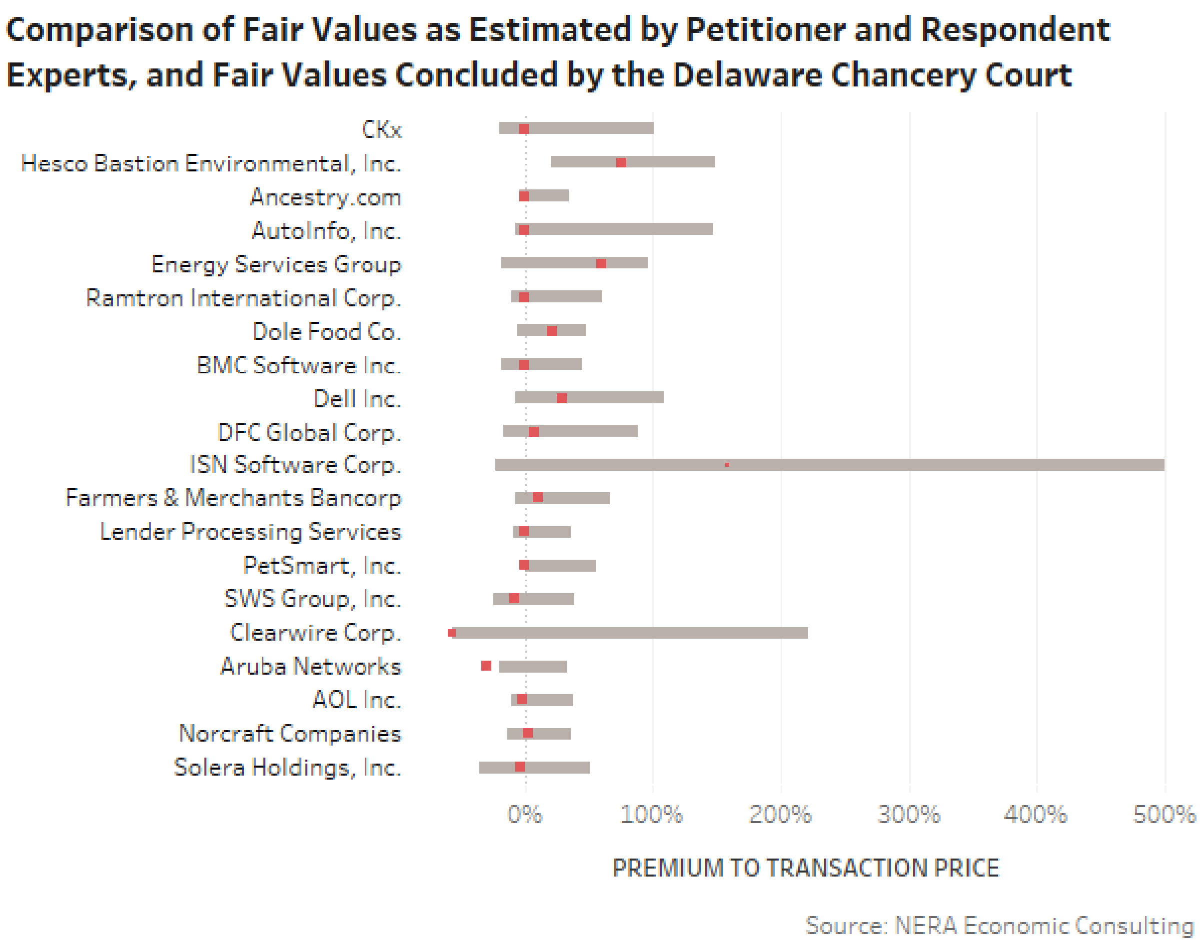

Figure 2, below, shows the valuation methodology used by the Delaware Chancery Court in determining fair value. In the 20 cases decided during this period, the court based nine determinations of fair value on market evidence — either the transaction price or the common share price prior to the transaction.[21]

The premium awarded above the transaction price depends on the court's decision as to whether the acquisition was an arm's-length transaction. In the seven cases in which the Chancery Court determined the transaction was not an arm's-length transaction, the court found that, on average, the fair value was 40% above the acquisition price. In the 12 cases in which the court determined there was an arm's-length transaction, the average premium to the transaction price was slightly less than zero.

Figure 2

Delaware Chancery Court Decisions Since CKx

Subject Company	Decision Date	Transaction Price	Concluded Fair Value	Valuation Methodology
CKx Inc.	11/1/2013	$5.50	$5.50	Transaction price
Hesco Bastion Environmental Inc.	5/12/2014	$207.50	$364.24	Direct capitalization
Ancestry.com	1/30/2015	$32.00	$32.00	Transaction price
AutoInfo Inc.	4/30/2015	$1.05	$1.05	Transaction price
Energy Services Group Inc.	6/17/2015	$19.95	$31.93	Discounted cash flow
Ramtron International Corp.	6/30/2015	$3.10	$3.07	Transaction price less synergies
Dole Food Co.	8/27/2015	$13.50	$16.24	Discounted cash flow
BMC Software Inc.	10/21/2015	$46.25	$46.25	Transaction price
Dell Inc.	5/31/2016	$13.75	$17.62	Discounted cash flow
DFC Global Corp.	7/8/2016	$9.50	$10.21	Discounted cash flow, comparable companies, transaction price
ISN Software Corp.	8/11/2016	$38,317.00	$98,783.00	Discounted cash flow
Farmers & Merchants Bancorp	11/10/2016	$83.00	$91.90	Discounted net income
Lender Processing Serves Inc.	12/16/2016	$37.14	$37.14	Transaction price
Petsmart Inc.	5/26/2017	$83.00	$83.00	Transaction price
SWS Group Inc.	5/30/2017	$6.92	$6.38	Discounted cash flow
Clearwire Corp.	7/21/2017	$5.00	$2.13	Discounted cash flow

Aruba Networks Inc.	2/15/2018	$24.67	$17.13	30-day average stock price
AOL Inc.	2/23/2018	$50.00	$48.70	Discounted cash flow
Norcraft Companies	7/27/2018	$25.50	$26.16	Discounted cash flow
Solera Holdings Inc.	7/30/2018	$55.85	$53.95	Transaction price

DFC and Dell

The DFC Global Corp. and Dell Inc. decisions by the Delaware Supreme Court in 2017 highlighted that the market-based indicators of value are often preferable to estimates of value determined by financial models. This can be true even when the transaction process itself is less than perfect.

DFC is a payday lending company that was acquired in 2014 by a private equity buyer for $9.50 per share. The Chancery Court found that the acquisition occurred at a time of “turbulent regulatory waters,” which affected the estimated values found in the discounted cash flow analysis, market approach analysis and the transaction price. It estimated fair value at $10.21, the average of the values from the three approaches.[22] The Delaware Supreme Court overruled this decision, instructing the Chancery Court to place greater weight on the market evidence.[23]

The courts did the same in the case of Dell. The computer technology company was taken private in a management buyout for $13.75 per share, completed in October 2013. The Delaware Chancery Court found that the market for Dell shares before the transaction was affected by a valuation gap driven by the market’s “focus on short-term, quarter-by-quarter results,” and the market’s failure to properly evaluate Dell’s $14 billion investment in its transformation.

These factors led to an anti-bubble in Dell’s stock price. That price then anchored the price of the transaction, which was also flawed due to limited competition before the transaction agreement, Dell management’s conflict of interest and limited go-shop provisions. The Delaware Chancery Court found that flaws in the market for Dell shares and in the management buyout deal process meant the transaction price undervalued the company. It estimated the fair value as $17.62.[24] The Delaware Supreme Court overturned this decision after determining that the court erred in downplaying the market evidence of value.[25]

These two Delaware Supreme Court decisions emphasized the preference for market information, absent compelling evidence that the transaction was significantly flawed or that the stock price prior to the transaction was unreliable.

Following these decisions, the Delaware Chancery Court has produced two opinions with alternative interpretations regarding what the need to rely on market evidence should mean.

In the Aruba Networks decision in 2018, the Delaware Chancery Court found that the best evidence of fair value can be the preacquisition stock price. In 2015, Aruba Networks was acquired by Hewlett-Packard Co. for $24.67 per share. The court found that the synergies between Aruba Networks and Hewlett-Packard meant the transaction price did not represent fair value, and that estimating the value of synergies required too many assumptions to be reliable.[26]

It also stated that elimination of the agency costs associated with minority ownership was a result of the transaction, and therefore not part of fair value. So rather than attempt to estimate the synergy value analytically and subtract it from the acquisition price, the court concluded that the 30-day average stock price of the company prior to the transaction was the best indication of fair value.[27]

In reaching that decision, the court observed that Aruba Networks' stock likely traded in an efficient market, as evidenced by the fact that its shares traded on the Nasdaq, the lack of a controlling shareholder, timely public filings, sufficient coverage by equity analysts, relatively high weekly trading volume and a narrow bid-ask spread.[28] The court noted that neither side presented expert testimony regarding the efficiency of the Aruba Networks stock price.[29]

The Chancery Court also addressed the question of when the stock market price may represent fair value in the Solera Holdings Inc. decision.[30] Solera is a provider of data and software for automotive, home ownership and digital identity management. It was acquired by a private equity fund for $55.85 per share in March 2016.

The Chancery Court determined Solera was sold in an "open process that, although not perfect, was characterized by many objective indicia of reliability." It concluded that fair value was equal to the merger price, minus synergies, or $53.95 per share. In doing so, it rejected the petitioners' argument based on a discounted cash flow analysis that the fair value of Solera stock was $84.65 per share.

It also rejected arguments from respondents, introduced late in the process, that the preacquisition stock price was the best indicator of fair market value.[31] The court disagreed with the idea that the stock price can represent fair value, on the grounds that the common stock price does not represent control value, but instead reflects an embedded minority interest discount. The court found that control value is part of the value of a going concern.

On April 16, 2019, the Delaware Supreme Court reversed the Delaware Chancery decision in Aruba Networks.[32] It rejected the argument that the transaction price was higher than the pretransaction stock price because of a reduction in agency value, noting that one group of diffuse stockholders was replaced by another.[33]

Moreover, the Delaware Supreme Court identified two additional reasons it believed the transaction price may be a better indicator of value than the preannouncement stock price. First, an acquirer may obtain nonpublic information as part of the due diligence process that leads the acquirer to believe that the value is higher than the stock price, which is informed only by public information.

The court stated that this was an important consideration in the Aruba Networks case because the acquirers learned about the company's positive quarterly results in due diligence, which led them to conclude that the fair value was higher than the public stock price.[34] Second, the acquirer "had a much sharper incentive to engage in price discovery than an ordinary trader because it was seeking to acquire all shares."[35]

Conclusion

In appraisal litigation, the Delaware courts have increasingly relied on the transaction price as the best evidence of fair value. They have reached this conclusion even when the transaction process had minor flaws, or when reliable management projections are available for estimating value through a discounted cash flow model. The Aruba Networks decision indicates that the transaction price is likely a better indicator of value than the preannouncement deal price, especially when the due diligence process provides favorable nonpublic information.

William Hrycay is an associate director at NERA Economic Consulting.

[1] The author would like to thank Faten Sabry and David Tabak for their helpful comments and suggestions.

[2] Verition Partners Master Fund Ltd. v. Aruba Networks Inc., No. 368, 2018 (April 16, 2019).

[3] Delaware General Corporations Law, Section 262 (h).

[4] Statutory interest has been set at the federal funds rate plus 500 basis points. Delaware General Corporations Law, Section 262 (h).

[5] Charles R. Korsmo and Minor Myers, "Appraisal Arbitrage and the Future of Public Company M&A," Washington University Law Review, 92(6), 2015, pp. 1551–1615.

[6] Ibid, p. 1558.

[7] Ibid.

[8] Ibid.

[9] Ibid.

[10] Delaware General Corporations Law, Section 262 (h).

[11] Weinberger v. UOP Inc., 457 A.2d 701 (Del. 1983).

[12] Huff Fund Investment Partnership v. CKx Inc., No. 6844-VCG (Del. Ch. Nov. 1, 2013). The previous decision where the court only used the transaction price to estimate the value was Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847.

[13] For example, the Delaware Chancery Court has found management projections can be unreliable when they were developed as part of the process of selling the company where the projections include "speculative" assumptions; when they were developed outside the ordinary course of business; when they were developed in anticipation of "shopping" the

company; when they project a longer period than management had previously estimated; when they use a different method than management used previously; and when they were made by a management team with a questionable ability to make reasonable forecasts. (See Ramtron International, 2015).

[14] Huff Fund Investment Partnership v. CKx, Inc., No. 6844-VCG (Del. Ch. Nov. 1, 2013). The previous decision where the court only used the transaction price to estimate the value was Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847.

[15] Ibid, p. 5.

[16] Ibid, pp. 7, 14–19, 24–27.

[17] For example, Ramtron International, 2015.

[18] This discrepancy may be caused by the belief that, other than by removing synergies, the respondents cannot plausibly argue that the fair value is less than they paid for it. Also, the respondents cannot argue that the fair value is more than 100% below the transaction price while several experts for petitioners have argued that the fair value is more than 100% above the transaction price.

[19] The median value was a 63% premium over the transaction price.

[20] In some cases, these decisions were reversed by the Delaware Supreme Court.

[21] In one additional case, DFC, the Chancery Court placed one-third weight on the market price.

[22] In re Appraisal of DFC Global Corp., C.A. No. 10107-CB, July 8, 2016.

[23] DFC Global Corp. v. Muirfield Value Partners, L.P., No. 518, 2016 (Del. Aug. 1, 2017).

[24] In Re: Appraisal of Dell Inc., C.A. No. 9322-VCL (Del. Ch. 2016).

[25] Dell v. Magnetar et al., Case No. 565, 2016 (Del. Sup. Ct. Dec. 14, 2017).

[26] Verition Partners Master Fund Ltd. and Verition Multi-Strategy Master Fund Ltd. v. Aruba Networks, Inc. 2018.

[27] Ibid.

[28] Ibid, pp. 60–61.

[29] Ibid, p. 60.

[30] In re Appraisal of Solera Holdings, Inc., Del. Ch., C.A. No. 12080-CB, 7/30/18.

[31] Ibid, pp. 84–90.

[32] Verition Partners Master Fund Ltd. and Verition Multi-Strategy Master Fund Ltd. v. Aruba Networks, Inc. 2019.

[33] Ibid, pp. 9–12.

[34] Ibid, pp. 19–20.

[35] Ibid, pp. 22–23.