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Analyzing Value Changes between Signing and Closing in Delaware Appraisal Actions

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Pursuing a Delaware appraisal action is a risky and expensive endeavor. Often initiated by event-driven hedge funds, any dissenting shareholders must conduct a significant amount of research and market analysis to determine whether to make the investment to see an appraisal action through. A great deal has been written about the recent trend in Delaware appraisal decisions that are awarding the deal price or transaction price, resulting in a loss for dissenting shareholders. But what happens if the target company's value increases significantly between signing and closing? Should dissenters to the merger be awarded more for their shares in such a case? Recent Delaware Chancery decisions may offer answers to these questions and provide important insights for how to approach future mergers. This article explores recent Delaware court decisions that touch on these valuation issues and discusses analyses that experts may perform to evaluate whether a target company's value has changed between signing and closing.

In the Delaware Chancery Court, there is a trend toward using the deal price or the market price in appraisal decisions, and acquisitions of large, publicly traded corporations there tend to be the result of robust, heavily publicized deals in which third parties are not prohibited from making offers. Thus, petitioners have been seeking other sources of value that can be awarded in an appraisal decision. One source is a potential increase in value during the time between the signing of the merger agreement and closing (hereafter referred to as the temporal gap).

The Delaware General Corporation Law, Section 262, states that the time for determining the value of a dissenter's shares is immediately before the merger closes.[1] Given that the closing date is usually a few months after the deal is signed, one could argue that any increase in the target company's value during the temporal gap should be awarded to dissenters. This value could come from macroeconomic changes, such as changes in tax policy, changes in commodity prices, or changes in overall consumer demand. It could come from changes in the target company's business, such as improved operating performance that was not incorporated into the transaction price. However, measuring this increase can be difficult, because a target company's stock price is usually pegged to the agreed-on per-share transaction value and thus may not reflect the market's assessment of changes in the company's future performance in the temporal gap.[2]

The recent trend in Delaware appraisal litigation—the Delaware Chancery Court's and the Delaware Supreme Court's increasing reliance on the deal price and the target's unaffected market price to determine fair value in an appraisal proceeding—has been widely discussed and analyzed.[3] This trend became particularly clear after two relatively recent Delaware Supreme Court decisions: (1) the 1 August 2017 reversal of the Chancery Court's decision in the *DFC Global Corp.* appraisal that gave only one-third weight to the deal price, and (2) the 14 December 2017 reversal of the Chancery Court's decision in the *Dell* appraisal that gave no weight to the target's stock price or the deal price.[4] In the seven Chancery Court decisions in appraisal matters since the Delaware Supreme Court's *Dell* decision, the court awarded a value over the deal price in only one case.[5] Although the Delaware Supreme Court has made clear that it is "not saying that the market is always the best indicator of value or that it should always be granted some weight," the court suggests that it is unreasonable to ignore the deal price or market price unless there are clear indicators that "market efficiency, fair play, low barriers to entry" or "outreach to all logical buyers" were not present in the deal process.[6]

Going forward, petitioners may need to argue that the deal price undervalues the target company because of issues unrelated to the target company's activities before signing the merger agreement. Indeed, in three recent Delaware appraisal cases that went to trial, petitioners argued that they deserved compensation for changes during the temporal gap. These decisions offer some insight into what may cause the Delaware courts to award increased value during the temporal period.

For example, the Chancery Court's decision in *Jarden* (19 July 2019), in which petitioners were awarded Jarden's unaffected market price, explained that petitioners argued simply that the market price before the transaction was announced was "stale" as of the closing date, but there was "no evidence to suggest that Jarden gained value from the date set for the Unaffected Market Price and the closing" of the transaction.[7]

In the *Columbia Pipeline* appraisal matter (decided on 12 August 2019), in which petitioners were awarded the transaction price, petitioners also argued that Columbia Pipeline's value increased during the more than three-month time between signing and closing.[8] Specifically, petitioners argued that (a) the value of Columbia Pipeline's peers increased during the temporal gap, and (b) Columbia Pipeline's stock would have increased without the transaction because prices of natural gas and natural gas futures increased by more than 50% during the temporal gap.[9] Although these arguments were found to be unpersuasive partly because petitioners "did not suggest a means of adjusting the deal price to reflect the increases in value" from these factors, the court showed a willingness to consider an increase in value, indicating that with enough evidence and a sound methodology from a valuation expert, in theory the court could account for changes in value between signing and closing.[10]

In the *Stillwater Mining* appraisal matter (decided on 21 August 2019), in which petitioners were awarded the transaction price, the petitioners' expert claimed that because Stillwater was a mining company that produced primarily palladium and platinum, the company's unaffected market price required an adjustment to account for the large increase in commodity prices between signing and closing.[11] In his decision, Vice Chancellor J. Travis Laster agreed that an adjustment might be warranted, stating that the "nature of Stillwater's business makes this case a plausible one for an upward adjustment that goes beyond inflation."[12] Although Laster rejected petitioners' adjustment to the unaffected market price and ruled in favor of the deal price, he suggested that he would have considered an adjustment to the transaction price had petitioners argued for it. However, because they did not, the court found that the deal price provided reliable evidence of fair value.[13]

These decisions indicate that the Chancery Court is willing to consider adjustments to either the transaction price or the unaffected price if petitioners can develop a methodologically sound adjustment. However, given the fact that target stock prices rarely move much in the temporal gap, petitioners' experts must rely on indicators other than target stock prices to measure the change in value. In addition to arguing that the target company's value increased during the temporal gap because of increased operating performance by the target, petitioners' experts may have to show that there were macroeconomic or industry factors affecting companies other than the target firm that justify the argument for an increase in value.

To illustrate the types of analyses that valuation experts may conduct to evaluate changes in value during the temporal gap, one can review the valuation issues arising from the corporate tax reduction that accompanied the passage of the Tax Cuts and Jobs Act of 2017 (the 2017 Tax Reform). That federal law (introduced on 2 November 2017 and signed into law by President Donald Trump on 22 December 2017) reduced the corporate tax rate from 35% to 21%. Reductions in taxes can have a direct and positive effect on future equity cash flows because reduced taxes allow companies to retain a larger portion of their earnings. Companies can use the taxes saved to invest in new projects, buy back shares, or pay dividends, among other things. Any target company that signed a merger agreement before the announcement (or passage) of the 2017 Tax Reform and closed after its announcement (or passage) could be the subject of arguments from petitioners that the reduction in corporate tax rates represents measurable value that should be awarded to petitioners in an appraisal proceeding.[14]

According to FactSet, there have been 59 completed acquisitions of US public companies where the announcement date and the closing date straddled 2 November 2017, 22 December 2017, or both. I reviewed the Delaware Chancery Court dockets and found that shareholders for nine of these target companies exercised their appraisal rights.[15] Although none of these cases have gone to trial and produced a Chancery Court decision, it is possible that petitioners used the 2017 Tax Reform as a source of value in some of them. It would be fairly easy for petitioners to show, using a discounted cash flow (DCF) analysis, that reducing the corporate tax rate from 35% to 21% results in a large increase in value. Tables 1 and 2 are illustrative DCF valuations of a hypothetical growing and profitable company. The only difference between the analyses is the tax rate. Table 1 uses a tax rate of 35%, and Table 2 uses a tax rate of 21%.

Reducing the tax rate alone results in a 21% increase in the company's enterprise value ($2,135.60 versus $2,587.00) and a 28% increase in the price per share ($16.36 versus $20.87). Clearly, these percentages partly depend on the assumptions in this illustrative exercise, but they show that reducing taxes by 14 percentage points can result in a large increase in value.

This does not mean that respondents must always concede that reductions in corporate taxes will result in value increases implied by a DCF analysis. The impact of federal corporate tax rates can vary greatly from company to company based on profitability, tax assets, and countries of operation. For example, recent academic research analyzing the impact of Trump's election (and with it, an expectation that corporate taxes would decline) on stock prices predictably found that high-tax companies grew in value, whereas companies with large deferred tax assets dropped in value.[16] Furthermore, presidential administrations change, as does tax law, and it is unreasonable to assume that a particular tax rate will exist in perpetuity. Respondents' experts could perform multiple analyses to test petitioners' experts' arguments regarding the impact of the 2017 Tax Reform on value. For example, respondents' experts could:

- Perform event study analyses to measure the impact of the 2017 Tax Reform on the equity values of comparable companies. Such an analysis could yield increases in value well below the increases implied by a DCF.

- Perform statistical analyses to measure how US markets generally reacted to the 2017 Tax Reform. For example, the nominal returns for the Russell 2000 for the three months after Trump's election and the introduction of the 2017 Tax Reform were 14.6% and 3.1%, respectively. An expert could compare these and other return measures from these periods to the value increase implied by the DCF.

- Review analyst and general market commentary for comparable companies around the dates the 2017 Tax Reform was announced.

- Review analysts' comparable company valuations and price targets to see if analysts are assuming value increases that are consistent with what is implied by petitioners' DCF.

- Analyze the valuation analyses performed by each company's financial advisor to determine if the 2017 Tax Reform was incorporated into the acquisition price in some way.

- Analyze the results of the shareholder vote and argue that a vote in favor of the transaction contradicts the assertion that the target company's value increased significantly during the temporal gap because presumably shareholders would not vote for a transaction that did not account for significant value increases during the temporal gap.

Note that these analyses could be performed by respondents' experts in any situation where petitioners argue for increases in value during the temporal gap. A Delaware Chancery decision that evaluates the impact of the 2017 Tax Reform could provide useful insight on the types of analyses that would convince a judge that there was a change in value during the temporal gap.

Table 1. **Illustrative DCF with a 35% Tax Rate**

Input Assumptions						
Valuation Date	12/31/2019					
Cost of Equity	12.0%					
Cost of Debt	4.0%					
Debt of Capital %	25.0%					
Tax Rate	35.0%					
Weighted Average Cost of Capital	9.7%					
Perpetuity Growth Rate	3.0%					
	2020	2021	2022	2023	2024	Terminal Year
EBIT	$200.0	$220.0	$237.6	$251.9	$261.9	$261.9
Taxes	($70.0)	($77.0)	($83.2)	($88.1)	($91.7)	($91.7)
Depreciation / Amortization	$10.0	$11.0	$11.9	$12.6	$13.1	$13.1
CapEx	($9.0)	($9.9)	($10.7)	($11.3)	($11.8)	($11.8)
Change in Net Working Capital	($15.0)	($15.0)	($15.0)	($15.0)	($15.0)	($15.0)
Free Cash Flow (FCF)	$116.0	$129.1	$140.6	$150.0	$156.6	$155.3
Discount Period	0.5	1.5	2.5	3.5	4.5	
Discount Factor	0.95	0.87	0.79	0.72	0.66	
Present Value of FCF	110.8	112.4	111.7	108.6	103.4	
Future Value of Terminal Value	$2,404.7					
Present Value of Terminal Value	$1,588.6					
Present Value of FCF	$547.0					
Enterprise Value	$2,135.6					
Less: Debt	$500.0					
Equity Value	$1,635.0					
Shares Outstanding	100					
Price per Share	$16.36					

Table 2. **Illustrative DCF with a 21% Tax Rate**

Input Assumptions	
Valuation Date	12/31/2019
Cost of Equity	12.0%
Cost of Debt	4.0%
Debt of Capital %	25.0%
Tax Rate	21.0%
Weighted Average Cost of Capital	9.8%
Perpetuity Growth Rate	3.0%

	2020	2021	2022	2023	2024	Terminal Year
EBIT	$200.0	$220.0	$237.6	$251.9	$261.9	$261.9
Taxes	($42.0)	($46.2)	($49.9)	($52.9)	($55.0)	($55.0)
Depreciation / Amortization	$10.0	$11.0	$11.9	$12.6	$13.1	$13.1
CapEx	($9.0)	($9.9)	($10.7)	($11.3)	($11.8)	($13.1)
Change in Net Working Capital	($15.0)	($15.0)	($15.0)	($15.0)	($15.0)	($15.0)
Free Cash Flow (FCF)	$144.0	$159.9	$173.9	$185.2	$193.2	$191.9

Present Value of Terminal Value	$1,912.3
Present Value of FCF	$674.6
Enterprise Value	$2,587.0
Less: Debt	$500.0
Equity Value	$2,087.0
Shares Outstanding	100
Price per Share	$20.87

Notes

1. See, for example, *Memorandum Opinion in Re Appraisal of Stillwater Mining Company*, dated 21 August 2019, 104.
2. Cases where the target company's stock price rises significantly above the transaction price can indicate that the market expects a topping offer. Conversely, cases where the target company's stock price stays well below the transaction tend to indicate that the market believes there is a high risk the transaction will not close.
3. See, for example, Bill Hrycay, "Transaction Price Dominates Delaware Appraisal Litigation," *Law360*, 30 July 2019.
4. In Supreme Court of the State of Delaware, *DFC Global Corporation v. Muirfield Value Partners, et al.,* decision dated 1 August 2017; in Supreme Court of the State of Delaware, *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, et al., decision dated 14 December 2017.
5. These target companies and Delaware Chancery Court decision dates are: Aruba Networks Inc. (decided 15 February 2018), AOL Inc. (decided 23 February 2018), Norcraft Companies, Inc. (decided 27 July 2018), Solera Holdings, Inc. (decided 30 July 2018), Jarden Corp. (decided 19 July 2019), Columbia Pipeline Group, Inc. (decided 12 August 2019), and Stillwater Mining Company (decided 21 August 2019). The Norcraft decision was the only one in which the Delaware Chancery Court awarded a value over the deal price. In that case the transaction price was $25.50, and the petitioners were awarded a value of $26.16.
6. In Supreme Court of the State of Delaware, *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., et. al.,* dated 14 December 2017, 60.
7. In Court of Chancery of the State of Delaware, I*n Re: Appraisal of Jarden Corporation Memorandum Opinion,* dated 19 July 2019, 87.
8. In Court of Chancery of the State of Delaware, *In Re: Appraisal of Columbia Pipeline Group, Inc.,* dated 12 August 2019, 94.
9. Ibid., 95–98.
10. Ibid., 95.
11. In Court of Chancery of the State of Delaware, *In Re: Appraisal of Stillwater Mining Company,* dated 21 August 2019, 110.
12. Ibid., 109.
13. Ibid., 115.
14. This argument may be more difficult to make in transactions with partial stock consideration if the acquiring company's stock price was positively affected by the reduction in corporate tax rates associated with the 2017 Tax Reform.
15. The target companies in these cases are Rice Energy, Capital Bank Financial Corp., Gigamon, Bob Evans Farms, Barracuda Networks, Regal Entertainment Group, Calpine Corp., Orbital ATK, and Kindred Healthcare.
16. See, for example, A. Wagner, R. Zeckhauser, and A. Ziegler, "Company Stock Price Reactions to the 2016 Election Shock," *Journal of Financial Economics* 130 (2018), 428–451, at 428.

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