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Client Alert

June 2017

Delaware Appraisal Proceeding Results in Fair Value Below Merger Price

In a recent Delaware appraisal proceeding, a court determined that the "fair value" of the stockholders' shares was almost 8% *below* the closing merger price. The court found that a significant portion of the merger consideration arose from the buyer's synergistic plans for the target company, which under Delaware law must be excluded from determining the fair value of the petitioners' shares. Although they will be entitled to interest, the investment funds that sought appraisal will receive a payment less than what was paid to the non-dissenting stockholders when the merger closed almost two and a half years ago.

Overview of the Court's Ruling

In re Appraisal of SWS Group, Inc., C.A. No. 10554-VCG (Del. Ch. May 30, 2017), involved the 2015 merger of a financial services company, in which seven appraisal arbitrage funds petitioned the Court of Chancery for a judicial appraisal of their stock in the target company.

1. *The Court Did Not Rely on Deal Price as Evidence of Fair Value*. Neither party argued that the deal price was evidence of fair value. The petitioners claimed that the company's sale process was flawed and the merger significantly undervalued their shares, whereas the buyer argued that the deal price included synergies that must be excluded from the court's determining of fair value. Consistent with several other recent appraisal cases, the court observed that deal price is often strong evidence of fair value. But in this case, the court said aspects of the company's sale process were "problematic." The court noted, however, that even in cases involving a strong market check, "tranfer[s] to the sellers of value arising solely from a merger...are properly removed from the calculation of fair value."

2. *Synergies from the Merger Were Excluded from "Fair Value."* Under the Delaware General Corporation Law, an appraisal proceeding requires the court to determine the "fair value" of the petitioners' stock "*exclusive of any element of value arising from the accomplishment or expectation of the merger*." The court concluded that the buyer "would derive much of its benefits from cost savings in reduction of overhead rather than [from the target's] stand-alone performance" and that the buyer's "acquisition thesis was synergies-driven." This led to the conclusion that the deal price exceeded the statutory fair value of the stock.

3. *DCF Analysis*. In conducting its valuation, the court rejected the petitioners' comparable companies analysis, finding that the companies were not comparable to the target. Rather, the court relied solely on a discounted cash flow ("DCF") analysis, commonly used by the Delaware courts. The court also rejected the petitioners' attempt to extend management's internal projections by an additional two years with projections created by the petitioners' valuation expert. The court found that the petitioners' approach would add two years of "unprecedented straight-line growth, reaching a profit margin far exceeding any management projections, despite the Company's structural issues and performance problems." The court instead used management's three-year projections, subject to certain modifications it deemed appropriate.

Conclusion

In recent years, there has been a significant rise in appraisal proceedings initiated not by long-term shareholders with valuation grievances, but by investment funds that purchase shares after a transaction is announced for the purpose of pursuing appraisal. In some cases, these funds leverage the nuisance value of an appraisal proceeding and the statutory rate of interest payable on their shares (5% over the Federal Reserve discount rate, compounded quarterly) to negotiate settlements with buyers. They also minimize their costs by using counsel on contingency fee arrangements. Many times, their appraisal demands are settled before the petition is made public, which makes it difficult for commentators to track how often these funds demand payment. In other cases, these investment funds will pursue appraisal through trial. Sometimes these trials result in fair value above the deal price (e.g., in the recent *Dell* opinion that remains on appeal). But other times (including, most recently, in *PetSmart*), Delaware courts have looked to the deal price as the best evidence of fair value when the company undertook a market check.

SWS is an important decision since the fair value was determined to be below the deal price. Although there were some unusual circumstances affecting the target company, the court's ruling shows the potential risk to stockholders of pursuing so-called appraisal arbitrage. While many Delaware cases have relied on deal price as fair value, it is likely that synergies are frequently shared with selling stockholders. Buyers may benefit, therefore, by detailing their synergies analysis in reaching the merger consideration. That analysis may have greater evidentiary value if prepared before an appraisal demand is made.

Contact

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