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The Latest Significant Delaware Appraisal Decisions and Potential Effects on Appraisal Litigation

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As has been widely reported, the number of post-merger appraisal petitions filed in Delaware has sharply increased in recent years. From 2004 through 2010, appraisal claims were filed in approximately 5 percent of appraisal-eligible merger transactions. In 2011, the rate of petitions more than doubled to 11 percent, further increasing to 17 percent in 2013. Appraisal has continued to be a frequently sought remedy, with 40 appraisal cases filed in Delaware in 2014 and 28 additional appraisal claims filed through June 2015. Practitioners and other commenters have attributed this significant uptick in appraisal activity to the emergence of appraisal arbitrageurs – hedge funds and other sophisticated investors that seek to identify merger transactions where a court-appraised value is likely to exceed the merger price and then acquire relatively large equity positions in the public company target, with the express purpose of asserting appraisal rights under the Delaware statute. A key distinguishing characteristic of appraisal arbitrageurs from stockholders who historically sought judicial appraisal is that the arbitrageur takes a position in the company *after* a merger transaction is announced and *after* the record date for voting on the transaction.

The Delaware Chancery Court has handed down a number of appraisal decisions in 2015 that are likely to affect the continued attractiveness and availability of an appraisal arbitrage strategy. These decisions, addressing share ownership requirements and fair value in appraisal proceedings, are discussed below. These most recent decisions suggest that the success of the appraisal arbitrage strategy likely will hinge on the quality of the sales process for the transaction. Additionally, as outlined below, potential amendments to Delaware's appraisal statute, drafted by the Council of the Corporation Law Section of the Delaware State Bar Association (DSBA) in March 2015, attempt to ensure that appraisal actions are motivated by a genuine dispute over the fairness of the merger price.

Appraisal under the Delaware General Corporation Law

Under Delaware's appraisal statute, Section 262 of the Delaware General Corporation Law (DGCL), a stockholder may elect to dissent from a merger and forego the merger consideration and instead file a petition with the Chancery Court to determine the fair value of the target company's stock. Only a stockholder who is the record owner may make an appraisal demand and that record holder must continuously hold the shares through the consummation of the merger. Once a demand is made by the record holder, the beneficial owner of the shares may initiate the appraisal proceeding to determine the fair value of the shares. Fair value is determined by reference to the going concern value of the target company immediately prior to the merger, exclusive of any cost saving synergies and control premiums arising from the merger. In an appraisal proceeding, both the petitioning stockholder and the surviving corporation in the merger bear the burden of proof as to the company's fair value. It is within the court's discretion to select one of the parties' valuation models as its general framework, or fashion its own, to determine fair value in the proceeding. In so doing, the court may consider any valuation methodology that is "generally considered acceptable in the financial community and otherwise admissible in court." The four techniques generally relied upon by the

Chancery Court have included a discounted cash flow (DCF) analysis, a comparable companies analysis, a comparable transactions analysis, and an examination of the merger price itself, less synergies. Historically, the DCF valuation methodology has been featured most prominently because, according to the Chancery Court, "it is the approach that merits the greatest confidence within the financial community."

Significant Appraisal Decisions in 2015

Stock Ownership and Share-Tracing Cases – BMC Software and Ancestry I

A pair of Chancery Court opinions – *Merion Capital LP v. BMC Software, Inc.*, 2015 WL 67586 (Del. Ch. Jan. 5, 2015), and *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 66825 (Del. Ch. Jan. 5, 2015) – confirm that the DGCL does not impose any requirement on petitioning stockholders to demonstrate that prior owners of the shares refrained from voting in favor of the merger transaction. In *Ancestry*, the company argued that in order to have standing under Section 262 the beneficial owner needed to demonstrate that it did not vote in favor of the merger and, to the extent purchased after the record date, that no prior owner had voted those shares in favor of the merger. The *Ancestry* court made clear that the record owner, not the beneficial owner, is the only holder required to demonstrate that a sufficient number of shares to cover the demand were not voted in favor of the merger. The decision also clarified that Section 262 does not require a beneficial owner of shares acquired after the record date to trace the history of their shares to prove that those particular shares were not voted in favor of the merger by a prior owner.

The *BMC Software* decision similarly held that Section 262 does not impose an obligation to trace the voting history of a particular share in order to prove standing. The *BMC Software* court specifically found that paragraph (e) to Section 262 (providing the ability of beneficial owners to bring appraisal claims in their own name) did not create in conjunction with paragraph (a) a requirement that beneficial owners also show that their specific shares were never voted in favor of the merger.

In *BMC Software*, the petitioning stockholders had changed the record holder from Cede & Co. to the beneficial owner, Merion Capital L.P., before the record date, thus satisfying the continuous ownership requirement. Certain petitioning stockholders in *In re Appraisal of Dell Inc.*, 2015 WL 4313206 (Del. Ch. July 13, 2015), however, had changed the record owner of their shares from Cede & Co. to their brokers' custodial bank nominees and lost standing to bring an appraisal claim even though beneficial ownership of the shares had not changed. Therefore, arbitrageurs may acquire shares after the record date without being subjected to the burden of proving those shares were never voted in favor of the merger, but the record holder of the shares cannot change after the record date even if the beneficial owner remains the same.

Valuation Cases – Ancestry II, AutoInfo, and Ramtron

- *In re Appraisal of Ancestry.com, Inc.*: In the post-trial decision involving the appraisal of Ancestry, *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726 (Del Ch. Jan. 30, 2015), the Delaware Chancery Court effectively rejected the appraisal claims of the hedge fund petitioners who had sought an award substantially in excess of the merger price. The decision confirms that the merger price resulting from a comprehensive, arm's length sales process will be accorded substantial weight in Delaware appraisal proceedings.

  In summary, two hedge funds specializing in appraisal arbitrage – Merlin Partners and Merion Capital – acquired a substantial equity stake in Ancestry, then a publicly traded company, following the October 2012 announcement of Ancestry's proposed acquisition by Permira Advisors at $32.00 per share, a 41 percent premium to the preannouncement stock price. The acquisition closed in December 2012 following Ancestry's stockholders' meeting at which 99 percent of the voting shares voted in favor of the transaction. The hedge funds brought appraisal proceedings following the closing of the transaction with respect to the shares that they had purchased after the announcement of the merger. At trial, both the petitioners and the company relied exclusively on DCF valuations to establish fair value. However, the parties disagreed on the components of the DCF methodology, including the projections to use to calculate future cash flows. The petitioners' expert developed a blended set of projections (based on two different sets of management projections prepared in connection with the sale process) for its DCF analysis, yielding a value of more than $42.00 per share. Ancestry's expert's DCF analysis relied exclusively on the more conservative set of management projections, producing a value of $30.63 per share, less than the merger price.

  Vice Chancellor Glasscock determined that management's premerger projections were "imperfect" and unreliable: one set of projections was aggressive to bolster a potential sale and the other set of projections was conservative and prepared to support a fairness opinion, and neither set was prepared in the ordinary course of business. The court also found that both experts tailored their DCF analyses in a "results-oriented" manner. After conducting his own DCF analysis that resulted in a valuation slightly below the merger price, Vice Chancellor Glasscock found that the untainted robust auction conducted by Ancestry, involving contacts with over a dozen parties, was unlikely to have left significant value unaccounted for and, because it was a nonstrategic acquisition, he could not identify any value attributable to synergies that would need to be deducted from the merger price to arrive at fair value. The court concluded that the merger consideration was better evidence of fair value.

- *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. April 30, 2015), represents another example of the Delaware Chancery Court placing heavy weight on the merger price in the absence of alternative reliable valuation analyses and where the merger price resulted from a fair and adequate sales process. In *AutoInfo*, the board of directors of AutoInfo, Inc., a small, publicly traded transportation services company, decided in 2011 to explore strategic options, including a potential sale of the company. At the instruction of the investment bank retained by AutoInfo, management prepared a five-year financial forecast. Management had never prepared multiyear projections before and internally doubted its ability to do so, leading members of management to characterize the projections as "aggressively optimistic" and "a bit of a chuckle and a joke." Following a months-long auction process involving 164 potential acquirers and the formation of a special committee to evaluate several formal bids, Comvest Partners emerged as the highest bidder at $1.26 per share. During due diligence, however, Comvest learned of various issues with AutoInfo's business, including accounting irregularities, poor bookkeeping, and weaknesses in the company's financial reporting practices. As a result, Comvest lowered its offer to $0.96 per share. After negotiations, the parties settled on a price of $1.05 per share.

Two of the company's stockholders, Merlin Partners and AAMAF, LP – both hedge funds, petitioned the Delaware Chancery Court for an appraisal of their shares. The petitioners' expert valued the company at $2.60 per share based on a DCF analysis using management-prepared projections and two comparable companies' analyses. The company's expert valued AutoInfo at $0.967 per share by analyzing the merger price and market evidence regarding the strength of the sales process and then deducting certain merger-related cost savings. The court ultimately agreed with AutoInfo's expert that the merger price was the best indicator of the company's value at the time of the deal, but declined to adjust the merger price downward to reflect theorized cost savings because the figures were not subject to outside objective assessment.

The court rejected the petitioners' valuation for several reasons. First, the court discredited the petitioners' DCF analysis because it relied exclusively on management's projections, which the court found to be unreliable because (1) the projections were not prepared in the ordinary course of business, but rather at the investment bank's request and with the guidance that the projections "needed to be optimistic," and (2) AutoInfo had never before prepared such projections and admitted having serious doubts about their accuracy. Second, the court gave no weight to the petitioners' comparable companies analyses because the analyses used companies that were significantly larger than AutoInfo and, unlike AutoInfo, were based on a less risky business model. Additionally, the court showed its willingness to test the reliability of the petitioners' claimed value by measuring it against real world factors such as the company's historical trading price, the bidding history for the company in the sales process, deficiencies in the company's controls and processes, and the competitive realities of the industry in which the company operated, concluding that the $2.60 per share valuation offered by petitioners' expert did not accord with reality.

The court performed its own DCF analysis based on projections that Comvest had prepared for its internal use in evaluating the deal, which produced a fair value of $0.93 per share, less than the merger price. However, the court noted that while it would normally be appropriate to provide weight to the value implied by the court's DCF analysis, it put full weight on the merger price because it appeared to be the best estimate of fair value given the nature of the sales process. Petitioners thus received an award equal to the merger price, plus interest at the statutory rate.

AutoInfo sends a clear message that a valuation analysis is only as reliable as the inputs used. Financial projections prepared routinely in the ordinary course of business are considered more reliable than those prepared solely for strategic transactions. In addition, companies that operate in the same industry may nonetheless be unreliable indicators of value due to differences in business model, size, or other relevant considerations. Furthermore, *AutoInfo* confirms that where a petitioner has not offered any reliable alternative analysis, "the merger price [may be] the most reliable indicator of value." However, the court also made clear that "the dependability of a merger price [as evidence of fair value] is only as strong as the process by which it was negotiated," providing further incentive for companies to engage in a robust arms-length sales process.

- *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015), is the latest decision in which the Delaware Chancery Court has selected merger price as the most reliable indicator of fair value where it is the result of a fair and adequate sales process. The case arose from Cypress Semiconductor Corp.'s bid for Ramtron in 2012. In response to the bid, Ramtron tested the market for months, but no other buyers emerged. Following another bid by Cypress and a subsequent hostile tender offer, Ramtron eventually agreed to be acquired by Cypress for $3.10 per share, a substantial 71 percent premium to the stock's unaffected trading price. After the merger was announced, LongPath, a hedge fund in the business of buying appraisal claims, acquired a small percentage of Ramtron's outstanding stock for the sole purpose of bringing an appraisal action.

At trial, LongPath relied on an expert DCF analysis based on management projections to argue that the fair value of Ramtron's stock was $4.96 per share. The court rejected the petitioner's claim, finding that management's projections suffered significantly from numerous flaws, that they were entirely unreliable and, therefore, that it would be inappropriate to determine fair value based on a DCF analysis at all. The court also expressed skepticism regarding what it considered to be expert-fueled valuation claims, noting that "[m]uch has been said of litigation-driven valuations, none of it favorable," and observed that a valuation far above the deal price would be a significant market failure, particularly in the context of a well-publicized hostile bid and a target actively seeking a white knight. The court also concluded that the comparable transactions approach promoted by LongPath failed to provide a reliable indication of Ramtron's fair value and that there were no comparable parties to Ramtron.

After noting the lack of a reliable DCF or comparable transactions or companies analysis to determine fair value, Vice Chancellor Parsons noted that "in the situation of a proper transactional process likely to have resulted in an accurate valuation of an acquired corporation, this Court has looked to the merger price as evidence of fair value and, on occasion, given that metric one hundred percent weight." The court added that nothing in the case law "hold[s] that a multi-bidder auction . . . is a prerequisite to finding that the merger price is a reliable indicator of fair value." The court thus looked to the merger price to derive fair value, and because the petitioner conceded synergies of $0.03 per share, it was awarded just $3.07 – three cents less than the price received by stockholders who accepted the merger consideration.

The *LongPath* decision builds on the *Ancestry.com* and *AutoInfo* appraisal rulings that accorded substantial weight to the merger price. The Chancery Court has repeatedly confirmed its willingness to rely on merger price as a strong indicia of fair value so long as the process leading to the transaction is untainted and any merger-specific value is excluded from fair value. The Delaware Supreme Court has similarly demonstrated its support for merger price as evidence of fair value this year with its affirmance in *Huff Fund Investment Partnership v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), *aff'd* (Del. Feb. 12, 2015). Furthermore, the decision confirms that there can be downside risk – a finding of fair value that is less than the merger price – as well as opportunistic upside for funds that buy appraisal claims. Of course, the downside risk is moderated by the statutory interest that accrues on the award.

Proposed Amendments to Delaware's Appraisal Statute

Legislative proposals introduced by the Council of the Corporation Law Section of the DSBA in March 2015 seek to improve the operation of Section 262 of the DGCL and lessen nuisance-type appraisal proceedings. The first proposed modification to Section 262 would foreclose the appraisal of shares of public companies "unless the dispute with regard to valuation is substantial and involves little risk that the petition for appraisal will be used to achieve a settlement because of the nuisance of discovery and other burdens of litigation." To achieve this goal, the proposed amendment to Section 262(g) permits the court to dismiss an appraisal proceeding involving shares traded on a national securities exchange unless (1) the total number of shares perfecting appraisal rights exceeds 1 percent of the total outstanding shares of the class or series entitled to appraisal, (2) the value of the consideration provided in the merger for the total number of dissenting shares exceeds $1 million, or (3) the merger was approved pursuant to a short-form merger provision of the statute (Section 253 or Section 267 of the DGCL). We would expect this proposed amendment to have little practical effect on appraisal arbitrage, as there are few petitions by stockholders holding a stake of less than $1 million.

The second proposed modification, to Section 262(h) of the DGCL, would allow acquiring companies to cut off the accrual of statutory interest on at least a portion of the appraisal award by permitting them to prepay to the petitioners, before the entry of judgment in an appraisal proceeding, a cash amount of the company's choosing. Statutory interest (5 percent over the Federal Reserve discount rate) would only accrue on the difference, if any, between the amount paid by the company and the fair value of the shares as determined by the court. This amendment may encourage companies to prepay significant amounts, even up to the full merger price, to petitioners, which would in turn dampen the incentive for interest rate arbitrage and ensure that appraisal actions are motivated by a genuine dispute in proving that the merger price was unfair. However, the proposed amendment could have the unintended consequence of encouraging more appraisal claims by freeing up petitioners' funds for redeployment in other mergers that otherwise would have been locked up during the pendency of the appraisal proceeding.

The proposed amendments were not introduced to the Delaware General Assembly as the Council chose to focus on other amendments to the DGCL. However, the Council will take the issue up again this fall and determine whether to reintroduce the amendments when the Delaware General Assembly reconvenes in January 2016. The Council's proposed amendments are designed to reduce potentially perverse incentives for appraisal specialists, but they do not ban or substantially limit appraisal arbitrage and have only fueled further debate on the topic.

Conclusion

The appraisal cases discussed above offer potential lessons for companies, directors, stockholders, and their counsel. When considering strategic mergers, companies and their boards may be able to prevent, or at least successfully defend against, claims that the company was sold at an inadequate price by creating and implementing a sales process that is fair, negotiated at arm's length, and free from any self-interest. Conversely, stockholders may hesitate before demanding appraisal where proxy materials disseminated by the company in connection with the merger suggest that a proper and fair process was followed. Additionally, stockholders have learned that their appraisal rights are not limited by their ability to trace the voting history of their shares but that any disruption in the continuous record ownership of their shares after the record date will be fatal to their claim. Accordingly, while the future prospects of an appraisal arbitrage strategy will continue to be decided in real-time, recent case law in Delaware suggests that appraisal arbitrage should only be successful on the merits when flawed deals undervalue companies.

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