

Delaware Appraisal – when is the negotiated sale price also the 'fair value'?

Two recently-decided Delaware Chancery Court appraisal decisions, [PetSmart](#) and [SWS Group](#), provide useful guidance as to when and how the Court will adopt, or decline to adopt, the agreed sale price approved by the target company's board of directors when the Court makes its fair value determination in a statutory appraisal proceeding brought by dissenting stockholders following the sale of a publicly-traded Delaware corporation. The two decisions reinforce the desirability of a well-designed, demonstrably value-maximizing sale process.

Background

If a publicly-traded Delaware corporation has been sold for cash, a stockholder who doesn't like the price can sue the corporation's directors on a claim the directors breached their fiduciary obligations, by failing to get the best price reasonably obtainable (a *Revlon* claim). Such a claim can be, and usually is, brought as a class action on behalf of all public stockholders. Success leads to a retroactive price bump (in the form of a damages award) for all the target's former public stockholders (whether or not they voted for the transaction or tendered their shares to the acquirer). Or the unhappy stockholder can bring a statutory appraisal action, in which the Chancery Court decides what the fair value per share was at the time the sale was completed. In an appraisal action, the surviving corporation (or effectively, the acquirer) must pay the judicially-set fair value per share, plus interest from the effective time of the merger used to complete the sale, to the dissenting stockholder. The fair value as determined by the Court may be more or less than, or the same as, the price specified in the negotiated merger agreement by which the corporation was sold. Stockholders who voted for the sale or tendered their shares in the first step of a two-step acquisition are ineligible for appraisal rights, as are other stockholders who fail to begin an appraisal process within a specified period after the merger. Appraisal proceedings cannot be brought as class actions; thus in an appraisal proceeding, the only stockholders to get the benefit of any price bump award are the ones who brought the proceeding.

In *Revlon* cases, the analysis focuses significantly on the quality of the auction or other process employed by the target's board that led to the sale of the corporation. *Revlon* claims may be brought as class actions and can lead to recoveries on behalf of all public stockholders, and historically have been brought more frequently than appraisal claims. Following the Delaware Supreme Court's decision in [Corwin](#), however, *Revlon* claims have become less attractive to plaintiffs, because under *Corwin* the target's stockholders effectively extinguish all *Revlon* claims (including claims belonging to stockholders who don't vote the same way) when the requisite majority votes to approve the corporate sale, after appropriate disclosure to them of the sale process and its possible deficiencies. In a trend that began before the *Corwin* decision (and has continued since), appraisal claims have become increasingly common. One of the lessons provided by a recent series of appraisal action decisions in Delaware is that the quality of the sale process followed by target companies' boards continues to be important, even after *Corwin*. This is because over the past few years the Chancery Court has made clear that in many cases the fair value per share determined in appraisal cases will be the same price per share approved by the target's board of directors, provided, among other things, the Court finds the sale process run by the target's board of directors was

sufficiently robust to serve a reliable price discovery function. The converse of course is that if the Court decides the price discovery function is insufficiently reliable it will substitute its own view of a fair price. This is an outcome transaction participants – especially acquirers -- generally prefer to avoid.

At the end of 2015, there was reason to be sanguine about the potential for adverse outcomes in appraisal proceedings, because in 2015 the Chancery Court adopted the contracted-for deal price as the fair value in four out of five decided appraisal cases. For those who felt that way, 2016 may have been jolting, because in 2016 the Chancery Court adopted the contracted-for deal price in only one of five decided appraisal cases. It found fair value to be higher than the agreed deal price in the other four cases.

Against this backdrop, *PetSmart* and *SWS Group* perhaps help put things in context.

In *PetSmart*, the Chancery Court held the fair value for appraisal purposes was the same as the deal price approved by the target's board because that deal price was the result of a "proper transactional process" comprised of a robust pre-signing auction in which adequately informed bidders were given every incentive to make their best offer in the midst of a "well-functioning market." This made for a different outcome than in the 2016 cases in which the Chancery Court found the agreed deal price insufficiently reliable. For example, in the Chancery Court's 2016 decisions in *Dell* and *DFC Global*, the Court apparently concluded that private equity-backed sponsors had taken advantage of situations in which the market did not properly recognize the targets' intrinsic values (in *Dell*, the Court found unrecognized value resided in recently-pursued new business initiatives that had consumed substantial capital; in *DFC Global*, the Court found the target's market value was temporarily depressed by internal turmoil and regulatory uncertainty). The *Dell* and *DFC Global* decisions also reflect a view that the price discovery function of a sale process is diminished when the target's management is subject to the conflicts of interest potentially involved in sales to private equity-backed acquirers. In *Dell*, the Court disregarded the deal price altogether; in *DFC Global*, the Court used the deal price as one of three relevant data points. In both cases the fair value determined by the Court was higher than the deal price.

In *SWS Group*, the Court did not adopt the deal price as the fair value because of various flaws in the sale process. Instead, the Court performed its own valuation analysis. Interestingly, that analysis generated a fair value *lower* than the deal price. This was because (according to the Court) the deal price reflected the value of substantial synergies expected to be derived from the target's combination with its strategic acquirer. The synergy value was excluded because under the Delaware appraisal statute, the Court is directed to determine fair value "exclusive of any element of value arising from the accomplishment or expectation of the merger."

Takeaways

- The public M&A transactions most potentially vulnerable to appraisal claims are those involving management buyouts, because the Chancery Court clearly is skeptical of the validity of price discovery derived from a process leading to an MBO.
- The transactions least potentially vulnerable to appraisal claims are sales to strategic acquirers where the contracted-for deal price reflects synergy benefits to be realized by the acquirer.
- In transactions that involve neither an MBO nor substantial synergy values, the Court is likely to defer to the agreed deal price unless it finds the sale process was poor or that the price was negotiated under circumstances that involved uncertainty as to the target's business (such as regulatory uncertainty). In these cases, the Court also may use a DCF analysis that produces a lower value than the deal price.
- Accordingly, transaction participants who wish to reduce the potential for a retroactive price increase for some of the target corporation's shares in an appraisal proceeding should focus on developing a record that the sale process followed by the target's board was reasonably designed to maximize value and the value generated for the target's stockholders in the sale was not adversely impacted by temporary factors that made it hard for bidders to recognize the target's intrinsic value. (This of course is the same record that public M&A transaction participants historically have sought to develop in anticipation of *Revlon* claims.)

Further guidance on this topic may soon be forthcoming. *Dell* and *DFC Global* were appealed to the Delaware Supreme Court.

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