

IMPACT OF 2018 DELAWARE CHANCERY COURT APPRAISAL DECISIONS ON TRANSACTION VALUATIONS

Introduction

When a Delaware corporation is sold, certain shareholders have the right to forego the negotiated share price and elect an appraisal of their shares to determine their fair value. These appraisal rights protect shareholders against a sale of the company at a price below the company's fair value, without requiring that the shareholders demonstrate wrongdoing or breaches of fiduciary duties by the company's management or directors. In some cases, appraisal rights claims have resulted in large awards to the petitioners based on findings that the companies' fair values were double the deal prices (or more). While these types of appraisal awards significantly exceeding the deal price are still possible, Court of Chancery ("the Court") decisions in 2018 suggest a narrowing of the range of circumstances in which such an award may occur. This article will discuss these circumstances and other takeaways from some noteworthy 2018 Court decisions.

DELL AND DFC IMPACTS

The Court's appraisal rulings in 2018 were heavily influenced by the Delaware Supreme Court's ("the Supreme Court") decisions in two 2017 cases: [*Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*](#) and [*DFC Global Corp. v. Muirfield Value Partners, L.P.*](#) In both cases, the Court did not rely solely on the deal price to determine the subject company's fair value, and in both cases the Supreme Court decided the deal price deserved significant – if not dispositive – weight.

In its decisions, the Supreme Court discussed the significance of market evidence specific to the subject company. In its decision on *DFC*, the Supreme Court stated, "When, as here, the company had no conflicts related to the transaction, a deep base of public shareholders, and highly active trading, the price at which its shares trade is informative of fair value, as that value reflects the judgments of many stockholders about the company's future prospects, based on public filings, industry information, and research conducted by equity analysts."

It similarly advised on the value of market information in its decision on *Dell*, warning that “[w]hen... an appraisal is brought in cases like this where a robust sale process of that kind in fact occurred, the Court of Chancery should be chary about imposing the hazards that always come when a law-trained judge is forced to make a point estimate of fair value based on widely divergent partisan expert testimony.”

In the words of Vice Chancellors Glasscock and Laster, the *Dell* and *DFC* decisions were “seminal cases” that “contained an unprecedented level of discussion of the efficient capital markets hypothesis” and “changed things” for Delaware appraisal decisions.

NOTABLE 2018 DECISIONS¹

Aruba Networks, Inc. – In the [Aruba Networks appraisal](#), the Court concluded that Aruba Networks’ unaffected historical trading price provided the best indication of the company’s fair value at the merger date. The Delaware Supreme Court subsequently reversed this decision and instead awarded a value based on the deal price less an estimate of synergies.

Solera Holdings, Inc. – In the [Solera appraisal](#), the Court found the deal price less an estimate of synergies included in the deal price was the best indicator of Solera’s value at the merger date.

AOL Inc. – In the [AOL appraisal](#), the Court found flaws in the deal process and relied on a DCF analysis to value AOL at the merger date, but still used the deal price as a reasonableness check on the DCF.

Norcraft Companies, Inc. – In the [Norcraft appraisal](#), the Court found flaws in the deal process and relied on a DCF analysis to value Norcraft at the merger date, but still used the deal price as a reasonableness check on the DCF.

KEY TAKEAWAYS

The Delaware Supreme Court may have created *de facto* deference to the deal price

In *DFC*, the Supreme Court denied *DFC*’s request that it create a formal deference to the deal price, but it may have created a *de facto* deference. In both decisions, it emphasized the reliability of the deal price under certain circumstances. This appears to have led the Court to conclude that deference to the deal price is the necessary outcome in cases in which the sale “has the requisite objective indicia of reliability emphasized in *DFC* and *Dell*.”

The Court’s rulings in 2018 suggest that a petitioner may need to demonstrate significant flaws in the sale process or the market’s inability to accurately assess the company’s value in order to convince the Court not to anchor its fair value opinion to the deal price. As an example, in *Aruba Networks*, the Court found that the company’s financial advisor’s eagerness to establish a good relationship with the buyer and complete a deal undermined its role as *Aruba Networks*’ advisor and made it less effective negotiating on the company’s behalf. Nonetheless, it still concluded that the company’s fair value was below the deal price.² Unfortunately, *Dell* and *DFC* did not establish the criteria that would make the deal price unreliable (whether as the determinant of value or as a reasonableness check); this will likely be addressed in future cases.

Increased risks could result in continued decreases in appraisal activity

An emphasis on the deal price creates significant risks for appraisal claims arising from strategic acquisitions. It is not unusual for a strategic buyer to pay a premium over stand-alone fair value with the expectation that it can generate synergies that exceed that premium. However, the fair value appraisal standard excludes any value associated with synergies. If a strategic acquisition meets the *DFC/Dell* criteria, the Court’s 2018 decisions suggest the best a petitioner could realistically hope for is the deal price. The more likely outcome appears to be something less than the deal price, reflecting the exclusion of synergies. After litigation costs, this could mean significant losses for the petitioners.

¹ In addition to these appraisal actions, the Court’s ruling in the *PLX Technologies, Inc.* breach of fiduciary duty case provides another example of the Court attributing significant weight to the deal price as part of its decision not to award damages to the plaintiffs.

² Although the Delaware Supreme Court selected a different value than the Court of Chancery initially awarded, that value was still below the deal price.

Admittedly, this risk existed prior to the Supreme Court's recent rulings³, but that risk is enhanced by a greater emphasis on the deal price and pre-deal market evidence.

These considerations could cause appraisal activity to continue to decline. Acquisitions will likely appear less appealing as appraisal opportunities if they resulted from a robust sales process ending with a sale to a third party. Even an imperfect sales process can still result in a deal price that the Court may view as the ceiling for fair value in a strategic acquisition. These rulings also may provide additional confidence for acquirers and make them less likely to agree to pre-trial settlements.

Despite these recent rulings, reliance on market evidence isn't automatic. The deals discussed in this article involved publicly traded companies, and the Court appears to have concluded the sales processes were reasonably determining fair value. These types of transactions could still provide good opportunities for appraisal actions.

Potential benefits from providing more support for valuation opinions

A major 2018 takeaway for valuation analysts is that their valuations will be more convincing if they are able to explain the specific circumstances that led to the market overestimating or underestimating the company's value. The *Dell* and *DFC* decisions suggest that the most convincing arguments will be those that show a breakdown of the premises underlying the efficient markets hypothesis. For example, one might demonstrate that key information was withheld from the market, or that the market historically has not consistently responded to information about the company's performance. A valuation analyst who can explain to the Court how those issues contributed to a deal price that is below fair value (not just below the price it otherwise may have been able to obtain) will likely be more credible to the Court. Additionally, the Court's willingness to use the deal price as a reasonableness check even when the circumstances don't meet the *Dell/DFC* standards suggests that this explanation may need to show that the deal price is wholly unreliable in order to convince the Court of a value significantly above the deal price.

Aruba Networks provides an example of the potential importance of providing this type of explanation. In that case, the Court found the petitioners' expert's methodology to be "seemingly sound" and criticized aspects of the respondent's expert's valuation, yet it attributed no weight to the petitioners' expert's valuation because the result differed so substantially from market indicators. Similarly, in *Solera*, the Court declined to resolve differences in the experts' valuation inputs on the merits of the individual assumptions, choosing instead to give no weight to petitioners' expert's valuation because it resulted in a value that significantly exceeded the deal price.

Aruba Networks highlights another consideration: the Court may want a more robust explanation for analyses that produce results the Court may not intuitively expect. The Court in *Aruba Networks* noted that precedent supports the methodology petitioners' expert used to estimate the company's beta. However, this calculation resulted in a beta of less than 1.0, and the Court appears to have taken issue with petitioners' expert's inability to provide a compelling explanation for the result being that low.

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³ As examples, the Court's conclusions of values below the deal prices in the appraisals of [Clearwire Corporation](#) and [SWS Group, Inc.](#) in 2017 demonstrate that risk.

CONCLUSION

The *Dell* and *DFC* rulings in 2017 were profoundly influential in 2018 Delaware appraisal rulings, even leading the Court to coin and use the phrase “*Dell*-compliant” in some of its decisions. Those rulings appear to demonstrate the following trends for valuation and appraisal:

- Greater deference to deal price as evidence of fair value, or at least a reasonableness check
- Greater risk for appraisal claims in strategic acquisitions, which could lead to reduced appraisal activity
- Greater skepticism and examination of valuation factors and assumptions that produce a result different from the deal price

Overall, these trends suggest a narrower range of circumstances where an appraisal award significantly exceeding the deal price might occur. Valuation experts should expect the Court to remain focused on market efficiency considerations, and their opinions will likely be more compelling to the Court if they are able to convincingly address these issues.

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