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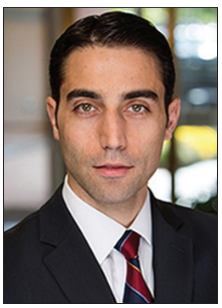

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Statutory Appraisal Rights Explained

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Minority shareholders who believe they have been unfairly compensated as a result of a merger transaction often have only one available remedy: to dissent from the merger and exercise their right to have a court determine the so-called "fair value" of their shares. In any such appraisal action, the dissenting shareholders will claim that the merger consideration was not fair and that they should be paid more. The acquirer, on the other hand, will claim that the merger consideration was fair or more than fair.

In the last several years, the number of shareholders dissenting from corporate actions and asserting their statutory appraisal rights has surged. Appraisal petitions filed in Delaware, for example, have tripled over the last three years. It appears that this trend may be here to stay. In fact, this increase has been attributed, in part, to the rise of so-called "appraisal arbitrage" in which an investor purchases shares in the target of a merger solely for the purpose of asserting appraisal rights.

Whether you are corporate counsel facing an appraisal action for the first time or counsel to shareholders considering the exercise of their appraisal rights, here are the top six issues to be aware of as you consider your client's options.

1. Fair Value ≠ Fair Market Value

In an appraisal proceeding, the court is charged with determining the "fair value" of the petitioner's shares of the subject company on a statutorily-defined appraisal date.[1] "This is done in a jurisprudentially specific manner that is policy-based and that is different from that which would be undertaken to find the 'fair market value' of the petitioners' shares." [2]

Fair Market Value (FMV) is defined as "the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."[3] An FMV appraisal allows for the application of certain discounts, such as the *minority discount*, which adjusts for the lack of control over the business entity on the theory that non-controlling shares of stock are not worth their proportionate share of the firm's value because they lack voting power to control corporate actions,[4] and the *marketability discount*, which adjusts for a lack of liquidity in one's interest in an entity, on the theory that there is a limited supply of potential buyers for stock in a closely-held corporation.[5]

Generally speaking, and under Delaware law, a fair value appraisal, unlike other valuation contexts, may not include the application of discounts for minority positions and the lack of marketability.[6] As discussed below in the next section, the fundamental issue in an appraisal proceed-

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continued

ing is a determination of a company's intrinsic value as a going concern, without consideration of factors such as lack of marketability, a minority interest discount, or synergies that might result from the transaction at issue.

2. Fair Value is the Dissenting Shareholder's Proportional Interest in a Going Concern Value

Courts require that a company be valued as a "going concern", employing an underlying assumption in these matters that the dissenting shareholder would be willing to continue its investment in the company had the corporate action being dissented from not occurred.[7] "Consequently, the corporation must be valued as an operating entity, and the dissenting shareholder's shares valued as what is being taken from the shareholder, that is, the shareholder's proportionate share in the corporation as a going concern,[8] … rather than value that is determined on a liquidated basis." [9]

Moreover, courts are required to exclude from any determination of value any synergies (*i.e.*, benefits) of the transaction at issue.

The exclusion of any synergies that would result from a merger derives from the mandate that the subject company be valued as a going concern. "Logically, if this mandate is to be faithfully followed, this court must endeavor to exclude from any appraisal award the amount of any value that the selling company's shareholders would receive because a buyer intends to operate the subject company, not as a stand-alone going concern, but as a part of a larger enterprise, from which synergistic gains can be extracted." [10]

Put another way: the court will determine the value of the subject company from the perspective of a stockholder of that company on the statutory appraisal date, not the company's value from the perspective of a potential acquirer.[11]

3. Discounted Cash Flow is the Preeminent Valuation Methodology

The next step is to move from the concept of going concern value to the application of a valuation methodology to determine that value. In the landmark 1983 case of *Weinberger v. UOP, Inc.*, the Delaware Supreme Court held that a proper approach to valuation "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." [12]

Since the *Weinberger* decision, a body of jurisprudence has developed on the acceptable methodologies and their appropriate application in the fair value appraisal context. The most prevalent approach is a type of the income approach called the Discounted Cash Flow method (DCF), which Delaware courts have described as "the preeminent valuation methodology" [13] and "[i] n many situations … in theory the single best technique to estimate the value of an economic asset." [14]

Put simply, a DCF analysis projects operating cash flows for an extended period, determines a terminal value upon sale at the end of that period, and then discounts those values at a set discount rate (*i.e.*, cost of capital) to determine the net present value of the company. DCF is based generally upon three inputs: (1) the free cash flow projections for a certain number of years (the "discrete period"); (2) the terminal value estimate at the end of the discrete period; and (3) the discount rate.[15] The discount rate, which may be the most important and most contested, input of this analysis, represents the *cost of equity*, or, put another way, the total expected rate of return that an investor would require to invest in the company at issue.[16]

It should be noted that the DCF approach is not appropriate in all contexts as either a standalone methodology or utilized in conjunction with other methodologies. Other "generally acceptable" approaches include: the Comparable Companies approach, the Comparable Transactions approach, Net Asset Value (NAV), and market value (prior transactions in the company's securities or market price when listed on an exchange). It is critical to consult the controlling (or, if none available, persuasive) case law before relying on any one method. For example, under Delaware law, courts may not afford any weight to the market value (usually based on previous transactions) unless the proponent has established the existence of an established and reliable market for the subject company's securities.[17] But, even if such a market can be established, the market value approach may not be used as the sole method for valuing the business.[18] Similarly, Delaware law precludes the use of the NAV approach as a standalone method for valuing a business.[19]

4. Battle of the Experts

At trial, litigants should expect fact testimony by corporate insiders concerning such issues as: the validity of financial projections, marketing and sales success, financial health of the business, and business plans already in place on the appraisal date. Ultimately, however, this type of litigation may come down to a battle of the experts.

Under Delaware law, both sides have the burden of proving their respective valuation positions by a preponderance of the evidence.[20] The court "may not adopt at the outset an 'either-or' approach, thereby accepting uncritically the valuation of one party, as it is the Court's duty to determine the core issue of fair value on the appraisal date."[21] If neither party meets the preponderance standard on the ultimate question of fair value, the Court will make its own determination.[22] If the record (practically speaking, the expert testimony) is insufficient for the court to make its own determination, the court may appoint its own expert. The cost of this expert will likely be shared equally by the parties.[23]

5. Relevance of a Liquidation Preference

Recent decisions in Delaware indicate that courts must look at the contractual rights granted to preferred shareholders (*i.e.*, liquidation preferences) when determining the fair value of a company, regardless of whether the petitioner is a preferred shareholder or common shareholder.

For example, in *Shiftan v. Morgan Joseph Holdings, Inc.*, the Chancery Court recognized that it was "required to take into account all <u>non-speculative</u> information bearing on the value of the shares at issue," which necessarily included the fact that the preferred shareholders were entitled to mandatory redemptions of $100 per share.[24] The court held that, in practice, this means that a court must first determine the fair value of a company as going concern as of the merger date, and then apportion a percentage of that value to the preferred shareholders based on their contractual preference rights.[25] Although the petitioners in *Shiftan* were preferred shareholders, this decision has implications for common shareholders whose shares are inferior to preferred shares in the company's capital structure:

> This works no harm to the other [non-preferred] equity holders, as that is what you sign up for when you invest in a company with senior security holders entitled to specific preferred rights with economic value…[26]

This principle was reinforced in *In re Trados Incorporated S'holder Litig.*, where the merger at issue constituted a liquidation event that entitled the company's preferred shareholders to a liquidation preference.[27] As a result of the payment of the preference obligation, the common shareholders received nothing and certain of those shareholders exercised their appraisal rights. The court ultimately held that the fair value of the common shares was zero because "the common stock had no economic value before the Merger, making it fair for its holders to receive in the Merger the substantial equivalent of what they had before."[28]

6. Limited Scope ≠ Limited Discovery

Despite the limited scope of an appraisal proceeding, discovery may not be limited to financial and business information. A dissenting shareholder may inquire into those facts necessary to "assess[] the credibility of the respondent corporations' valuation contentions."[29] Moreover, despite the mandate that courts must exclude the synergies of a transaction, discovery may not necessarily be restricted to a time period predating the appraisal date. Delaware courts have held that a corporation cannot "hide behind the bar of the date of the merger to prevent" discovery of "admissible evidence ascertainable at the time of the merger which could throw light on the future prospects of the merged corporation as of that time."[30] More specifically, Delaware law "permit[s] consideration of post-merger evidence that could have been discerned at the time of the merger, but not to permit consideration of post-merger evidence that was not capable of being known on the date of the merger."[31]

Conclusion

Whether you are representing the company or the dissenting shareholders, fair value appraisal actions involve many different issues. This article highlights some of the most prominent ones.

Footnotes:

1 This statutory date can vary. For example, under Delaware law, the appraisal date is the merger date, but, under New Jersey law, the appraisal date is the day before the vote (by shareholders or the board of directors, depending on the circumstances) approving the merger.

2 *Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd.*, 847 A.2d 340, 355-56 (Del. Ch. 2004).

3 Rev. Rul. 59-60, 1959-1 C.B. 237 (1959)

4 *See Lawson Mardon Wheaton v. Smith*, 160 N.J. 383, 398-399 (N.J. 1999).

5 *See Lawson Mardon Wheaton v. Smith*, 160 N.J. 383, 402 (N.J. 1999).

6 *In re: Appraisal of The Orchard Enterprises, Inc.*, 2012 Del. Ch. LEXIS 165 (Del. Ch. July 18, 2012).

7 *Holiday Medical Center, Inc. v. Weisman*, 2008 WL 2677504 (N.J.Super.A.D. July 10, 2008) (quoting Stuart L. Pachman, *Title 14A—Corporations*, commentary to

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continued

14A:11–11 at 508 (2008)).

8 *Id.*

9 *Id.* (quoting *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996)) (emphasis in original).

10 *Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd.*, 847 A.2d 340, 356 (Del. Ch. 2004).

11 *See Golden Telecom, Inc. v. Global GT LP,* 11 A.3d 214, 217 (Del. 2010).

12 *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-713 (Del. 1983) (emphasis added).

13 *Neal v. Ala. By-Prods. Corp.*, 1990 Del. Ch. LEXIS 127, *20 (Del Ch. Aug. 1, 1990) (citing S. Pratt, *Valuing A. Business: The Analysis and Appraisal of Closely Held Companies* (2d ed. 1989)).

14 *Cede & Co. v. Technicolor, Inc.*, 1990 Del. Ch. LEXIS 259 (Del. Ch. Oct. 19, 1990). Courts, however, have found DCF to be inappropriate in certain cases, such as where the inputs to the method, including cash flow projections and terminal value estimates, are unreliable. For example, in a recent decision, *Huff Fund Investment P'ship v. CKx, Inc.*, the Chancellor held that management's projections were unreliable, relying on prior decisions where Delaware courts have "disregarded management projections where the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation or where the projections were created for the purpose of obtaining benefits outside the company's ordinary course of business." 2013 Del. Ch. LEXIS 269, *30-31 (Del. Ch. Nov. 1, 2013); *see also Laidler v. Hesco Bastion Environmental, Inc.*, 2014 WL 1877536 (Del. Ch. May 12, 2014) (same Chancellor rejects merger price as fair value because company's "ninety-percent controlling stockholder itself determined the price it would pay for the Company's sole minority stockholder's shares.").

15 *See Cede & Co. v. Technicolor, Inc.*, 1990 Del. Ch. LEXIS 259 at *4.

16 *See* SHANNON PRATT, COST OF CAPITAL 11 (4th ed. 2010).

17 *See Cede & Co. v. Technicolor, Inc.*, 1990 Del. Ch. LEXIS 259, *60 n.39 (Del. Ch. Oct. 19, 1990); *see also Seagraves v. Urstadt Property Co., Inc.*, 1996 Del. Ch. LEXIS 36 (Del. Ch. April 1, 1996).

18 *See Cede & Co. v. Technicolor, Inc.*, 1990 Del. Ch. LEXIS 259, *60 n.39 (Del. Ch. Oct. 19, 1990). Similarly, under New Jersey law, market value cannot be determinative of fair value, but courts will consider it to be "a valuable corroboration tool." *Lawson Mardon Wheaton Inc. v. Smith*, 315 N.J.Super. 32, 49-50 (App. Div. 1998).

19 *Cede & Co. v. Technicolor, Inc.*, 1990 Del. Ch. LEXIS 259 (Del. Ch. Oct. 19, 1990).

20 *See M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 520 (Del. 1999); *In re: Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 899 (Del. Ch. 2009).

21 *In re: Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d at 899-900.

22 *See id.* ("[A]fter having considered the parties' legal arguments and the respective experts' reports and testimony supporting their valuation conclusions, the Court has broad discretion either to select one of the parties' valuation models or to fashion its own.")

23 *See In re Shell Oil Co.*, 607 A.2d 1213, 1222 (Del. 1992).

24 57 A.3d 928, 941 (Del. Ch. 2012) (emphasis added).

25 *Id.* at 941-942.

26 *Id.* at 942.

27 2013 Del. Ch. LEXIS 207 (Del. Ch. Aug. 16, 2013).

28 *Trados*, 2013 Del. Ch. LEXIS 207 at *3 and *183 (Del. Ch. Aug. 16, 2013).

29 *Neal v. Ala. By-Prods. Corp.*, 1990 Del. Ch. LEXIS 127, *15 (Del Ch. Aug. 1, 1990).

30 *Cede & Co v. Technicolor, Inc.*, 1984 WL 8247 (Del. Ch. Oct. 22, 1984).

31 *Cinerama, Inc. v. Technicolor, Inc.,* 999 WL 135242 (Del. Ch. Feb. 25, 1999) (emphasis in original).

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