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Unlocking Intrinsic Value Through Appraisal Rights

Law360, New York (September 10, 2013, 3:48 PM ET) -- A review of all Delaware appraisal cases in the last 20 years shows that the court has consistently established a “fair value” greater than the amount a buyer offered to pay for a stand-alone business. The only cases in which appraised value was less than the merger price — fewer than 20 percent of the decisions — were those in which the buyer was paying for something more than the value of the stand-alone business, such as synergies of a combination with the buyer’s existing operations or a resolution of disputes.

These results reflect the Delaware law’s definition of “fair value” as the long-term intrinsic value of a company, considered as a stand-alone “going concern,” and the state’s Supreme Court has recently made it clear in Golden Telecom Inc. v. Global GT LP, 11 A.3d 214, 217-28 (Del. 2010) that the court must make its appraisal independently of current market pricing or auction bids. In this context, it is reasonable to assume that a stand-alone buyer would not have offered to pay more for a company than what it was worth, and that a judge will reach the same conclusion. This logic is especially compelling when the buyer is a well-informed management insider partnering with professional private equity investors.

Management Buyouts are Likely Priced Below Intrinsic Value

In a management buyout, one or more individuals responsible for a company’s management purchase the stand-alone going concern with funding from professional equity and debt investors. With full access to the company’s inside information, the manager and partnering investors price the offer to profit from the difference between market pricing and the intrinsic value of the company.

Viewing a management buyout as a pure “stand-alone buyout” — which, for purposes of this article means a buyout in which the purchaser pays only for the value of the company as a going concern (and not for any additional value resulting from the transaction such as synergies of combination with another company, or for the “resolution of disputes”) — it is highly unlikely that management (together with the professional investor) could present a credible argument to the court that they knowingly overpaid for a company. Indeed, court opinions from the Delaware Courts show that there has not been a single case during the past 20 years in which a stand-alone buyout’s “fair value” was appraised at less than the offer price.

The Only Appraisal Cases Over the Last 20 Years That Have Been Appraised at Less than Merger Price are Not Stand-Alone Buyouts

Over the last 20 years, 45 appraisal actions have gone to trial and resulted in a post-trial opinion (some appraisal actions, including Cede v. Technicolor have resulted in more than one post-trial opinion). Of those 45 cases, only eight (17.8 percent) resulted in an appraisal of fair value by the court that was less

than the merger price.

Significantly, none of those eight cases was a stand-alone buyout. Rather, six of them — Gerreald v. JustCare; Highfields Capital v. AXA Financial; Union Illinois 1995 Inv. Ltd. Partnership v. Union Financial Group; In re Grimes v. Vitalink Communications Corporation; Kleinwort Benson v. Silgan Corporation; and Cooper v. Pabst Brewing Company — involved a competitively bid acquisition as part of a strategic business combination. The other two — Andaloro v. PFPC Worldwide Inc. and Finkelstein v.Liberty Digital Inc. — involved the resolution of disputes with affiliates.

It appears that the acquiring company in each of those eight cases paid for value beyond that of the stand-alone going concern, whereas it is well established that the court's analysis must be based exclusively on the company's value as a stand-alone going concern. Because the buyer's valuation in those cases was based on benefits beyond the stand-alone enterprise value, the price they were willing to offer was more than the fair value of the company.

Foundations of Delaware Appraisal of Fair Value

Under Delaware law, stockholders who properly perfect their appraisal rights are entitled to have the Court of Chancery determine the "fair value" of their shares of stock as of the merger date. The basic concept of fair value is simple, as stated in a frequently cited Delaware Supreme Court case from 1950: stockholders are entitled to be paid for their "proportionate interest in a going concern," which means they are entitled to be paid "the true or intrinsic value of [their] stock which has been taken by the merger." Tri-Cont'l Corp. v. Battye, 74A.2d 71, 72 (Del. 1950).

In determining the price that represents fair or intrinsic value, the Court of Chancery is required to perform an independent evaluation. In doing so, the court must take into consideration all relevant factors that "reasonably might enter into the fixing of value," including (i) market value, (ii) asset value, (iii) dividends, (iv) earning prospects, (v) the nature of the enterprise subject to the appraisal proceeding, and (vi) any other facts (such as the value of intellectual property, including patents, trademarks, trade secrets and other proprietary data) that were known or could have been known as of the date of the merger and which shed light on future prospects of the merged corporation.

Factors Not Relevant to the Court's Determination of "Fair Value"

While the court must consider all relevant factors to determine fair value, those factors do not include merger price, or whether the merger price resulted from a fair process. The merger price is not the same thing as a company's "fair value" as a going concern. As noted above, the Delaware Supreme Court made this point unambiguously clear in its 2010 Golden Telecom decision by refusing to "establish a rule requiring the Court of Chancery to defer to the merger price in any appraisal proceeding."

Subsequent to Golden Telecom, Chancellor Leo Strine refused to give any weight to the merger price in valuing a company at $4.67 per share, which was more than double the $2.05 merger price. In re Orchard Enters. Inc. (Del. Ch. July 18, 2012). And Vice Chancellor Parsons found the merger price irrelevant in concluding that the fair value of a company was $10.87 per share, in excess of the $10.50 merger price. Merion Capital LP v. 3M Cogent Inc. (July 8, 2013). Accordingly, not only is it well settled law that the court need not rely on merger price in an appraisal action, the court does not even have to consider merger price.

Moreover, the court need not consider whether the merger price was a product of a "fair process" in an appraisal action. In Orchard, the company attempted to justify the merger price by "mak[ing] some rhetorical hay out of its search for other buyers." But the court appropriately pointed out that it "[w]as an appraisal action, not a fiduciary duty case, and although I have little reason to doubt Orchard's assertion that no buyer was willing to pay Dimensional $25 million for the preferred stock and an

attractive price for Orchard's common stock in 2009, an appraisal must be focused on Orchard's going concern value." Id. In other words, the court recognized its statutory obligation to independently analyze Orchard's "fair value" regardless of whether the company conducted an auction or performed a market check.

Similarly, the Court of Chancery recently explained that "the determination that no breach of duty occurred because the Merger price was fair does not necessarily moot the companion appraisal proceeding." In re Trados Incorporated Shareholders Litig. (Del. Ch. Aug. 16, 2013). For example, the court stated that while the merger price may not support a fiduciary liability claim if it fell within a certain range of reasonableness, an appraisal analysis could still yield an award in excess of the merger price. By way of example, the court cited Cinerama v. Technicolor, 663 A.2d at 1156, 1176-77 (Del. 1995) and Cede & Co. v. Technicolor Inc., 884 A.2d 26, 30 (Del. 2005), in which the Delaware Supreme Court affirmed the determination that the merger consideration of $23 per share was "entirely fair" in the context of that company's breach of duty case, but also awarded "fair value" of $28.41 per share in the company's appraisal case.

Conclusion

The Delaware Courts have made clear that fair value in the context of an appraisal of a corporation's going concern is distinct from a market-based merger price for the stock of that corporation. Given that all the factors the courts must consider in determining fair value in an appraisal proceeding are based on long-term business fundamentals rather than the current market fluctuations that determine a merger price, appraisal actions have resulted in court determinations of fair value (often far) in excess of the merger price in more than 80 percent of the cases that went to trial.

Applied to stand-alone buyouts, appraisal offers a practical and very reliable process for unlocking a company's intrinsic value above the merger price, and such an action is even more likely to unlock value when the stand-alone buyer is a corporate insider. Management buyers, after all, can be expected to know their company's intrinsic value best and are not likely to convince the court that they knowingly offered to pay more than the company was worth.

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