Paul|Weiss

Private Equity Digest

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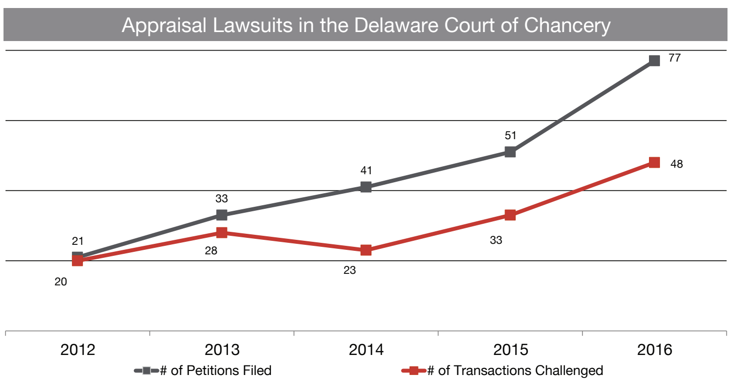
Appraisal Risk in Private Equity Transactions

Overview

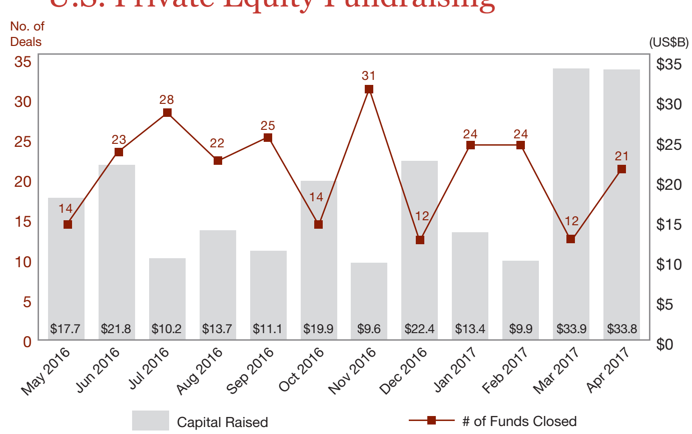
Although still a minority of M&A transactions, appraisal actions are on the rise. In 2012, 20 transactions involving Delaware-incorporated target companies were challenged, but in 2016, this number increased to 48, representing a 240% bump in four years. Further, these figures do not include transactions where appraisal demands were settled before the 120-day deadline for filing an appraisal petition.



Source: Bloomberg Law

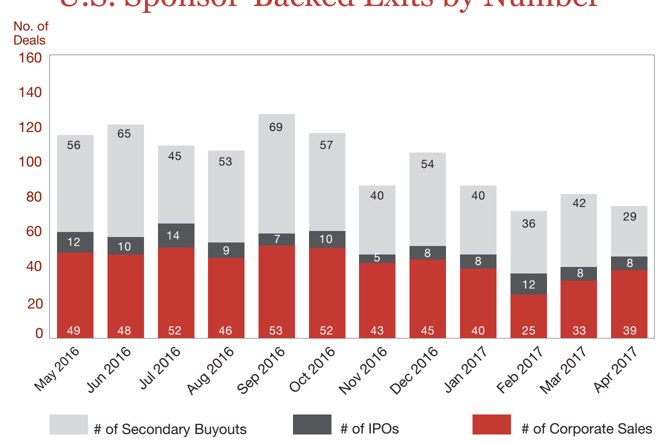
With this recent uptick in appraisal litigation, private equity firms should understand the associated risks for, including some that may be unique to, PE deals. Recent Delaware decisions and anecdotal perceptions (real or otherwise) have suggested that private equity-led buyouts may result in lower merger consideration being paid to stockholders for reasons ranging from the demands of an LBO pricing model to alignment with target companies' management to reluctance to make topping bids after a company has entered into a definitive agreement with another private equity buyer. These perceptions in turn have led to less judicial deference to the transaction price as representative of the fair value of the target company. In contrast, deal prices that result from a robust, arm's-length sale process are more likely to be accorded substantial weight in determining fair value, particularly where both private equity firms and strategic buyers participated in a pre-signing market check. Private equity firms should weigh the risks of an appraisal action before inking a buyout, and may be able to address such risks through comprehensive due diligence, factoring the risk of appraisal in merger price negotiations, focusing on company value broadly and negotiating appraisal conditions (although there may be some risk to such conditions as we discuss in more detail below).

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits by Number



Source: Pitchbook

What Are Appraisal Rights?

Appraisal rights are a statutory remedy available in many jurisdictions to stockholders who object to certain extraordinary actions taken by a corporation (such as a merger or consolidation). The remedy allows dissenting stockholders to receive a cash judgment equal to the "fair value" of their shares immediately before the extraordinary corporate action is taken, as determined by a court, in lieu of the merger consideration.

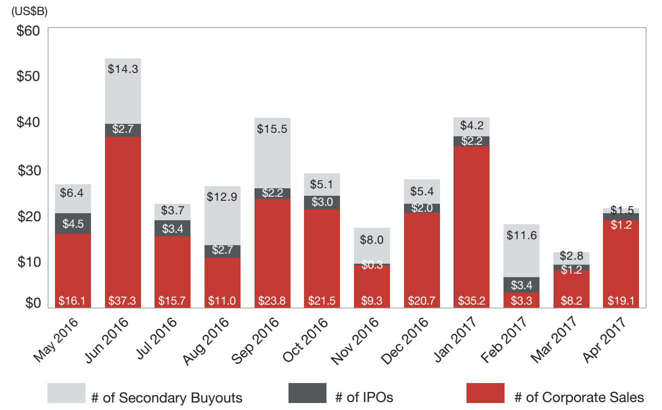
The policy rationale behind appraisal rights is to protect minority stockholders from being squeezed out of a corporation by the majority stockholders at an unfair price. At a practical level, demanding and perfecting appraisal rights can be legally formalistic, lengthy, costly and speculative as courts have a lot of discretion.

The mechanics of an appraisal action vary from state to state, but Delaware's appraisal statute (§262 of the Delaware General Corporation Law) is the most commonly used:

- The appraisal right must apply to the transaction. In Delaware, appraisal rights are generally only available for certain mergers and consolidations. A notable exception to the availability of appraisal rights in Delaware is the "market out" exception—that is, appraisal rights are not available if the shares were publicly traded before the merger and the stockholders were not required by the merger to accept anything other than shares of the surviving corporation or another publicly traded corporation (except for cash in lieu of fractional shares)—because it represents a market solution for dissenting stockholders to obtain fair value for their shares. Also, certain jurisdictions (including New York) do not provide appraisal rights in cash-out mergers.

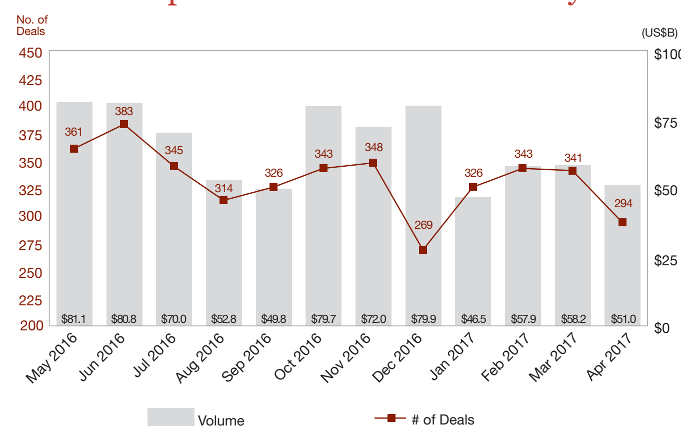
- Demand for appraisal must be made by the record holder of the shares. The record holder must not vote in favor of the merger and must continuously hold the shares through the effective date of the merger. For appraisal, a stockholder only needs to be a record holder as of the date of the demand and not as of the record date for determining stockholders entitled to vote on the merger. Thus, a stockholder who is not entitled to vote on the merger because it purchased its shares after the record date nevertheless can still demand appraisal rights. Additional, fairly technical rules apply for perfecting the appraisal rights, which we do not go into in detail in this article.

U.S. Sponsor-Backed Exits by Dollar Volume



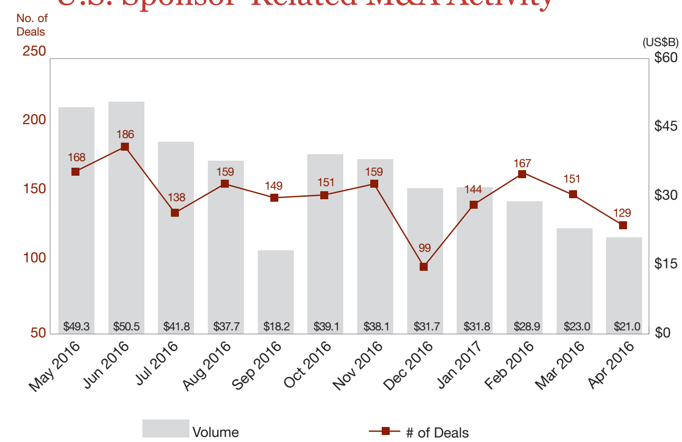
Source: Pitchbook

Global Sponsor-Related M&A Activity



Source: Dealogic

U.S. Sponsor-Related M&A Activity



Source: Dealogic

- In the appraisal proceeding, a court must determine the "fair value" of the shares, which notably is different from other Delaware standards for price, such as the *Revlon* standard that a board must find the highest price reasonably available in a sale process. In determining fair value, the Court has "significant discretion" but must consider "all relevant factors" together. The calculation is made without taking into account the value created by any expected synergies. Both dissenting stockholders and the corporation bear the burden of establishing fair value by a preponderance of the evidence, usually through expert testimony. Commonly used valuation techniques include discounted cash flow (DCF) analysis, comparative companies analysis and comparative transactions analysis. In appropriate circumstances, the negotiated merger price itself can be a "relevant factor" in valuing the shares. Like typical litigation, the court enters a judgment in the amount of what it determines to be the "fair value" of the shares, with that award bearing pre- and post-judgment interest until paid at the statutory rate, minus any amounts prepaid by the corporation.

Why the Increase in Appraisal Litigation?

There are several explanations for the increased appraisal litigation, including the following:

- The law on appraisal rights, especially in how fair value is calculated, intentionally lacks precision by requiring courts to consider "all relevant factors" and thus is ripe for litigation. For example, in the recent *Dell* and *DFC* decisions, the Courts chose not to rely solely on the merger price, even though in both cases there had been a pre-signing market check with seemingly competitive bidding. Notably, other "relevant factors" in both cases were the results of experts' discounted cash flow analyses, indicating higher valuations for appraisal purposes than the negotiated transaction price.

- There has been a rise of hedge funds that actively seek target companies in which to invest after the announcement of a merger for the express purpose of seeking appraisal, bringing significant capital and disciplined financial analytics to such actions.

- There is speculation that Delaware courts' recent narrowing of a couple of important avenues of deal litigation, *i.e.*, by heavily scrutinizing, and therefore limiting the availability of, disclosure-only settlements and by clarifying that the business judgment applies if a merger transaction has been approved by an uncoerced and informed stockholder vote (aka the "*Corwin*" doctrine), has forced deal litigation to other venues and types of claims, such as appraisal.

What Are the Appraisal Risks Unique to Private Equity Firms?

The judicial and academic commentary on the use of merger price as an indication of fair value in private equity-led deals is mixed. Recent appraisal decisions from the Court of Chancery reveal a subtle, implied perception that strategic bidders are willing to pay more than financial bidders and that transactions in which a management team has affiliated with a financial sponsor (such as an MBO) will not generate top bids.

With this backdrop, private equity firms should understand the common features of PE deals that may increase appraisal risk:

- First, regarding financing, there is the notion that LBO pricing models make a private equity firm's price less indicative of fair value than a strategic buyer's price. In the recent *Dell* transaction, which was an MBO involving private equity partners, the Court ultimately valued the shares 28% higher than the merger consideration after reasoning that the buyers' reliance on an LBO pricing model undermined the Court's ability to rely on the negotiated merger price as fair. The Court's reasoning may encourage stockholders to seek appraisal in future transactions with private equity buyers, whether or not also an MBO.

- Second, private equity firms often negotiate mergers after entering into exclusivity arrangements with the target company, which may make defending the merger consideration as indicative of "fair value" more difficult. Even absent a pre-signing exclusivity agreement, the effect of a customary "no-shop clause" may cause a court to give less deference to the negotiated merger price in an appraisal proceeding if there was not an active pre-signing market check process that included multiple potential bidders, including strategic buyers.

- Finally, private equity firms often retain management or, during the negotiation process, employ former target insiders as consultants, either of which may lead a court to reason that potential conflicts of interest undermined the reliability of the negotiated merger price for purposes of an appraisal proceeding.

In contrast to typical private equity deals, the Court of Chancery has demonstrated a willingness to defer to the merger price where there has been a pre-signing market check involving competitive bidding by strategic buyers and private equity firms. In a 2015 decision, Re Appraisal of Ancestry.com, Inc., the Court held that if there are shortcomings in the three valuation methods and if the merger price was generated at arm's length in an auction process, a court may rely entirely on merger price as the best indicator of the corporation's value.

How Should Private Equity Buyers Address These Risks?

Appraisal demands are a headache for target companies and bidders. If the appraisal value of the shares exceeds the merger consideration, the surviving company will experience an immediate drain on its cash position, thereby impacting its financial viability. Private equity bidders can mitigate the risk of an appraisal action in a few ways:

- Private equity bidders should try to identify as early as possible the real and perceived risks of an appraisal demand. Early due diligence of the target, including of its assets and liabilities, financial information and other publicly disclosed information, if available, is important to understanding whether a DCF or other valuation method might result in an implied value greater than the negotiated deal price. Ascertaining whether the target conducted a full auction, if possible, could also help determine the likelihood that the courts would defer to merger price.

- The parties should consider the risk of an appraisal demand when negotiating merger terms. If a private equity bidder anticipates significant appraisal actions or wants to insulate against that risk, the bidder could request a closing condition that caps the percentage of shares for which appraisal is sought before the parties are obligated to proceed to closing. Linking various appraisal-out thresholds to tiers of reverse break fee payouts could be an alternative method of drafting these conditions. We note, however, that common percentages for this type of condition range from 5% to 25%, which is likely to be much higher than the typical appraisal amounts. We are aware of only one such "appraisal out" condition that has been triggered since 2014. Further, there is also the risk that including such a condition would effectively paint a "target" for appraisal seekers and perversely increase the likelihood of such actions.

- If an appraisal condition is included in the purchase agreement, it is important that the debt and equity financing commitment letters reflect this conditionality and any related termination rights as well. Because "appraisal out" conditions have been so rarely used (as demonstrated below), market practice is still developing in this area.

Year	Agreements w/ Appraisal Outs (Delaware Public Targets)	Percent of Total Transactions (Delaware Public Targets)	Appraisal Out Condition (Range / Mean)
2014	5	4.1%	1-10% / 6.7%
2015	8	5.4%	5-15% / 8.8%
2016	10	6.7%	5-28.4% / 14.7%
Jan.-Feb 2017	4	18.1%	5-20% / 12.5%

Source: FactSet MergerMetrics

- Private equity bidders should focus on company value broadly, as opposed to market premium and ROI narrowly, at least from a due diligence perspective. Moreover, private equity bidders would benefit from documenting the "synergies" that they would bring as part of the bid, but backing out this amount when assessing company value. This may provide some insight into what a court or an appraisal hedge fund would consider fair value and anticipate possible appraisal actions.

- There may also be structural methods to mitigate the risk of an appraisal action. For example, a private equity bidder could explore the possibility of having the target reincorporate in a jurisdiction such as New York or New Jersey, which does not provide for appraisal in cash deals, and then complete a cash deal with the target. Another alternative to be considered is having the private equity buyer structure a transaction as an election merger, with the option of a lower value equity component to take advantage of the market-out exception in Delaware (though the ongoing equity interest would obviously be a significant factor for any private equity firm to take into account).

This publication is not intended to provide legal advice, and no legal or business decisions should be based on its content.
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