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Recent Delaware Court of Chancery Appraisal Decisions Continue to Highlight Reliance on Deal Price to Determine Fair Value Absent a Problematic Sale Process

Two decisions by the Delaware Court of Chancery in the past two weeks reached seemingly disparate outcomes on fair value for the companies involved, but together stand for the general trend of recent appraisal decisions that deal price is the best indicator of fair value if the price resulted from a fair and robust sale process. However, the court will rely on other methods to determine fair value if the record suggests that the process could not have resulted in a deal price that is a reliable indicator of fair value (for example, where there were board conflicts or other indicia of a tainted process). In those situations, the valuation most often used is a discounted cash flow ("DCF") analysis but only if reliable management projections are available. Further, because synergies are statutorily required to be excluded for appraisal purposes, the court recently found a fair value that was approximately 8% lower than the deal price due to the high synergies in that strategic transaction.

In the first decision, *In re Appraisal of PetSmart, Inc.*, the court found that the merger price, negotiated following a robust auction process, provided the most reliable indicator of fair value. The court rejected the petitioners' DCF analysis, which suggested a company value 45% greater than the deal price, reasoning that the analysis was based on aggressive and unreliable management projections. In the second decision, *In re Appraisal of SWS Group, Inc.*, the court found that the merger price was not a reliable indicator of fair value due to, among other things, the acquirer's partial veto power over competing offers under a credit agreement. Instead, the court applied a DCF analysis to derive a fair value that was approximately 8% below the merger price.

In re Appraisal of PetSmart, Inc.

Background

In re Appraisal of PetSmart, Inc. related to the acquisition of PetSmart, Inc. by private equity acquirer, BC Partners, Inc. Between 2000 and 2012, PetSmart had significant positive growth each year, but by 2012, the company's growth stalled. In 2013 and 2014, the company experienced significant management turnover, with new management also failing to implement a successful turnaround. Following this decline, the board determined to form a committee to explore strategic alternatives for PetSmart. One month later, certain activist stockholders also began pressuring the company to explore its alternatives, with one stockholder threatening a proxy fight if a sale did not occur. Nonetheless, the board indicated to its financial advisor that it was willing to face a proxy fight if it decided that a sale was not in the best interests of the company.

In connection with the company's exploration of strategic alternatives, management prepared long-term projections for PetSmart, which it did not usually prepare in the ordinary course of business. Moreover, the board rejected the first set of projections, instructing management to be more aggressive in their assumptions because potential buyers themselves would discount the projections. Indeed, the board pressured management into creating increasingly aggressive sets of projections, noting that their "jobs depended upon it." Ultimately, management formulated a set of projections with such aggressive assumptions for company performance that PetSmart's CFO characterized them as approaching "insan[ity]." Later in the process, when some directors indicated that they did not believe the management projections were realistic, the board instructed its financial advisor to prepare sensitivity analyses on the projections with less aggressive assumptions.

The company's banker then commenced an auction process, speaking with 27 potential bidders (including three potential strategic partners). Fifteen bidders signed nondisclosure agreements, and five submitted preliminary bids. The board then focused on four bidders (two of which ultimately worked together). BC Partners made the highest "best and final" offer at $82.50 per share, which the company's banker was able to increase to the final offer of $83 per share. After reconsidering all strategic alternatives, the board ultimately determined to recommend a merger with BC Partners to the stockholders, which the stockholders approved. The merger closed in March 2015.

Petitioners, PetSmart stockholders (including several investment funds), declined the merger consideration and demanded appraisal of their shares. They argued that a DCF analysis based on the management projections was the most reliable indicator of fair value of their shares and supported a $128.78 price per PetSmart share, or a company purchase price that was $4.5 billion (approximately 45%) over the agreed merger price. The company, however, argued that the $83 deal price provided the most reliable indicator of fair value under the circumstances.

Analysis

Vice Chancellor Slights, noting the court's obligation to independently review "all relevant factors" that may inform the determination of the fair value of the petitioners' shares under the Delaware General Corporation Law ("DGCL"), held as follows:

- *The auction process leading to the merger was fair, and therefore achieved a fair value for the company.* The court recognized that although the focus on determining fair value in an appraisal action is the value of the company as a going concern rather than its value to a third party as an acquisition, in certain cases, fair market value may be the most reliable indicator of fair value where it is the product of not only a fair sale process, but also of a well-functioning market. Here, the court found that the auction leading to the merger qualified as such a process and produced a reliable indicator of PetSmart's fair value because, among other things: (i) the board viewed the sale of the company as one of several strategic outcomes, not as the inevitable outcome; (ii) the board did not rush the sale process and its banker solicited 27 potential bidders (including three possible strategic partners) and received indications of interest from multiple bid groups; (iii) while the company did not affirmatively seek a bid from its main competitor (and most likely strategic partner) due to antitrust concerns and the desire to protect its confidential information, the company nevertheless remained receptive to bids from the competitor should it have expressed a serious interest in making a bid (which it did not); and (iv) the company's banker was able to negotiate an increased offer from the highest bidder, which the board chose not to accept until after it had analyzed all of its options. Under these circumstances, the court concluded that the deal price was a reliable indicator of fair value.

- *Because management projections were unreliable, any DCF analysis that relied upon them was "meaningless."* Even though the court had concluded that the merger price was a reliable indicator of fair value for PetSmart, because the DGCL requires that the court consider "all relevant factors," the court also considered the reliability of other valuations of the company in the trial record. The court recognized that while a DCF analysis is often the "gold standard" of valuation tools, its reliability depends upon the reliability of the projections used. Citing prior decisions, the court noted that projections have been found unreliable where "'the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, where the projections were created for the purpose of obtaining benefits outside the company's ordinary course of business,' where the projections were inconsistent with a corporation's recent performance, or where the company had a poor history of meeting its projections." Here, the court observed that the management projections suffered from nearly all these infirmities.

- *DCF analyses prepared by the parties' experts based on non-management projections were also unreliable indicators of fair value.* The parties' experts also prepared DCF analyses based on (i) projections reflecting various assumptions and scenarios of how PetSmart would be run under BC Partners and (ii) other projections prepared by the company's bankers that adjusted assumptions in the management projections to demonstrate certain sensitivity analyses for the board. With regard to DCF analyses based on the first type of projections, the court reasoned that because these projections reflected the operative reality of the company in the hands of the acquirer, and not at the time of the merger, the DCF analyses that relied upon them could not be viewed as reliable indicators of PetSmart's fair value at the time of the merger. Similarly, the court found that DCF analyses based on the second type of projections were unreliable indicators of fair value because the underlying projections were ultimately derived from the unreliable, aggressive management projections.

- *There was no evidentiary basis in the trial record for the court to construct its own valuation structure.* The court found that the projections prepared by the bankers in connection with the sensitivity analyses, which were derived from the unreliable management projections, but with more conservative assumptions, provided the most reliable evidence in the record of the actual, expected future cash flows of the company. Nonetheless, the court determined that there was nothing in evidence that would allow it to credibly adjust these projections further, nor to alter the DCF analyses prepared by the experts based on these projections.

In re Appraisal of SWS Group, Inc.

Background

A few days following the *PetSmart* decision, Vice Chancellor Glasscock issued a decision in *In re Appraisal of SWS Group, Inc.* The case related to the acquisition of SWS, a small bank holding company, by Hilltop Holdings, Inc., also a bank holding company. From 2007 to 2011, SWS's banking segment faced numerous difficulties leading federal regulators to limit certain of the segment's business and requiring increased capital ratios. As a result, the company sought to prop up that segment, ultimately entering into a credit agreement with Hilltop and a private equity firm in 2011.

Under the credit agreement, the creditors, including Hilltop, made a $100 million senior unsecured loan to SWS at an interest rate of 8%. The creditors received warrants to purchase SWS common stock, the exercise of which would eliminate the debt, but would result in the creditors owning substantial positions in the company. The loan would mature in five years absent the exercise of the warrants or permissible prepayment. A related investor rights agreement also gave the creditors board appointment and observer rights, and the credit agreement itself contained a covenant prohibiting the company from undergoing a "Fundamental Change," which included the sale of SWS (the "Merger Covenant").

In the few years following the execution of the credit agreement, the company continued to produce disappointing results. In January 2014, Hilltop made an initial offer to acquire SWS for $7.00 per share payable in 50% cash and 50% Hilltop stock. Following this offer, the SWS board formed a special committee to conduct a sale process, and the committee's financial advisor contacted 17 potential merger partners, with one party making a non-binding offer at $8.65 per share, subject to due diligence, which was made with the assumption that it "would not be subject to blocking" by the Merger Covenant. Hilltop's representative on the SWS board, angered by the continued process with the second bidder, indicated that Hilltop would not waive the Merger Covenant and would withdraw its offer if the company did not sign a deal with Hilltop by March 31, 2014. When the second bidder requested an extension on due diligence beyond March 31, the company denied it.

The special committee rejected Hilltop's initial offer of $7.00 per share as inadequate, and after negotiations, the parties agreed to a price of $7.75 per share consisting of 25% cash and 75% Hilltop stock.

Following announcement of the deal, Hilltop and the other creditor exercised the majority of their warrants, thereby extinguishing a majority of the debt under the credit agreement. Ultimately, the stockholders approved the merger, which closed on January 1, 2015. Due to fluctuations in Hilltop's stock, the value of the merger consideration had decreased to $6.92. Petitioners, former stockholders of SWS (again including several investment funds), demanded appraisal of their shares.

Analysis

In connection with its determination of fair value under the Delaware appraisal statute, the court made the following findings:

- *The merger price derived from a problematic sales process was not a reliable indicator of fair value.* The court acknowledged that "a public sales process that develops market value is often the best evidence of statutory 'fair value.'" Here, however, because of the "problematic process, including the probable effect on deal price of the existence of the Credit Agreement under which the acquirer exercised a partial veto power over competing offers," the court found it inappropriate to rely on the merger price to determine fair value.

- *The comparable companies analysis used by the petitioner's expert was also an unreliable indicator of fair value.* The court noted that a comparable companies analysis is appropriate to determine fair value only where the companies selected are "truly comparable" to the company being appraised. Here, the court found that the companies forming the basis of the petitioner's comparable companies analysis diverged in "significant ways from SWS in terms of size, business lines, and performance," and therefore, it declined to rely on that analysis to determine the fair value of SWS.

- *A DCF analysis produced the best indication of fair value for the company, although that amount was approximately 8% below the deal price due to the exclusion of deal synergies.* After excluding other valuation methodologies, the court determined that a DCF analysis would produce the best indication of the company's fair value. After resolving the value of various inputs to the analysis contested by the parties, the court's DCF analysis produced a fair value of $6.38 per share, approximately 8% below the final merger price value of $6.92 per share. The court noted that the fact that the DCF analysis resulted in a value below the merger price was "not surprising" because the record showed that this was a "synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS." The Delaware appraisal statute requires that this type of value be excluded from the court's calculation of the company's fair value.

Takeaways

In line with prior appraisal decisions issued by the Court of Chancery, the *PetSmart* and *SWS* opinions demonstrate that the court has wide latitude when determining fair value and therefore appraisal decisions are heavily fact dependent. In general, where the record reflects a non-interested transaction at a price that was reached after a robust process (often including an auction or other meaningful, competitive bidding), the court will rely heavily on the merger price as the best indicator of fair value and will make an appraisal award at or near the merger price. Where the record reflects an interested transaction, or where the deal price was reached after a poorly run process, the court tends to look to other methods to determine fair value, most often to a DCF analysis in cases where the record reflects reliable management projections. As demonstrated by the *SWS* decision, where the court determines to rely upon a DCF analysis in determining fair value, it is willing to make adjustments to the various inputs of the analysis, which adjustments can have a significant impact on fair value calculations. Moreover, as required by the appraisal statute, synergies resulting from the accomplishment of the transaction cannot figure into the court's calculation of fair value, and therefore, the removal of value related to synergy can have a significant impact on the court's determination of fair value.

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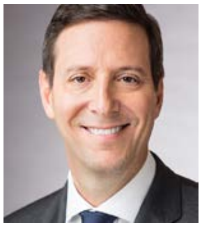

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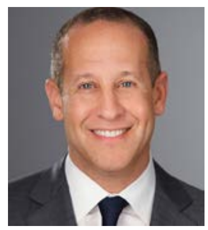

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