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ALERT

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Delaware Court of Chancery Determines Fair Value in PetSmart and SWS Group Appraisal Cases

In recent years, the Delaware Court of Chancery has issued a number of high-profile opinions in appraisal litigations, many of which addressed the central question of whether and to what extent the underlying transaction price is the best proxy for "fair value" in an appraisal proceeding. In the recent *Dell* and *DFC* decisions, the Court of Chancery declined to adopt the transaction price as the best measure of fair value, creating concern that appraisal petitioners would be able to regularly obtain awards at a premium to the deal price, even where the underlying transaction was the product of a sales process that otherwise satisfied the board's obligations under Delaware law.

However, the Court of Chancery recently issued two opinions in appraisal actions that may provide some comfort to potential public company sellers, buyers and M&A practitioners. The first, Vice Chancellor Slights's opinion in the PetSmart appraisal litigation, concluded that the $83 per share transaction price was the best measure of fair value, which was *$4.5 billion* less than what the appraisal petitioners claimed was the fair value of PetSmart. In the second opinion, in which bank holding company SWS Group was bought by Hilltop Holdings, Vice Chancellor Glasscock concluded that the fair value of SWS was actually *8% lower* than the final transaction price, which he found reflected value derived from the acquirer's expected transaction synergies. Further clarity is expected when the Delaware Supreme Court issues its decisions in *Dell* and *DFC*, both of which are on appeal (*DFC* was argued on June 7, 2017).

PetSmart

The PetSmart appraisal litigation is one of the largest appraisal actions in recent memory. The appraisal petitioners held over 10.7 million shares worth almost $900 million at the deal price. The PetSmart petitioners positioned their case aggressively, arguing that the company's fair value exceeded the $83 per share deal price by over $45 per share.[1]

In an appraisal proceeding, the trial judge's role is to independently determine fair value after taking into account all relevant factors. Following a four-day trial, Vice Chancellor Slights found that the deal price was the best measure of the fair value of PetSmart's shares. The deal price resulted from a competitive bidding process in which 27 potential bidders were contacted, including three potential strategic buyers. BC Partners' successful offer of $83 per share reflected a 39% premium over PetSmart's unaffected stock price. No other bidder for PetSmart emerged in the several months between the announcement of the deal and the stockholder vote.

The petitioners, who had acquired a substantial majority of their 10.7 million shares after the transaction was announced, argued that the deal price was unreliable for a variety of reasons. However, Vice Chancellor Slights found that the credible evidence did not support the petitioners' argument, and determined that the deal price was the result of a fair sales process "comprised of a robust pre-signing auction in which adequately informed bidders were given every incentive to make their best offer in the midst of a 'well-functioning market.'" Indeed, the court noted that the PetSmart sales process "came close enough to perfection," and refused to second-guess the board's good-faith strategic decisions, including deciding to exclude Petco, PetSmart's principal competitor, from the sales process. The court also praised the board for accepting BC Partners' offer only after engaging in an analysis of all strategic options, including continuing as a standalone company, and for being ready to defend the company in a proxy contest against activist investors, if necessary.

[1] *In re Appraisal of PetSmart, Inc.*, C.A. No. 10782-VCS (Del. Ch. May 26, 2017).

The court also rejected the petitioners' argument that the sales process could not have produced a "fair value" price because it was largely populated by private equity bidders (even though strategic bidders were invited), holding that "while it is true that private equity firms construct their bids with desired returns in mind, it does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the *best* indicator of fair value for the company." Fundamentally, the court's conclusion regarding financial bidders appears to depart from certain recent appraisal cases, including the decision by Vice Chancellor Laster in *Dell*, that discounted the value of bids from private equity buyers because their investments are typically premised on desired returns and therefore their bids may not reflect a target company's "economic fair value."

The court also found that there was "no basis" to accept the contention that PetSmart's financial advisor labored under disabling conflicts, noting that the advisor's previous work with Petco had been disclosed to the PetSmart board and, if anything, was "deemed as a benefit not a conflict." The court further noted that the advisor's prior relationships with potential private equity buyers, including some that actively participated in the sale process, was "correctly deemed by the Board to be a 'fact of business life.'"

After determining that the deal price was a reliable indicator of fair value, the court reviewed the DCF analyses prepared by the parties' valuation experts. The court was skeptical of both parties' DCF analyses, noting that the "vast delta between the valuations generated by the parties' proffered methodologies raises red flags." In rejecting the parties' DCF analyses as the best measure of fair value, Vice Chancellor Slights concluded that they were unreliable because the created-for-auction management projections upon which those analyses were based could not "support a meaningful DCF analysis."

SWS

Several days after the *PetSmart* decision, Vice Chancellor Glasscock decided the SWS Group appraisal action.[2] In contrast to *PetSmart*, Vice Chancellor Glasscock concluded that the deal price was unreliable as evidence of fair value and instead relied on a DCF analysis to find that the fair value of SWS at the time of the merger was $6.38 per share, approximately 8% below the merger price of $6.92 per share.

This appraisal proceeding arose from the January 2015 merger between SWS Group, a small bank holding company, and a wholly-owned subsidiary of Hilltop Holdings, itself a major creditor of SWS. A group of investment funds, holding an aggregate of 7.4 million shares of SWS common stock, sought appraisal. The petitioners' valuation expert placed 80% weight on a DCF analysis and 20% on a comparable companies analysis, arriving at a fair value of $9.61 per share, or 39% above the deal price. The respondents' valuation expert used a DCF analysis exclusively to reach a $5.17 per share valuation, or 25% below the deal price.

Vice Chancellor Glasscock found that "certain structural limitations unique to SWS," such as its relatively small size ($198 million market capitalization) and lack of scale, made the "application of the merger price not the most reliable indicia of fair value." The court also noted that the sales process was "problematic." In rejecting the use of a comparable companies analysis, Vice Chancellor Glasscock found that the companies selected by the petitioners' valuation expert "diverge[d] in significant ways from SWS in terms of size, business lines, and performance." The court then reviewed the DCF analyses and adopted the use of management projections in this case because SWS's management "routinely prepared three-year projections." Vice Chancellor Glasscock also observed that the fact that his DCF analysis, which was based on management projections but employed several different inputs and assumptions than those used by the parties' valuation experts, resulted in a value below the deal price was "not surprising" because this was a "synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."

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[2] *In re Appraisal of SWS Group, Inc.*, C.A. No. 10554-VCG (Del. Ch. May 30, 2017).

The deference that the Court of Chancery will or should give to the merger price is closely watched by deal professionals. In *Lender Processing Services*,[3] Vice Chancellor Laster observed that, since the Delaware Supreme Court's 2010 *Golden Telecom* opinion, the Court of Chancery has "regularly considered the deal price as a relevant factor when determining fair value, but it has not deferred automatically or presumptively to the deal price." In *CKx*,[4] the court relied exclusively on the deal price because the other valuation methods were unreliable, where the court found that the company lacked sufficiently comparable peers and management projections could not be relied upon. In *Ancestry.com*, the court again relied exclusively on the deal price because the court concluded that the strength of the sale process was "unlikely to have left significant stockholder value unaccounted for," and the court's own DCF analysis was confirmatory of the deal price. The court has also given exclusive weight to the deal price in the *AutoInfo*, *Ramtron*, *BMC* and *Lender Processing* appraisal actions, all of which involved a robust sales process and where the court found the other evidence of fair value to be unreliable or weak.

In contrast, the Court of Chancery has also issued decisions where it has not given exclusive weight to the deal price. In *Dell*, the court gave limited weight to the deal price because the respondent failed to establish that the outcome of the sale process offered the most reliable evidence of the company's value as a going concern. In *DFC*, the court gave equal weight to the deal price, the court's DCF valuation, and one of the valuation expert's comparable companies analysis as a result of the fact that the negotiated price was derived "during a period of significant company turmoil and regulatory uncertainty." In *Dunmire*, the court again declined to rely on the deal price where, among other things, the merger was not a product of an auction, no third parties had been solicited, and a controlling stockholder stood on both sides of the deal.

The *PetSmart* and *SWS* decisions do not depart significantly from the Delaware courts' appraisal jurisprudence and demonstrate that a well-run sales process will be an important element in determining whether a court will rely upon transaction price as the best measure of fair value. In *PetSmart*, the court held that the arm's-length auction process produced reliable evidence of the company's fair value, while the *SWS* opinion describes a flawed transaction process that did not provide reliable evidence of fair value. The adequacy of the sales process was particularly important in *PetSmart*, given the petitioners' claim that the fair value of PetSmart actually exceeded the deal price by *$4.5 billion* – essentially asking the court to conclude that the market and process drastically undervalued PetSmart. In addition, the *SWS* opinion highlights the potential risk to appraisal arbitrageurs that fair value determinations pursuant to appraisal proceedings may be below the deal price. Both opinions also reflect judicial skepticism of the now standard appraisal litigation practice of retaining paid expert witnesses to conduct valuation analyses, with Vice Chancellor Slights observing that such paid experts have "very different incentives" than the buyer and seller in an arm's-length, competitive sales process that takes place within a fully functioning market and that Delaware courts "must remain mindful" that the DCF method is subject to manipulation and guesswork, which can produce "volatile" valuation results in a litigation setting. These opinions provide useful data points for understanding Delaware's approach to the appraisal process. The pending appeals in the *Dell* and *DFC* actions are likely to provide additional guidance regarding the degree to which, in various circumstances, Delaware courts will be influenced by transaction price in the determination of fair value in appraisal proceedings. Indeed, the June 7, 2017 oral argument on the *DFC* appeal highlighted the fundamental tension between the broad language of the Delaware appraisal statute, as underscored by the Delaware Supreme Court's 2010 *Golden Telecom* opinion, and attempts by appraisal defendants to argue that the Court of Chancery must defer to the deal price where the transaction results from a robust, arm's-length process and the relevant management projections are not a reliable basis for a valuation analysis.

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[3] *Merion Capital L.P. v. Lender Processing Services, Inc.*, C.A. No. 9320-VCL (Del. Ch. Dec. 16, 2016).
[4] *Huff Fund Inv. P'ship v. CKx, Inc.*, C.A. No. 6844-VCG (Del. Ch. Nov. 1, 2013).