Litigating Appraisal Actions

Key Issues and Considerations

Statutory appraisal remedies allow stockholders who believe they have received inadequate consideration in certain transactions, such as mergers or consolidations, to obtain a judicial determination of the fair value of their shares. Over the years, courts, litigants, and experts alike have grappled with how to make an appropriate fair value determination. To marshal the evidence necessary to most favorably present their case, it is vital for counsel involved in appraisal proceedings to understand the relevant statutory requirements and stay up to date on the shifting case law, including the valuation approach courts are likely to prefer in a given situation.

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Appraisal rights are a longstanding feature of most corporate law statutes and the availability of this statutory remedy provides important protections for stockholders. Without the potential for an appraisal award, there would be less incentive for buyers in mergers and acquisitions (M&A) to ensure the price they pay to stockholders of the target company is fair.

Appraisal statutes vary from state to state, but share certain key features. For example, each state statute specifies what types of transactions give rise to appraisal rights in the particular jurisdiction (see Model Business Corporation Act Ann. § 13.02 (statutory comparison 1(A)) (2013)). Generally, appraisal rights allow stockholders to forgo accepting the consideration offered in certain types of transactions, usually involving some type of change of control, and instead demand a judicial determination of the "fair value" of their shares. Under the Delaware General Corporation Law (DGCL), fair value means the going concern value of the company as of the closing date, excluding any elements of value that were accomplished by reason of the transaction (for example, merger synergies) (8 Del. C. § 262(h); see *In re Appraisal of PetSmart, Inc.*, 2017 WL 2303599, at *27, *31 (Del. Ch. May 26, 2017)).

Typically, once a transaction gives rise to appraisal rights, a stockholder seeking an appraisal must comply with the relevant statute's procedural requirements to properly demand and perfect those rights. Because dispositive motion practice is not usually available in an appraisal proceeding, unless a stockholder withdraws the demand for appraisal or a settlement is reached, the parties should expect the matter to proceed to trial, which often lasts several days. Like any trial, the ultimate outcome is difficult to predict with certainty.

Familiarity with the applicable rules and best practices is essential for counsel involved in an appraisal proceeding, whether representing the dissenting stockholders or the corporation. This article examines key issues counsel should consider when litigating an appraisal action, with a focus on Delaware law, including:

- Preliminary considerations for stockholders seeking to exercise appraisal rights.
- Perfecting appraisal rights.
- Discovery-related issues.
- Common approaches to determining fair value.
- Whether the company should make a prepayment before the appraisal proceeding concludes.
- Settlement considerations.
- Presenting testimony and evidence at trial.
- Allocating litigation costs.
- Appealing decisions on appraisal rights.

Search Appraisal Rights for more on the transactions triggering appraisal rights, the mechanics of exercising appraisal rights, and information on the advantages and disadvantages of appraisal proceedings.

PRELIMINARY CONSIDERATIONS FOR EXERCISING APPRAISAL RIGHTS

Before initiating the process of exercising appraisal rights, counsel should understand:

- The types of transactions that trigger statutory appraisal rights.
- The threshold requirements to exercise appraisal rights.
- The common fact patterns and factors that weigh in favor of pursuing an appraisal action.

TRANSACTION TYPES

Depending on the jurisdiction, dissenting stockholders may be eligible to exercise appraisal rights in various types of transactions, including:

- Mergers.
- Consolidations.
- Compulsory share exchanges.
- Transactions involving a significant disposition of a company's assets.

All corporate law statutes that grant appraisal rights do so for at least some types of mergers, and many appraisal statutes provide for other transaction types as well. Further, many jurisdictions allow stockholders to designate additional transaction types for which appraisal claims are permitted in the company's certificate of incorporation. In Delaware, appraisal rights are permitted only in mergers and consolidations, unless a company provides in its charter that appraisal rights are available in specified additional types of transactions as set out in Section 262(c) of the DGCL.

However, state statutes may also provide exceptions to appraisal rights, such as:

- **The "market-out" exception.** Under this exception, appraisal rights generally are not available for companies whose stock is publicly traded, based on the theory that dissatisfied stockholders can sell their shares in the open market pre-merger. For those states that recognize the market-out exception, the specific provisions vary from state to state. In Delaware, the exception applies if the target company's stock is:
  - listed on a national securities exchange; or
  - held of record by more than 2,000 stockholders.

  The market-out exception is not absolute in Delaware. Appraisal rights generally will be restored if stockholders are required to accept anything other than publicly traded stock for their shares, except cash in lieu of fractional shares (for example, if all or part of the stockholders' compensation for their shares is in cash). (8 Del. C. § 262(b)(1)-(2).)
- **The *de minimis* exception.** In Delaware, appraisal rights are not available for publicly traded stock if:
  - the total number of shares entitled to appraisal does not exceed 1% of the outstanding shares of the class eligible for appraisal; and
  - the value of the consideration provided for those shares in the merger or consolidation does not exceed $1 million.

  (8 Del. C. § 262(g).) Importantly, appraisal rights for short-form mergers under Section 253 or Section 267 of the DGCL (that is, mergers where 90% of the target company's stock is already held by a single entity before adoption of the transaction) are not subject to the *de minimis* exception because appraisal may be the only remedy available to those stockholders.

Search Appraisal Rights for more on the market-out and *de minimis* exceptions to appraisal rights.

THRESHOLD REQUIREMENTS

All corporate law statutes that grant appraisal rights provide for judicial resolution of appraisal disputes in a suit commenced by one of the following:

- The company (which is required in the majority of jurisdictions).
- The dissenting stockholder.
- Either the company or the dissenting stockholder (for example, Delaware allows either party to bring suit (8 Del. C. § 262(e))).

DEVELOPMENTS IN APPRAISAL PROCEEDINGS

Historically, appraisal proceedings were uncommon in M&A transactions involving public company targets (public M&A transactions) and were most common in private company transactions. However, the last decade saw a significant rise in appraisal proceedings in public M&A transactions, due in part to:

- **The Delaware Court of Chancery's *Transkaryotic* decision.** In *In re Appraisal of Transkaryotic Therapies, Inc.*, the Chancery Court held that a beneficial stockholder who purchased shares in the target company after the record date for the merger did not need to prove that the previous beneficial stockholder of those specific shares voted against the merger, as long as the number of shares for which appraisal was demanded was less than the total number of shares that abstained or voted against the merger (2007 WL 1378345, at *3-4 (Del. Ch. May 2, 2007)).
- **The DGCL's statutory prejudgment interest provision.** Under the 2007 amendment to Section 262(h) of the DGCL, dissenting stockholders generally are entitled to a presumptive amount of interest on an appraisal award at a rate of 5% above the Federal Reserve discount rate (including any surcharge) from the date of the merger through the date of judgment.

These two developments in 2007 were viewed as encouraging appraisal arbitrage. Appraisal arbitrageurs are investors (generally hedge funds) that acquire an equity position in an announced merger with the specific intention of exercising appraisal rights. Petitions filed by hedge funds in the early 2010s accounted for 75% of the dollar volume of the appraisal cases filed (with the top seven hedge funds involved in appraisal arbitrage accounting for over 50% of the dollar volume of the appraisal cases filed in that time period). Moreover, petitioners in appraisal actions filed from 2000 to 2014 enjoyed gross returns with an average annualized return of 32.9%, which suggests that appraisal was a profitable litigation arbitrage strategy during that time period (see Wei Jang et al., *Appraisal: Shareholder Remedy or Litigation Arbitrage?*, 59 J. L. & Econ. 697, 699, 701 (2016)).

As appraisal proceedings became more prevalent, however, the Chancery Court increasingly relied on the deal price to determine fair value, if the deal price was set in a robust arm's-length negotiation. In some cases, the Chancery Court set the fair value at or below the deal price, increasing the risk for a stockholder that bringing a costly appraisal proceeding may not be profitable. Several 2018 decisions have continued this trend, setting the fair value below the merger consideration (see, for example, *In re Appraisal of AOL Inc.*, 2018 WL 1037450, at *8-10, *21 (Del. Ch. Feb. 23, 2018); *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2018 WL 922139, at *55 (Del. Ch. Feb. 15, 2018)). As a result, the number of appraisal actions in public M&A transactions has begun to decline.

Search Appraisal Rights for more on appraisal arbitrage and Delaware Judiciary Sets Fair Value Below Deal Price in "Aruba," "AOL," and "SWS," Raising Risk for Appraisal Arbitrageurs for more on the *AOL* and *Verition* decisions.

Search Public Mergers: Overview for information on the various aspects of US public company mergers, including securities laws applicable to public mergers, process and timing, and the different types of merger structures.

To exercise its appraisal rights, a dissenting stockholder must generally:

- Be a stockholder of record. Some states, including Delaware, allow beneficial owners of stock to bring appraisal claims in certain circumstances after a stockholder of record has perfected an initial demand (see below *Perfecting Appraisal Rights*).
- Give notice to the company that the stockholder is exercising its appraisal rights before a vote on the particular transaction is taken.
- Either abstain from voting or, in some states, affirmatively cast a "no" vote in connection with the subject transaction. Abstaining from voting is sufficient in Delaware (8 Del. C. § 262(a)).
- Surrender custody of the stockholder's shares for appraisal.

Counsel should review the relevant state statute to ensure that all requirements, including for notice and demand, are met. For example, Ohio is one of the rare states that require a dissenting stockholder to make a written demand for payment for its shares after the vote, unless the corporation affirmatively takes action by providing the permissive stockholder with the notice referenced in Ohio's corporate law statute (R. C. 1701.85(A)).

COMMON FACT PATTERNS AND FACTORS

When deciding whether to pursue an appraisal action, stockholders commonly consider:

- The type of buyer involved.
- Whether the sale process is robust.
- Whether the potential returns justify proceeding with the action.

Buyer

The risk of an appraisal action is greater and more likely to result in a fair value determination that is above the deal price if the transaction involves a controlling stockholder or other affiliated party standing on both sides of the transaction (for information on what Delaware courts consider to be a controlling stockholder, search Defining Control for Entire Fairness on Practical Law). Examples include going private transactions and management buyouts (for more information, search Going Private Transactions: Overview and Buyouts: Overview on Practical Law), and transactions where a controlling stockholder receives different consideration in the transaction than the other stockholders (even if the buyer of the target company is an unrelated third party).

In the past, Delaware courts more often viewed transactions involving financial buyers, including private equity firms, as undervalued compared to transactions involving strategic buyers. This was due to the assumption that a strategic buyer enjoys more synergies from an M&A transaction and therefore is likely to, in effect, share a portion of those synergies with the target stockholders to induce them to vote to approve the transaction with a higher offer price. However, recent decisions by the Delaware Supreme Court have likely eliminated this default preference for strategic buyers (see, for example, *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 177 A.3d 1, 27-28 (Del. 2017) (finding "'no rational connection' between a buyer's status as a financial sponsor and the question of whether the deal price is a fair price," reasoning that "all disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger") (citing *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346, 349-50, 374-76 (Del. 2017))).

Search Strategic and Financial Buyers Comparison Chart for information on the key characteristics and differences between strategic and financial buyers in M&A transactions.

Search Dell Appraisal: Delaware Supreme Court Reverses Chancery Court's Appraisal Award, Upholds Negotiated Price as Evidence of Fair Value for more on the *Dell* and *DFC* decisions.

Sale Process

A sale process that is not sufficiently "robust" is likely to trigger an appraisal action and be viewed with skepticism by courts. In determining whether the robust standard is met, courts have emphasized that the sale process must either involve tests of what several or many potential buyers might pay or be structured in such a way that there are no unreasonable impediments to price competition. Interested transactions where there were essentially no market checks as part of the sale process are much more likely to result in above-market appraisal awards. Advice from investment bankers and M&A legal counsel is important in determining what is both robust and possible in a given situation. The pros and cons of any given sale process, and the vulnerability of the deal to legal attack, will vary with the factual circumstances.

Robust sale processes include so-called "clean" merger situations where:

- The stock is readily transferable.
- The transaction is approved by a disinterested board of directors or a committee of the board that is independent of any controlling stockholder or other conflict.
- The sale is consummated after a thorough market test.

(See Hon. Sam Glasscock III, Ruminations on Appraisal, Del. Lawyer (Summer 2017), available at *delawarebarfoundation.org*.) Appraisal actions are unlikely to be profitable for dissenting stockholders in clean merger situations.

Investment Factors

Pursuing an appraisal action is ultimately an investment decision that takes into account whether the likely returns outweigh the costs and risks of the litigation. Recently, the risk of a negative return has grown because of the increased frequency of below-deal price appraisal decisions (see *Box, Developments in Appraisal Proceedings*). In light of this, a stockholder must consider:

- The size of the investment.
- The size of the potential appraisal class and the value of the class's holdings.
- The level of visibility the stockholder has into the company's financial performance and future business plans.
- The reasons to doubt the fairness of the price offered in the transaction.
- The ability to forgo use of the investment proceeds during the pendency of litigation.
- The ability to fund litigation, including the cost of retaining an expert (or perhaps multiple experts).
- The prejudgment interest rate available in the relevant jurisdiction as compared to the opportunity cost associated with tying up the investment in litigation.

PERFECTING APPRAISAL RIGHTS

To have standing to bring an appraisal action, the dissenting stockholders must properly perfect their appraisal rights. Both counsel for the dissenting stockholders and counsel for the corporation should consult the relevant state statute to confirm compliance with all applicable requirements and procedures for perfecting appraisal rights. Counsel for the corporation should also ensure timely delivery of the notices required under the statute. The eligibility and notice requirements vary substantially from state to state.

To perfect appraisal rights in Delaware, the following requirements apply:

- The record holder of the stock must make a written demand for appraisal to the company before the merger vote.
- The dissenting stockholder must ensure that the shares for which it seeks appraisal are not voted in favor of the merger. Doing so would effectively invalidate the appraisal demand. However, Delaware does not require the dissenting stockholder to affirmatively cast a "no" vote. Abstaining is sufficient. (See above *Threshold Requirements*.)
- The dissenting stockholder must hold the stock (or have its broker hold the stock, if the stockholder is a beneficial owner) from the date of the demand through the date of the merger. The stockholder's appraisal demand will be deemed withdrawn if the shares are surrendered in exchange for the merger consideration.
- The dissenting stockholder (or the company) must file a petition for appraisal with the Chancery Court within 120 days after the merger's effective date.

(8 Del. C. § 262(a), (d), (e).)

In Delaware, the court typically resolves the issue of whether a stockholder perfected its appraisal rights pretrial in what is known as an entitlement proceeding. At this proceeding, the court decides any disputes about whether a particular stockholder is entitled to pursue appraisal.

Search Appraisal Rights for more on the steps to perfect appraisal rights.

DISCOVERY ISSUES

Once an appraisal action is initiated, rules of civil procedure apply, including those governing discovery (for example, Delaware Court of Chancery Rule 26 (general discovery provisions), Rule 33 (interrogatories), Rule 34 (production of documents, electronically stored information, and tangible things), and Rule 45 (subpoenas)). Common areas of discovery include information relating to:

- The sale process.
- The company's internal valuations and business plans for growth.
- The buyer's valuations.
- The standing of the stockholders seeking appraisal.

Management's own financial projections and business plans provide critical details. Additionally, parties obtain information through depositions of fact witnesses and others with factual knowledge, as well as expert witnesses (see below *Trial*).

Given the issues likely to be tried, discovery burdens typically fall disproportionately on the company. Dissenting stockholders are less likely to be subject to broad discovery demands beyond expert discovery and depositions. However, in some cases, where the dissenting stockholders possess relevant valuation information, they must produce that information (particularly in cases involving larger stockholders).

ANALYSIS OF FAIR VALUE

Under the DGCL, the Chancery Court must consider "all relevant factors" in determining the fair value of stock. This is a very broad standard which gives the court significant discretion. However, the fair value determination must be exclusive of any element of value arising from the "accomplishment or expectation" of the merger or consolidation. (8 Del. C. § 262(h).)

Typically, this means that the court must exclude synergies or other value obtainable by the merged entities that would not be available to either the buyer or seller alone. By contrast, value that could be obtained by the target company alone as of the date of the merger is considered part of the company's independent value and may be included in the fair value determination. The value of the shares is determined as of the closing date for the transaction.

Approaches commonly employed by Delaware courts to determine fair value include:

- A discounted cash flow (DCF) analysis.
- A comparable companies analysis.
- A comparable transactions analysis.
- The deal price.
- The unaffected stock price.

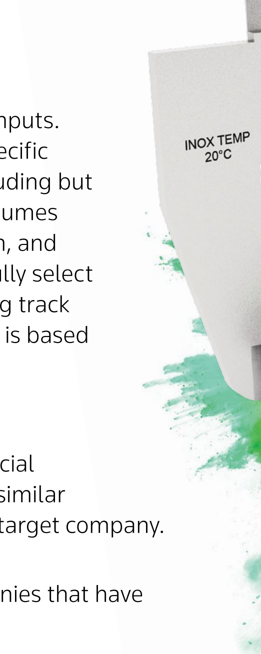
Where there is more than one relevant factor in the fair value assessment, courts often place different weights on various methodologies. For example, in a given situation, the court might place a 65% weight on the deal price, a 25% weight on the DCF analysis, and a 10% weight on the comparable companies analysis. The Delaware Supreme Court usually gives deference to the Chancery Court's determination on appeal if it is supported by a reasonable basis in the record and accepted financial and economic principles (see *DFC*, 172 A.3d at 348-49; see below *Appeals*).

DISCOUNTED CASH FLOWS

The DCF methodology is based on the economic premise that the value of a company is equal to the present value of its projected future cash flows. A DCF analysis capitalizes future free cash flow projections and discounts them to arrive at a present value of the company as a going concern. This number is divided by the number of total outstanding shares (typically on a fully diluted basis) to arrive at the fair value per share. More specifically, the analysis involves:

- **Projecting the operating cash flows.** An estimate is made of the company's future free cash flows over a specified period of time (often five years, though longer or shorter periods may be employed) using an appropriate method, such as the method used to create company projections in the relevant industry. Key factors in determining the appropriate projection period are:
  - management's common practice in the ordinary course of business; and
  - whether the target company can reasonably be expected to have reached a steady state of predictable cash flows by the terminal year of the projection.
- **Calculating the terminal value.** The value of the company's free cash flows in perpetuity after the last year of projected cash flows must also be calculated. This value is known as a "terminal value." The terminal value is derived from a calculation of the present value of all of the company's future free cash flows into perpetuity after the projection period. The most widely employed method of calculating a terminal value is a constant growth valuation model, but it is not the only accepted method. The growth rate applied to the terminal period is often a source of dispute among experts.

In the past, Delaware courts more often viewed transactions involving financial buyers, including private equity firms, as undervalued compared to transactions involving strategic buyers. However, recent decisions by the Delaware Supreme Court have likely eliminated this default preference.



- **Selecting a discount rate.** A discount rate is chosen to determine the present value of the cash flows for the items calculated in the previous two steps. A discount rate is often based on the company's weighted average cost of capital using the capital asset pricing model (CAPM). CAPM requires an estimation of both systematic risk and company-specific risk, which is often disputed by experts. Even small differences in these estimates can produce vastly different results in valuation.

Historically, the Chancery Court most heavily relied on the DCF analysis where it was based on projections prepared by the target company's management in the ordinary course of business. By contrast, the Chancery Court would place reduced reliance on a DCF analysis where it was based on underlying management projections that were not created in the ordinary course of business or not based on reasonable assumptions.

Notably, Delaware courts are becoming increasingly skeptical of the widely divergent DCF valuations that experts for petitioners and respondents often present to the court. In *Dell*, for example, the Delaware Supreme Court reviewed warring DCF valuations that "landed galaxies apart" and agreed with the Chancery Court's conclusion that the petitioners' DCF valuation, which found that the merger undervalued the company by well over $20 billion despite market data to the contrary, lacked credibility on its face (177 A.3d at 36).

However, the Delaware Supreme Court disagreed with the Chancery Court's reliance on its own DCF analysis, which gave no weight to the company's stock price or deal price and instead arrived at a value nearly $7 billion above the deal price. In rejecting the Chancery Court's approach, the Delaware Supreme Court noted that:

- The sale process was robust and the independent special committee and its advisors "did many praiseworthy things."
- The record did not support the Chancery Court's "favoring of management's optimism over the public analysts' and investors' skepticism — especially in the face of management's track record of missing its own projections."
- The Chancery Court's DCF value "did not reflect a value deemed attractive to the buyers of [the company's] publicly traded shares" or "the value that private equity buyers … put on it."

(*Dell*, 177 A.3d at 27, 30-31, 36-37.)

Search Appraisal Rights for more on the DCF analysis.

Search Dell Appraisal: Delaware Supreme Court Reverses Chancery Court's Appraisal Award, Upholds Negotiated Price as Evidence of Fair Value for more on the *Dell* decision.

Ultimately, a DCF analysis is only as good as its inputs. The outcome varies greatly depending on the specific methods and underlying assumptions used, including but not limited to the cash flow projection (which assumes predicable cash flows), terminal value calculation, and discount rate chosen. Practitioners should carefully select an experienced valuation expert who has a strong track record in court and ensure the expert's valuation is based on reasonable assumptions.

COMPARABLE COMPANIES

A comparable companies analysis uses the financial metrics of other publicly traded companies with similar characteristics in the same industry to value the target company. This approach involves:

- Identifying comparable publicly traded companies that have reviewable financial information.
- Deriving appropriate trading multiples for the comparable companies. Often, this is based on the comparable company's share price relative to current or projected earnings before interest, taxes, depreciation, and amortization (EBITDA).
- Adjusting the trading multiples to account for the differences between the comparable companies and the target company.
- Applying the average adjusted trading multiple of the comparable companies to the target company's EBITDA.

This methodology is reliable only to the extent that the companies used are actually comparable to the target company. The burden of proof on the question of whether the companies are truly comparable lies with the party putting forth that evidence. Delaware courts have expressed reservations regarding this approach and, at times, have accorded no weight to an expert's comparable companies analysis. Counsel should be prepared for the court to scrutinize not only the comparable companies chosen but also the inputs included in the methodology for any discrepancies.

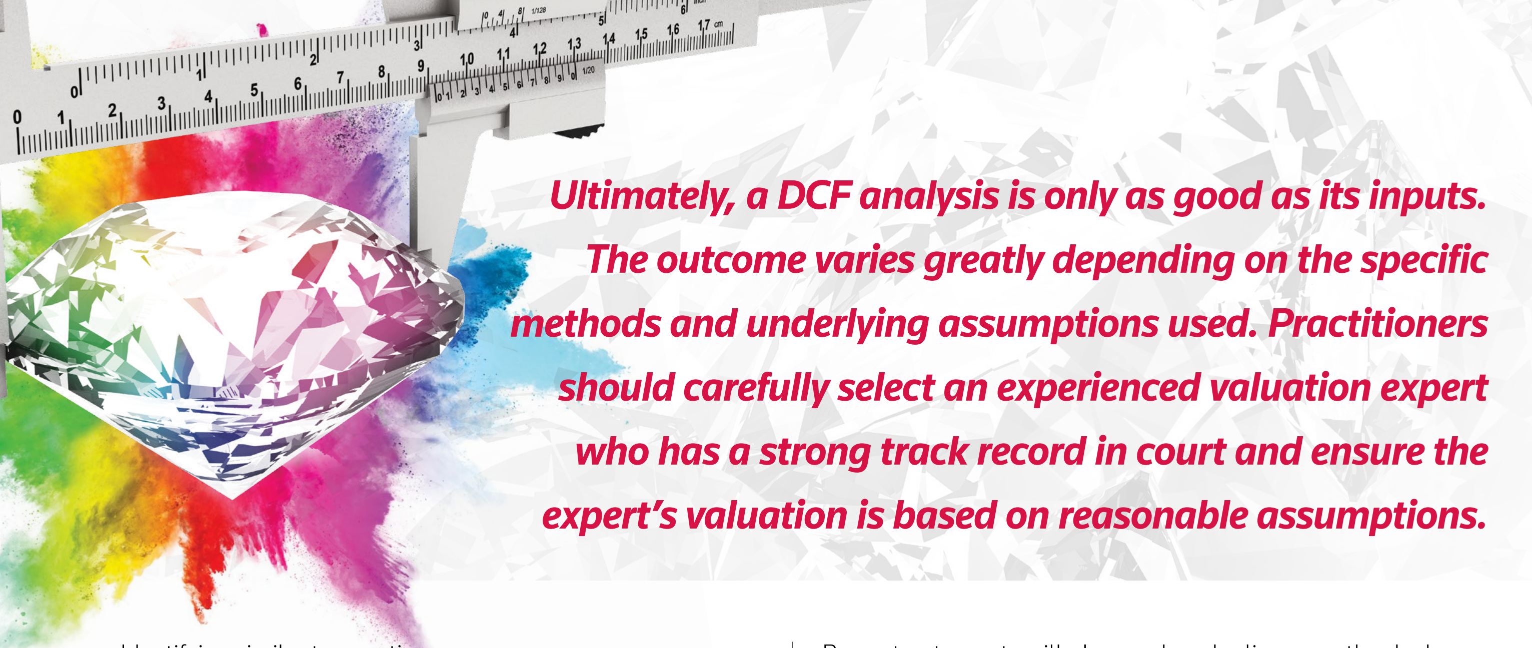
Key differences between comparable companies and the target company that can call into question the entire analysis include:

- Size.
- Geography.
- Product lines or services.
- Stages in the growth cycle.
- Trading multiples.

Courts typically express a preference for a DCF analysis over a comparable companies analysis. However, in cases where a reliable DCF analysis is not available, the comparable companies analysis may take on more importance. Even where a reliable DCF analysis is possible, a comparable companies analysis can serve as a useful check on the DCF valuation.

COMPARABLE TRANSACTIONS

The comparable transactions analysis uses the metrics of similar transactions to calculate a per share value of the target company. This approach involves:



Ultimately, a DCF analysis is only as good as its inputs. The outcome varies greatly depending on the specific methods and underlying assumptions used. Practitioners should carefully select an experienced valuation expert who has a strong track record in court and ensure the expert's valuation is based on reasonable assumptions.

- Identifying similar transactions.
- Deriving appropriate transaction multiples from the comparable companies (often computing the premiums paid as a percentage of EBITDA).
- Applying the metrics to the target company.

Like the comparable companies analysis, the comparable transactions analysis is only as useful as the degree of similarity between the subject transaction and the transactions used for comparison. Delaware courts do not favor this method because transactions can incorporate incompletely described control premiums and liquidation values, producing inflated values that do not accurately reflect the going concern value of the company.

DEAL PRICE

The deal price approach adopts the negotiated merger price and, if necessary, makes certain adjustments (for example, excluding proposed merger synergies) to reflect the value of the company's shares as a going concern. Counsel for a buyer employing this methodology should therefore consider evidence of value attributed to synergies so that this value can be deducted from the fair price calculation.

While there is no automatic presumption in favor of the deal price and courts must consider all relevant factors in determining fair value, recent cases, including *Dell* and *DFC*, have exhibited an increased judicial skepticism for expert valuations and have instead endorsed substantial reliance on deal price as evidence of fair value where a company is sold after a robust sale process (see above *Sale Process* and *Discounted Cash Flows*; see *Box, Developments in Appraisal Proceedings*).

In determining whether to accord weight to the deal price in a fair value calculation, the Chancery Court in *In re Appraisal of AOL Inc.* recently evaluated whether the deal was "*Dell* Compliant," which it defined as a transaction where both:

- Information was sufficiently disseminated to potential bidders so that an informed sale could take place.
- There were no undue impediments to price competition imposed by the deal structure itself.

(2018 WL 1037450, at *8.)

By contrast, courts will place reduced reliance on the deal price where a company is not operating in an efficient market, such as where:

- The market lacks a large and diffuse base of public stockholders.
- Information about the company is sparse or restricted.
- No active trading market for the shares exists.
- There is a controlling stockholder.

(See *Dell*, 177 A.3d at 25.)

Ultimately, the court in *AOL* held that the deal price was not the best evidence of fair value because the court was skeptical about whether there was active competition for the target company and observed "a considerable risk of informational and structural disadvantages" dissuading any prospective competitive bidder (2018 WL 1037450, at *8-9; but see *Dell*, 177 A.3d at 25 (rejecting the Chancery Court's view that "short-sighted analysts and traders impounded an inadequate — and lowball — assessment of all publicly available information into Dell's stock price" and finding that "the record shows just the opposite: analysts scrutinized Dell's long-range outlook when evaluating the Company and setting price targets, and the market was capable of accounting for Dell's recent mergers and acquisitions and their prospects in its valuation of the Company")).

UNAFFECTED STOCK PRICE

The unaffected stock price approach determines what the market price for the company's stock would have been on the date of the merger absent any impact from the public announcement of the merger. The starting point typically is the market price on the last day of trading unaffected by the announcement of the merger. This price may be adjusted to reflect trends in the subject industry and the market as a whole between the selected date and the merger date.

Several recent Delaware cases have suggested that some reliance on unaffected stock price as a proxy for fair value in public M&A transactions will likely be most appropriate if the target company's shares trade in an "efficient market." In contrast to the typical characteristics of an inefficient market (see above *Deal Price*), a market is more likely to be considered efficient where:

- The market has many stockholders.
- Information about the company is widely available and easily disseminated to the market.
- There is an active trading market for the shares.
- There is no controlling stockholder.

(*Dell*, 177 A.3d at 25; see, for example, *Verition*, 2018 WL 922139, at *26-27 (endorsing reliance on the unaffected stock price where the market for the company "had basic attributes" of efficient markets, including shares traded on a public exchange, lack of a controlling stockholder, coverage by securities analysts, a bid-ask spread that indicated market efficiency, and a high weekly trading volume).)

In addition to the deal price, Delaware courts have expressed a greater willingness to rely on the unaffected stock price as the best indicia of fair value in public M&A transactions. Therefore, while litigants should not forgo preparing all of the traditional valuation methodologies discussed above, to the extent they intend to proffer evidence of the unaffected stock price as a measure of fair value, they should consider evidence demonstrating or refuting the fact that the company's stock traded in an efficient market, as well as evidence defining the appropriate time period before the announcement of the transaction from which the unaffected stock price should be observed (for example, 30, 60, or 90 days before the announcement of the transaction).

Proponents of the unaffected stock price approach, however, should also familiarize themselves with the Chancery Court's recent decision in *In re Solera Holdings, Inc.*, in which Chancellor Bouchard rejected the respondent's argument (raised for the first time in supplemental post-trial briefing) that the unaffected stock price rather than the deal price was the best evidence of Solera's value as of the date of the merger. The Chancery Court noted that the argument, which advocated for a fair value determination based on Solera's unaffected stock price that was about 35% below the deal price, "reflects a dramatic change of position" that was "as facially incredible as petitioners' DCF model." Because the parties never litigated what Solera's true unaffected stock price was, the Chancery Court found that it was in no position to reliably make that determination. Additionally, the decision effectively called into question the role of non-synergy cost savings in appraisal actions (for example, whether agency cost reductions are an element of value derived from a merger that should properly be excluded from the deal price in determining fair value in an appraisal action). (C.A. No. 12080-CB, at 85-90 (Del. Ch. July 30, 2018).)

PREPAYMENT

A significant distinction among state appraisal statutes is whether the company is required to make a prepayment or an offer of payment of the undisputed fair value of the stock to the dissenting stockholders early in the appraisal process. The majority of jurisdictions have this requirement. Some jurisdictions permit, but do not require, the company to prepay before the appraisal proceeding concludes, thereby limiting the accrual of interest on an appraisal award.

Section 262(h) of the DGCL was amended, effective August 2016, to allow a company to prepay an amount (which may be determined in the sole discretion of the company) in cash to dissenting stockholders at any time before judgment. This amendment addressed a significant concern that the interest provision in Section 262(h) encourages appraisal arbitrage (see *Box, Developments in Appraisal Proceedings*).

Specifically, under amended Section 262(h), if a company makes a prepayment, interest will accrue only on the sum of:

- The difference, if any, between the prepaid amount and the fair value as eventually determined by the Chancery Court.
- The interest that accrued before the prepayment, unless paid at the time of prepayment.

After the amendment was enacted, companies initially were slow to adopt the prepayment option. Recently, however, companies have expressed increased willingness to prepay a portion of the merger consideration and cut off the prejudgment interest payable on that portion, particularly given that current statutory interest rates in some states exceed 7%. In Delaware appraisal actions, most companies that prepay a portion of the merger consideration choose to pay an amount that is less than the merger consideration because:

- The DGCL does not provide a mechanism for recouping overpayments in the event the court sets fair value below the deal price. (In cases where Delaware law does not apply, practitioners should review the relevant statute to determine if the provisions vary from Delaware.)
- While a court would not likely consider the prepaid amount when determining fair value, companies typically do not want to create bad optics or imply any weakness in their valuation case by paying an amount that exceeds their valuation case.

Companies deciding whether to prepay a portion of the merger consideration should consider if it makes financial sense to do so by evaluating:

- The risk that prepayment will go towards funding the petitioners' litigation costs.
- The company's:
  - availability of funds;
  - cost of capital; and
  - better uses for the capital.

SETTLEMENTS

Under Section 262(k) of the DGCL, a stockholder who has not filed a petition for appraisal or joined in an appraisal action that has been filed can withdraw his demand for an appraisal without court approval, provided that the stockholder receives only the merger consideration. A company that has received an unequivocal withdrawal of an appraisal demand in writing should instruct the stockholder to comply with the surrender and payment or exchange method provided in the merger agreement that was used for all other stockholders who voted for the transaction and elected to receive the merger consideration. For example, if the stockholders had to sign a letter of transmittal and surrender their certificates to the

BEST PRACTICES FOR LITIGATING APPRAISAL ACTIONS

When litigating an appraisal action, counsel should:

- Understand all requirements to perfect appraisal rights and rectify any standing issues, if representing the dissenting stockholders.
- Closely review Section 262(d) and (e) of the DGCL and provide the notices required under the provision, if representing the corporation.
- If litigation ensues, conduct an early assessment of settlement.
- If a settlement is not pursued or cannot be reached, undertake a thorough preparation of the case, and research and hire valuation experts with care.

Counsel should be prepared to offer evidence regarding all possible indicators of fair value, considering whether the court is likely to:

- **Rely on the deal price or unaffected stock price as a measure of fair value.** Because Delaware courts have expressed increasing willingness to rely on the deal price or unaffected stock price in the context of public M&A transactions, counsel should consider how to demonstrate or refute the argument that market values are the best evidence of fair value. Deal counsel would be well-advised to properly structure transactions pre-litigation to promote market competition and maximize the likelihood of a finding of a robust sale process. If an appraisal action is filed, the company should:
  - develop evidence of a robust sale process, as well as evidence of any merger-related synergies, and prove through trial testimony the value of any synergies that was reflected in the deal price so that they may be deducted from the appraisal award; and
  - assess whether to offer evidence that the company's stock trades in an efficient market and evidence of unaffected stock price as indicia of fair value.
- **Employ traditional valuation methodologies.** In private company transactions (or in situations where there are factors that distort true arm's-length dealing), traditional valuation methodologies will continue to be paramount. Appraisal litigation in these cases often takes on the characteristics of fiduciary duty litigation. Therefore, evidence concerning conflicts of interest, a flawed sale process, misappropriated corporate opportunities, or other evidence concerning diverted value will take on particular importance.
- **View expert testimony and valuations credibly.** Given courts' increasing skepticism of the battle of the experts, litigants should prepare their valuation case with an eye toward avoiding common credibility killers, such as:
  - making unsupported adjustments to management projections;
  - relying on overly optimistic or pessimistic assumptions;
  - using dissimilar companies in a comparable companies analysis; or
  - using stale transactions in a comparable transactions analysis.

transfer agent, the stockholder who withdrew the appraisal demand should follow the same process.

By contrast, Section 262(k) also provides that if a stockholder has filed a petition for appraisal or has expressly joined an appraisal action, the proceeding cannot be dismissed as to that stockholder without court approval. In reviewing a proposed voluntary settlement, the Chancery Court considers whether the settlement is "upon such terms as the Court deems just" (8 Del. C. § 262(k)) and may reject a settlement it believes is unfair to any party. The court may also require the company to send notice of the settlement to all stockholders who have demanded appraisal.

Most petitions for appraisal settle before trial. Factors that contribute to the decision of whether to settle or litigate through trial include:

- **The amount of the stockholders' investment.** The size of the petitioners' collective stake in the company is the most powerful indicator of whether a case will go to trial. An appraisal claim with a small collective investment may be more likely to settle, in part because the cost of litigation would not be justified for smaller claims.
- **The strength of the case.** Counsel may conduct an early assessment of the case to evaluate how likely it is that the company can prove that the fair value is equal to or lower than the deal price, or that the stockholder can prove that the fair value is higher than the deal price.
- **The amount of litigation costs and interest.** Common assumptions applied by attorneys litigating in Delaware include:
  - a statutory interest rate of at least 7% compounded quarterly;
  - a period of 24 months to judgment (which accounts for reaching trial in 18 to 20 months plus an additional five months for the parties to conduct briefing and the court to issue a decision); and
  - significant discovery and defense costs based on attorney and expert fees (which could reach millions of dollars depending on the size of the transaction).
- **The potential management distractions.** Litigation-related issues may distract management from their ongoing responsibilities.
- **The possibility of other claims.** Counsel for the corporation often consider whether the petitioners may assert breach of

fiduciary duty claims or aiding and abetting claims based on information learned through discovery (for more information on breach of fiduciary duty claims and aiding and abetting claims, search Understanding M&A Litigation on Practical Law).

Search Settlement Agreement and Release for a sample agreement between two or more parties settling a pending lawsuit and releasing future claims, with explanatory notes and drafting tips.

Search Settlement Tactics in US Litigation for more on the principal factors that can help counsel decide whether, when, and how to settle litigation proceedings.

TRIAL

In Delaware, an appraisal trial is typically a multi-day bench trial where the judge's mandate is to consider all relevant factors in determining the fair value of the subject shares, which allows the court significant discretion. The parties must prove fair value by a preponderance of the evidence, and the burden of proof is placed equally on the dissenting stockholders and the company.

The most persuasive testimonial evidence the parties can present at trial includes evidence that demonstrates or refutes:

- The existence of additional value not reflected in the deal price, for example:
  - misappropriated corporate opportunities;
  - value improperly diverted to insiders; and
  - overly opportunistic or pessimistic projections.
- In public M&A transactions:
  - a robust sale process;
  - the existence of conflicts of interest;
  - the potential synergies achieved through the transaction; and
  - relevant industry characteristics, where applicable.

The determination of fair value typically involves a battle of the experts at trial. An expert's task is to be seen as a neutral, reasonable appraiser of the shares' value rather than a hired gun. While Delaware judges generally have more on-the-bench experience with business litigation than judges in other jurisdictions, counsel should keep in mind that judges are not trained appraisers. Therefore, the parties should offer strong expert testimony on valuation. An expert should ground his valuation conclusions in sound economic or financial theories and methodologies, and the expert should be prepared to explain in detail the rationale behind his analysis. Additionally, for a valuation to be credible, an expert should:

- Take into account the characteristics of the relevant industry in his future growth projections, particularly when conducting a DCF analysis.
- Be prepared to articulate and defend his approach to using, adjusting, or rejecting management assumptions or projections.
- Be prepared to defend his choice of comparable companies in a comparable companies analysis, the discount rate in a DCF analysis, and other variables, as applicable.

After considering the experts' testimony, the court may:

- Adopt an expert's methodology in full, where it is supported by credible evidence and sound financial valuations.
- Select the most representative analysis from the information offered by the experts and make appropriate adjustments.
- Make a determination of fair value based on its own analysis, where it does not deem the parties' proffered valuations persuasive.

In addition to experts, parties can help establish fair value through:

- **Fact witnesses.** Common fact witnesses include those who possess knowledge of the company's value, including:
  - members of the management team;
  - directors;
  - accountants; and
  - financial advisors.
- **Documentary evidence.** The most persuasive documentary evidence includes:
  - recent historical financial statements (audited, if available);
  - financial analyses prepared in connection with the transaction; and
  - other reliable financial information, such as financial projections, future business plans, tax information, and information relating to the company's cost of capital.

ATTORNEYS' FEES AND COSTS

How courts allocate litigation costs in appraisal actions differs among states. In the majority of jurisdictions, there is a rebuttable presumption that the company will pay the court costs of an appraisal proceeding while the parties typically bear their own attorneys' fees and expert expenses, unless a court determines that those fees and expenses should be allocated equitably due to a party's bad conduct.

In other jurisdictions, including Delaware, there is no presumption regarding the allocation of costs and courts have discretion in making this determination. Section 262(j) of the DGCL provides that the costs of the appraisal proceeding may be determined by the court and taxed to the parties as the court deems equitable. In practice, Delaware courts tend to allocate court costs to the company. Section 262(j) is silent regarding whether attorneys' fees and expert expenses can be assigned to another party, but Delaware case law recognizes a bad faith exception to the general rule that parties bear their own attorneys' fees and expenses.

APPEALS

The Delaware Supreme Court reviews appeals from appraisal determinations in the Chancery Court using an abuse of discretion standard and gives significant deference to the factual findings of the trial court. The Delaware Supreme Court generally will accept the Chancery Court's factual findings if they are both:

- Supported by the record.
- The product of an orderly and logical deductive process.

(See *Dell*, 177 A.3d at 5.)

Search Initial Civil Appeals: Delaware for more on appealing orders from the Delaware Court of Chancery.