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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

2 Delaware Cases May Slow Appraisal Arbitrage Momentum

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On Feb. 12, 2015, the Delaware Supreme Court affirmed the Court of Chancery's ruling in Huff Fund Investment Partnership v. CKx Inc. in a decision that could potentially slow the surge in appraisal proceedings. In recent years, "appraisal arbitrage" has developed into a burgeoning industry among hedge funds seeking to take advantage of favorable case law on valuation, standing to assert the right with respect to shares acquired post-meeting and a beneficial statutory interest rate. Such arbitrageurs buy shares in a transaction about to close and file suit claiming that the fair value of the company is higher than the deal price. They hope to cash in on a higher court-determined price plus default interest at 5 percent above the Federal Reservediscount rate, compounded quarterly.[1]

Two recent Court of Chancery decisions authored by Vice Chancellor Sam Glasscock III — CKx,[2] just affirmed by the Delaware Supreme Court, and In re Appraisal of Ancestry.com[3] — may slow the momentum of appraisal arbitrage created by the court's historic valuation methodologies in appraisal proceedings. Both of these appraisal cases held that the merger price was the most probative evidence of fair value. Without confidence that a premium could be secured through competing valuation testimony — through which experts have asserted a wide range of values — arbitrageurs may find the appraisal path significantly less inviting.

However, the book may not be closed on appraisal arbitrage for two reasons: first, guaranteed interest of 5 percent above the Federal Reserve discount rate may be enough of an incentive to continue the practice, even without a likely premium over the deal price; and second, the courts may only deem the deal price probative of fair value when there has been an adequate market check.

Delaware Appraisal Law Leading up to CKx

Under Delaware law, “fair value” in the appraisal context is based on the corporation’s stand-alone value, and excludes any premium that is added from the potential synergies of the acquisition.[4] Historically, Delaware courts looked to the value paid in an arm's length transaction as indicative of fair value if “the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded.”[5] Thus, consideration of merger price was an assumed element of evaluation when determining fair value in arm's length transactions.

However, in 2010’s Golden Telecom Inc. v. Global GT LP opinion, the Delaware Supreme Court rejected the respondent’s request that the court adopt “a standard requiring conclusive or, in the alternative, presumptive deference to the merger price in an appraisal proceeding.”[6] Instead, the Supreme Court held in Golden Telecom that requiring deference “to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent. It would inappropriately shift the responsibility to determine ‘fair value’ from the court to the private parties.”[7]

Golden Telecom appeared to mark a shift away from the deal price in determining fair value. Though the Delaware Supreme Court did not determine that the deal price was irrelevant to fair value, the decision set an expectation among practitioners that the court should choose a value on its own, without taking guidance from the parties’ agreed-upon price.

Following Golden Telecom, the Court of Chancery issued two appraisal decisions that not only declined to defer but also markedly departed upward from the merger price in assessing fair value: In re Orchard Enterprises Inc.[8] and Merion Capital LP v. 3M Cogent Inc.[9] At this point, many practitioners became concerned merger price was “off the table” during judicial appraisal.[10]

Simultaneously — and not coincidentally — “appraisal arbitrage” began to rise as opportunistic hedge funds noticed significant upside potential from courts pushing deal price to the side and determining fair value from scratch.[11] About 5 percent of eligible transactions attracted at least one appraisal petition between 2004 and 2010; the appraisal rate more than doubled in 2011, and has continued to increase since.[12] In 2013, 17 percent of eligible deals attracted an appraisal petition.[13]

The CKx and Ancestry.com Decisions

In 2011, buyers expressed interest in acquiring CKx. Ultimately, only two bidders emerged: a private equity fund that bid $5.50 per share, and an unidentified bidder, who offered $5.60 per share. The CKx board accepted the private equity fund’s offer, recognizing that the other bidder had not yet obtained the financing to close the deal. Huff Fund Investment Partnership, among other investors, petitioned for appraisal.

The Court of Chancery held that the $5.50 per share deal price was the most reliable and probative indicator of fair value, and rejected each party’s expert valuations. In an opinion dated Nov. 1, 2013, Vice Chancellor Glasscock found that the sales process included “a full market canvas and auction” and that the CKx board had “instigated a bidding war” for the company.[14] After finding alternative valuation methodologies (including discounted cash flow and comparable companies analyses) unreasonable under the circumstances, Vice Chancellor Glasscock held that the “merger price is the most reliable indicator of value.”[15]

In re Appraisal of Ancestry.com, Vice Chancellor Glasscock reiterated its fundamental holding in CKx that, in appropriate cases, deal price is the key to assessing fair value. “The question becomes, should I rely on the [discounted cash flow analysis] to reach fair value, using what appears to be a relatively untainted market-derived valuation as a check, or should my analysis be the reverse?” He continued: “Because the inputs [to the discounted cash flow Analysis] here ... are problematic ... and because the sales process here was robust, I find fair value in these circumstances best represented by the market price.”[16]

Most critically, on Feb. 12, 2015, the Delaware Supreme Court affirmed the Court of Chancery’s decision in CKx, by a brief written order that adopted the lower court’s reasoning without opining further. During oral argument, Chief Justice Leo E. Strine Jr. held the market price in high regard: “[Y]ou can think you’re smarter than the market, but you better go read Burt Malkiel’s book called A Random Walk Down Wall Street, because you’re not, and the best indication of market value is in fact a market check.”17

Conclusion

These two Court of Chancery decisions — and the Supreme Court’s affirmation of CKx — mark an important judicial response to the recent spike in “appraisal arbitrage,” which may effectively subdue the rise of this practice. The scope of these decisions, however, should not be overstated. Delaware courts may be willing to rely on market price in situations if there was a reliable and robust market check; but absent proof that the company was aggressively shopped, or that the market had a real chance to price the target, arbitrageurs may still find appraisal a path to obtaining a premium above the merger price.

Further, so long as the appraisal process for any deal presents a reasonable prospect for valuation above the merger value, the statutorily presumed interest rate of the Federal Reserve discount rate plus 5 percent and flexible standing standards will likely continue to encourage these arbitrageurs.

—By Mark D. Gerstein, Blair Connelly, Sarah M. Lightdale and Zach L. Rowen, Latham & Watkins LLP

Mark Gerstein is a partner in Latham & Watkins' Chicago office and global chairman of the firm’s mergers and acquisitions practice.

Blair Connelly is a partner and Sarah Lightdale and Zach Rowen are associates in Latham & Watkins' New York office.

[1] 8 Del. C. §262(h) (2013).

[2] 2013 WL 5878807 (Del. Ch. Nov. 1, 2013) aff’d No. 348, 2014 (Del. Feb. 12, 2015).

[3] In re Appraisal of Ancestry.com Inc., No. 8173-VCG (Del. Ch. Jan. 30, 2015)

[4] 8 Del. C. § 262(h).

[5] Union Ill. 1995 Inv. LP v. Union Fin. Group, 847 A.2d 340, 357 (Del. Ch. 2004).

[6] Golden Telecom Inc. v. Global GT LP, 11 A.3d 214, 216 (Del. 2010).

[7] Id. at 217-18.

[8] In re Orchard Enterprises Inc., 2012 WL 2923305 (Del. Ch. July 18, 2012) (finding fair value to be $4.67 per share when deal price was $2.05 per share).

[9] Merion Capital LP v. 3M Cogent Inc., 2013 WL 3793896 (Del. Ch. July 8, 2013) (finding fair value to be $10.87 per share when deal price was $10.50 per share).

[10] CKx, 2013 WL 5878807, at *11 n. 119. Critically, although many practitioners sensed a broad change in judicial attitude disfavoring reliance on merger price, both In re Orchard and 3M Cogent are readily explicable on the basis of somewhat unusual facts. In re Orchard involved a going-private merger where the court was not persuaded that the company had been adequately shopped. 2012 WL 2923305 at *5. In 3M Cogent, the respondent did not attempt to point to the merger price as evidence of fair value or adjust the merger price to exclude any value created by the synergy of the acquisition. 2013 WL 3793896 at *5.

[11] The influx in appraisal proceedings can also likely be attributed to the revision of 8 Del. C. § 262(h) in 2007, defining the interest from the effective date of the merger through the date of payment of the judgment to be 5 percent over the Federal Reserve discount rate, compounded quarterly, unless the court determines otherwise for good cause. This marked an attractive return during a stretch when interest rates were otherwise at an all-time low.

[12] Minor Myers and Charles R. Korsmo, Appraisal Arbitrage and the Future of Public Company M&A, BROOKLYN LAW SCHOOL, August 2014, at 16.

[13] Id.

[14] 2013 WL 5878807 at *1, *13 (Del. Ch. Nov. 1, 2013) aff'd No. 348, 2014 (Del. Feb. 12, 2015).

[15] Id. at *13.

[16] In re Appraisal of Ancestry.com Inc., No. 8173-VCG (Del. Ch. Jan. 30, 2015), at 56.

[17] "2/11/2015 Delaware Supreme Court Oral Arguments," available at http://new.livestream.com/DelawareSupremeCourt/events/3801168/videos/76805879.
