Reappraising the Future of Appraisal Cases After the *BMC* Decision

Kirkland represented Bain and Golden Gate in the acquisition and BMC in the subsequent appraisal action.

In a 2013 *M&A Update*, we noted an increasing number of investors pursuing statutory appraisal actions to obtain a higher price for their shares in a cash-out merger. Perhaps in a sign that the judicial tide is turning against some of the more abusive manifestations of this trend, the Delaware Court of Chancery recently issued its decision in *BMC Software*, the largest Delaware statutory appraisal action ever to reach a post-trial decision.

The litigation arose out of the $6.9 billion acquisition of BMC by a group of private equity firms led by Bain Capital and Golden Gate Capital. Merion Capital, an appraisal arbitrage fund that had acquired approximately $350 million worth of BMC stock shortly before the closing, sought appraisal, claiming that its BMC stock was worth $180 million more than the deal price, according to its expert's discounted cash flow analysis of the company. Following a recent line of Delaware decisions, VC Glasscock decisively rejected Merion Capital's claims and found "the Merger price…to be the best indicator of fair value," in light of the "robust, arm's-length sales process."

Historically, Delaware courts have often relied heavily on DCF analyses based on management projections prepared in the ordinary course of business to determine fair value in appraisal proceedings. More recently, appraisal arbitrage firms have relied on this practice to argue that, based on their own experts' DCF analyses, target companies are worth far more than the price they were sold for — even if that price resulted from a robust arm's-length sale process.

The recent BMC appraisal decision will make it harder for appraisal petitioners to challenge a merger price resulting from a thorough and effective sale process.

In a 2010 decision (*Golden Telecom*), the Delaware Supreme Court noted that, because the appraisal statute requires the Court of Chancery to consider "all relevant factors" when valuing a company, "[r]equiring the Court of Chancery to defer — conclusively or presumptively — to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute." This decision led some practitioners to believe that the Chancery Court could not rely on the merger price at all in appraisal proceedings.

But in 2013, VC Glasscock held in the *CKx* appraisal case that while *Golden Telecom* may bar a systematic presumption in favor of the merger price, it allows reliance on the merger price where it is the best evidence of fair value in the record. The *CKx* decision (which was affirmed by the Delaware Supreme Court in a short order) went on to place 100 percent weight on the merger price where that price resulted from a robust, arm's-length sales process, and the DCF method could not reliably measure the target company's value because the company's projections were "not prepared in the ordinary course of business."

Four subsequent Chancery Court decisions have followed this analysis, but until *BMC*, each of those decisions was careful to note that the relevant target company's projections were prepared outside the ordinary course of business or were otherwise unreliable. Merion Capital sought to convince the *BMC* court that projections (and therefore a DCF analysis) should be used instead of the merger price because BMC *did* prepare ordinary course projections, and therefore could be distinguished from the other recent cases.

But VC Glasscock held that even though BMC created projections in the ordinary course of business, and BMC's "management was able to reliably predict a significant portion of revenue" due to BMC's multiyear contracts with customers, the merger price was still the best indicator in the record of BMC's fair value. In doing so, the court expressed a degree of skepticism in DCF modeling as a decisive valuation technique, at

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least where the court has confidence that the merger price resulted from a vigorous sale process.

Finding a merger price to be reliable evidence of fair value need not end the court's inquiry in appraisal proceedings, however. The appraisal statute requires that any synergistic elements be excluded from the merger price when deriving appraised fair value. Therefore, if the target can prove that a portion of the merger price reflected "synergies" between the target and its acquirer, the court could find that the target's fair value was *below* the merger price.

Delaware courts have generally declined to make such a downward adjustment, finding insufficient evidence in the record to prove the existence of synergies or the portion of the merger price attributable to them. For example, courts have held that internal documents from the acquirer quantifying going private savings are not sufficient. BMC went one step further in an attempt to prove synergies, by also offering testimony from a buyer representative explaining the basis for such synergies, and how they factored into the deal price.

VC Glasscock nevertheless found this evidence insufficient. But he provided a roadmap to possibly prove synergies in future cases and thereby qualify for a reduction in appraised fair value. The court began by rejecting Merion Capital's argument that synergies must be unique to a specific acquirer in order to be deducted from the merger price. Rather, the court explained that savings "that can be realized by an acquirer — any acquirer— taking the company private . . . [are] likely properly excluded from the going-concern value" so long as they are both (1) unachievable by the target as a standalone going concern, and (2) realized by the target's shareholders in the deal price. He also suggested that expert testimony may be necessary to show that synergies were embedded in the deal price.

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With signs pointing to the possibility that certain investors were beginning to (ab)use the appraisal process as a potentially more lucrative replacement for the now ubiquitous fiduciary litigation, the *BMC* court decision strengthens the ability of companies to argue that Delaware courts should reject challenges to a merger price resulting from a thorough and effective sales process, even where the target company prepared ordinary course projections. The decision may also enhance the ability of companies to defend against appraisal actions given the court's guidance on proving synergies as a deduction to the appraised price. Building a strong record on synergies, supported by expert testimony, exposes an appraisal petitioner to the very real risk that it may in fact receive less than the arm's-length merger price in future cases.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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