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Delaware Finds Merger Price Best Indicator of Fair Value in Appraisal Case

PENpoints

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

In a [2013 *M&A Update*], we noted an increasing number of investors pursuing statutory appraisal actions seeking to obtain a higher price for their shares in a cash-out merger. The possibility that a target could be required to pay additional merger consideration as a result of an appraisal proceeding is particularly problematic for a buyer, such as a private equity sponsor, who is financing a significant portion of the merger consideration with debt. 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 rejected an appraisal claim 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.

Following a recent line of Delaware decisions dating back to 2013, the *BMC* court 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."

Fair Value: Merger Price vs. DCF

Delaware courts have often relied heavily on discounted cash flow 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 historical practice to argue that, based on their own experts' DCF analysis, target companies are worth far more than the merger price negotiated by two independent parties after a robust, arm's-length sale process.

In 2010, the Delaware Supreme Court noted that, because the appraisal statute requires the Court of Chancery to consider "all relevant factors" when valuing a target, "[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, the Delaware Court of Chancery held (and in 2015 the Delaware Supreme Court affirmed in a one-page order) that while prior law may bar a systematic presumption in favor of the merger price, prior law does allow reliance on the merger price where it is the best evidence of fair value in the record. The Chancery Court opinion 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's value because the target's projections were "not prepared in the ordinary course of business, and [were] otherwise unreliable."

Four subsequent Chancery Court decisions followed this analysis, but until *BMC*, each of those decisions was careful to note that the target'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 govern in circumstances where the target did prepare ordinary course projections.

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However, the *BMC* court held that, even where a target created both short- and long-term ordinary course projections, and where "management was able to reliably predict a significant portion of revenue" due to BMC's multiyear contracts with customers, the merger price nonetheless constituted 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 least where the court has confidence that the merger price resulted from a vigorous sale process.

Treatment of Synergies

Finding a merger price to be reliable evidence of fair value does 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. Thus, if the target can prove that a portion of the price paid included "synergies" between the target and the acquirer, the court could find that the target's fair value was *below* the merger price.

Delaware courts have generally declined to make such an 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 alone 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.

The *BMC* court nevertheless found this evidence insufficient. But in so holding, it provided a roadmap for a target to possibly prove synergies in a future case 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. It further held that an acquirer's internal valuation alone is not sufficient to prove that synergies were embedded in the deal price and indicated that expert analysis using a deal-price-less-synergies approach may be needed.

Conclusion

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* decision strenghtens a target's ability to argue that Delaware courts should reject challenges to a merger price resulting from a thorough and effective sale process, even where the target prepared ordinary course projections. The decision may also enhance the ability of targets 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 *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

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2015 Registered Adviser Seminar & CCO Summit
Los Angeles, California, December 2, 2015

As the SEC continues its focus on private fund managers registered as investment advisers, firms must be familiar with the evolving regulatory environment. This seminar is designed specifically for private fund manager CCOs, general counsel and other senior executives. Click here for more information.

Building the Case for Private Equity Emerging Markets: A Conversation with HBS Professor Josh Lerner
Chicago, Illinois, December 8, 2015

Kirkland & Ellis and The Abraaj Group present this leadership summit for private equity investors focused on growth markets in Latin America, Eastern Europe, the Middle East and beyond. The event will engage industry thought leaders in discussions about the latest developments in the asset class and emerging economies and offer practical insight into capital investment in today's strategic growth markets. Click here for more information.

Drafting and Negotiating Corporate Agreements 2016
New York, New York, January 8, 2016
Chicago, Illinois, February 4, 2016

This PLI seminar will teach the basics of drafting and negotiating corporate agreements — from how the provisions of an agreement fit together, to the fundamental drafting and negotiating principles common to all corporate agreements. Kirkland partner Kevin Morris is co-chair of the Chicago event and partner Sarkis Jebejian will be a panelist at the New York event. Click here for more information.

43rd Annual Securities Regulation Institute
Coronado, California, January 25-27, 2016

Hosted by Northwestern Law, the 43rd Annual Securities Regulation Institute will take place in Coronado, California. One of the most visible and highly regarded securities and corporate law conferences in the country, the Securities Regulation Institute reaches prominent attorneys from both firm and in-house practices. Kirkland partner Robert Khuzami will be a panel member for the Enforcement and Government Investigations session. Click here for more information.

15th Annual Beecken Petty O'Keefe & Company Private Equity Conference
Chicago, Illinois, February 19, 2016

Kirkland is a sponsor of the Chicago Booth Private Equity Conference (PEC), an annual event that brings together financiers, students and entrepreneurs to network and share insights into the dynamics of investing in a constantly changing economy. This year's conference is themed "Navigating Industry Cycles: Investing in an Evolving Market." Click here for more information.

Columbia Business School's 22nd Annual Private Equity & Venture Capital Conference
New York, New York, February 19, 2016

Kirkland will sponsor Columbia Business School's 22nd Annual Private Equity & Venture Capital Conference, which will focus on the emerging challenges and opportunities facing the private equity and venture capital industries in the coming year. The event will bring together industry professionals, students, alumni and faculty to share their knowledge and experiences.

11th Annual Stern Private Equity Conference
New York, New York, March 4, 2016

Kirkland will sponsor New York University's Stern School of Business' 11th Annual Stern Private Equity Conference. The conference will provide a forum for industry leaders to discuss the opportunities and risks of today's private equity and venture capital environment, including how tepid global growth, regulatory dynamics, political pressure and financial market conditions are posing challenges to fundraising, deal financing and operations.

22nd Annual Harvard Business School Venture Capital and Private Equity Conference
Boston, Massachusetts, March 5, 2016

Kirkland will sponsor Harvard Business School's 22nd Annual Venture Capital and Private Equity Conference, held on the Harvard campus. The panels will address a range of today's most relevant topics, from growth equity investing and fundraising to geography-specific investment opportunities.

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Kirkland & Ellis' nearly 400 private equity attorneys have handled leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 400 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in 2012, 2013 and 2014 by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. Kirkland was named "Law Firm of the Year in Mergers and Acquisitions Law" by U.S. News Media Group and Best Lawyers in its 2014 "Best Law Firms" rankings. The Firm was named "Best M&A Firm" at *World Finance*'s 2014 Legal Awards, "North American Law Firm of the Year: Fund Formation" and "North American Law Firm of the Year: Transactions" at *Private Equity International*'s 2014 Private Equity International Awards and "Private Equity Deal of the Year" at the 2014 IFLR Americas Awards.

In 2012, 2013 and 2014, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011, 2012, 2013* and *2014*, and has consistently received top rankings among law firms in Private Equity by The Legal 500 and IFLR, among others.

The Lawyer has recognized Kirkland as one of its "Transatlantic Elite" every year since 2008, having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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