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The Growth of Appraisal Litigation in Delaware

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Editor's Note: The following post comes to us from David J. Berger, partner focusing on corporate governance at Wilson Sonsini Goodrich & Rosati, and is based on a WSGR Alert memorandum. The complete publication, including footnotes, is available here. This post is part of the Delaware law series, which is cosponsored by the Forum and Corporation Service Company; links to other posts in the series are available here.

Numerous commentators and academics have written about the growth of M&A litigation over the last several years. Less noticed, but perhaps more significant, has been the growing tendency of institutional and other large investors to exercise their appraisal rights under Delaware law. Investors in several recent high-profile mergers have announced their intention to, or sought to, exercise their appraisal rights, including in deals involving Dell, Dole Food Company, and 3M/Cogent.

In many of these situations, an even more novel phenomenon is occurring: hedge funds, arbitrageurs, and other money managers are buying the stock of target companies even after a deal is announced to have the option to exercise appraisal rights. Some funds even have been created expressly for this purpose, perhaps with the view that the risks in an appraisal proceeding may be far greater to the target company than to the shareholder.

One such risk is that historically the definition of "fair value" in an appraisal proceeding under Delaware law provides wide discretion to the court to "take into account all relevant factors" beyond the price paid in the underlying merger, even where that price was the result of an arms-length transaction. The practical impact of this standard is that the court's determination of value may get reduced to a "battle of the experts," while the experts' own analyses may be based on future projections and/or other financial information that is, by definition, uncertain. As a result, there is often little hard data to predict what the value of an entity in an appraisal proceeding could be.

A second significant risk is that under Delaware law, appraisal awards accrue interest at a statutory rate of *5 percent above the Federal Reserve discount rate compounded quarterly*. Further, this extraordinary interest begins accruing at the date of the deal's closing until the date that payment of the judgment is made. The statutory interest rate under Delaware law creates substantial risk to the target corporation (while also incentivizing a stockholder to bring an appraisal claim by potentially limiting the investor's "downside" risk) since even if the stockholder's recovery is limited to a value similar to the price paid in the merger, the investor currently receives compounded interest at a rate significantly above market rates on whatever award is ultimately obtained.

However, a recent decision by the Court of Chancery gives hope that one of the structural risks to companies defending an appraisal case may be slowly starting to change. Specifically, in *Huff Fund Investment Partnership v. CKx, Inc.*, C.A. No. 6844-VCG (Del. Ch. Nov. 1, 2013), the Delaware Court of Chancery held that under certain circumstances, Delaware courts can and should look to the merger price when determining fair value, and that there are even situations where the merger price generated by an arms-length sales process could be the best and most reliable indication of value. But this decision alone is unlikely to stop the increasing popularity of appraisal suits in Delaware.

The Risky Business of Valuation in Delaware Courts

Delaware law traditionally gives the court "significant discretion" to "consider the data and use [any] valuation methodologies" the court deems appropriate to determine "fair value" in an appraisal case. Because the court has such wide latitude to accept any of the parties' valuations "by any techniques or methods which are generally considered acceptable or otherwise admissible in court," appraisal cases often turn upon the credibility and analysis of expert testimony. This can be the case even where the expert's testimony is based upon projections and/or financial analyses that are questionable (a reality that is even more common in companies that have limited operating histories or operate in more volatile industries).

As a practical matter, a case that is determined by expert testimony can be a risky enterprise. Expert testimony often depends upon the skills of the expert as much as the analyses performed, and the underlying data can be highly questionable since it generally assumes how the company would have performed had the merger in question not occurred. Further, the risks again fall largely on the defendants in these proceedings since defendants must bear almost all of the burden of discovery. Management presentations made to the board in the context of the board considering its alternatives often include an "upside" case that is admissible for appraisal purposes even if it was unrealistic as a practical alternative, and even the passage of time benefits the stockholder since the longer the case continues, the longer interest accrues at the statutory rate discussed above.

The *CKx* Decision and the Use of Merger Price as a Factor in the Valuation of a Company in Appraisal

CKx was a publicly traded company that managed and invested in media and entertainment properties, including 19 Entertainment (which owned rights to shows such as “American Idol” and “So You Think You Can Dance”), Elvis Presley Enterprises, and Muhammad Ali Enterprises.

After several years of unsuccessfully seeking a buyer (both publicly and privately), in 2010, CKx made a public announcement that it was no longer considering a sale. Shortly thereafter, two private equity buyers expressed interest in acquiring the company, and the CKx board decided again to pursue a sale. Once more, the board retained a financial advisor, ran an auction process, and ultimately received two bids: one from private equity firm Apollo at $5.50 per share and a second offer from another private equity firm, “Party B,” at $5.60 per share. The board accepted Apollo’s lower bid because it offered greater deal certainty and other benefits. Following the now-standard class action litigation (which settled for additional disclosures and a slight modification to the termination fee), the deal closed.

After the deal litigation was resolved in principle and the merger closed, a large stockholder of CKx challenged the transaction and opted to seek appraisal rights rather than receive the cash-out price from Apollo. As is typical in appraisal cases, following discovery, the court conducted a three-day, full trial on the merits that included extensive testimony from, among others, expert witnesses retained by each of the parties, as well as post-trial briefing and post-trial arguments.

The Court’s Holding That an Arms-Length Sales Process Can Be the Best Indicator of “Fair Value”

The court began its analysis by recognizing that Delaware law provides the Court of Chancery with “significant discretion” in determining the fair value of stock in an appraisal action. Under well-established Delaware law, “fair value” is defined as the company’s value as a going concern (i.e., excluding merger-specific value) and, while the court must take into account “all relevant factors” in determining fair value, it has wide latitude to select one of the parties’ valuation models or to fashion its own.

In *CKx*, Vice Chancellor Sam Glasscock rejected the traditional analyses used in many appraisal cases. For example, the court found that the comparable companies and comparable transactions analyses were flawed because the evidence was “abundantly clear” that the comparables presented were not truly comparable to CKx and were thus unreliable. The court also found that the respective discounted cash-flow (DCF) analyses presented by the parties were inherently unreliable because they were based upon the company's unreliable revenue projections.

In the absence of comparable companies or transactions, and without reliable projections to discount in the DCF, the court held that "the merger price [w]as the best and most reliable indicator" of CKx's value. The court further recognized that "in at least one" appraisal case, the court placed 100 percent weight on the merger price.

The court concluded its analysis by specifically rejecting the plaintiffs' argument that the merger price is "irrelevant" in the context of appraisal proceedings. As part of this analysis, the court discussed the Delaware Supreme Court's decision in *Golden Telecom*, where the Delaware Supreme Court dismissed the notion that the Court of Chancery must defer to the merger price in appraisal proceedings. As the Vice Chancellor explained in *CKx*, the Delaware Supreme Court's holding in *Golden Telecom* was fully consistent with his analysis: Because the court has a statutory mandate to consider *all* relevant factors in conducting an appraisal proceeding, there should be no per se, bright-line rule that presumptively or conclusively relies upon one factor or excludes any one factor from consideration. Thus, the court concluded its analysis not far from where it began: that a trial court in an appraisal proceeding is afforded wide latitude to determine "fair value," including as appropriate the merger price in an arms-length transaction.

Conclusion: Even After *CKx* Appraisal, Litigation Is Likely to Increase in Delaware

The *CKx* decision makes clear that a court in an appraisal case can, and under certain circumstances should, look to a price obtained in an arms-length merger as a reasonable proxy for "fair value" under Delaware law. Yet this holding alone is unlikely to stop the increase in appraisal litigations for at least two reasons. First, while *CKx* makes clear that a merger price can be used to determine fair value, it does not limit or alter in any way the court's ability to take into account other factors that the court may find appropriate. Thus, as a practical matter, the "battle of experts" in appraisal cases, with the resulting risks and uncertainty, is likely to continue.

Second, nothing in *CKx* addresses the substantial above-market interest rate provided under Delaware law (nor could it, as this rate is based upon Delaware statutory law). Thus, the financial incentives for shareholders to bring appraisal cases remain in place, as a party challenging a merger can obtain a significant premium, even if the price awarded in the litigation is comparable to the merger price based solely on the interest rate awarded under Delaware law.