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Chancery Clarifies Appraisal Fundamentals

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In a recent decision in an appraisal action, the Delaware Chancery Court reaffirmed the court’s reluctance to substitute its own calculation of the “fair value” of a target company’s stock for the purchase price derived through arm's-length negotiations, provided it resulted from a thorough, effective and disinterested sales process. The Oct. 21, 2015, decision, Merion Capital LP and Merion Capital II LP v. BMC Software Inc., not only provides a comprehensive review of the fundamentals of appraisal actions but also serves as a cautionary tale for merger arbitrageurs and other stockholders looking to seek appraisal remedies.

Background

The appraisal action stemmed from the sale of BMC Software Inc. to a consortium of private equity firms, which included Bain Capital, Golden Gate Private Equity and Insight Venture Management.

In 2012, Elliot Associates, an activist investor, had acquired 5.5 percent of BMC’s stock and then advocated for a sale of the company, even initiating a proxy contest. In conjunction with a settlement with Elliot, BMC agreed to nominate two Elliot appointees to its board and explore strategic options, including a sale. The company initiated two separate sales processes and engaged with several bidders before agreeing to a sale of the company for $46.25 per share on May 6, 2013. Following a 30-day go-shop period, the sale closed on Sept. 10, 2013.

Merion Capital LP and Merion Capital II LP, after acquiring stock of BMC for the sole purpose of seeking appraisal in connection with the transaction, brought an appraisal action following consummation of the merger. After a four-day trial in March, the court held that the merger price in this case was the best indicator of the fair value of the company and elected against awarding the stockholders any additional consideration.

Takeaways

With the increasing prevalence of appraisal actions, this case provides valuable lessons to merger and acquisition participants in how to minimize potential exposure under the Delaware appraisal statute, and is instructive to merger arbitrageurs and other stockholders considering whether or not to seek appraisal rights in connection with a merger.

1. The Merger Price is a Persuasive Indicator of a Company's Fair Value When the Sales Process is Not Tainted

In an appraisal action, the court has significant leeway in determining the "fair value" of the target company as a going concern. Generally, the court will consider traditional valuation methodologies, such as a discounted cash flow analysis (DCF), a comparable transactions analysis and a comparable companies analysis, as well as the actual merger price. The court in this case confirmed that "where the sales process is thorough, effective, and free from any spectra of self-interest or disloyalty, the deal price is a relevant measure of fair value." In fact, given the uncertainty surrounding the various inputs to the DCF and the robust and disinterested nature of the sales process, the court found that the merger price was "the best indicator" of the fair value of the company.

In coming to this conclusion, the court emphasized that BMC ran two separate auctions in which it received multiple offers, all of which fell into a price range close to the final merger consideration of $46.25 per share. The company negotiated with the buying consortium and succeeded in having it raise their bid multiple times. The merger agreement also included a 30-day go-shop period, a robust go-shop marketing effort and a two-tiered termination fee of 2 percent and 3 percent, and a 6 percent reverse termination fee. Furthermore, the court noted that the sales process had already been unsuccessfully challenged as unfair in a class action breach of fiduciary duty litigation.

2. Investor Pressure to Sell a Company, Without More, Does Not Render the Sales Process Flawed

In attempting to refute the reasonableness of the sales process, the BMC stockholders argued that Elliot, the activist investor, had rushed the company into a sale when it could have received a higher price. The court disagreed, noting that even though Elliot was indeed pushing for a sale, these efforts did not compromise the sales process. In fact, the directors chose not to agree to a sale in its initial auction because they believed the company was recovering from a downturn and could elicit a higher price in the future. Therefore, Elliot's pressure, while "real," did not render the sales price to be an unreliable indicator of fair value.

In light of the court's decision in In re PLX, where Vice Chancellor J. Travis Laster noted that activist investors often have a short-term outlook that could be inconsistent with the long-term interest of the company, the decision highlights that a factual analysis is necessary and that the involvement of an activist investor in a sales process may not render its actions troublesome. Taking the opinions together, an activist investor must have an actual influence on the sales process and there must be specific, credible allegations that the activist was motivated by a short-term outlook (such as a specific need for liquidity or to monetize the specific investment) in order for its involvement to render the sales process suspect. Bare-bones allegations that an activist can still profit from a lower sales price are likely not enough.

3. A Company Will be Valued as an Independent Going Concern for Purposes of Appraisal — With Synergies Included in the Deal Price Excluded

Delaware's appraisal statute states that fair value must be determined "exclusive of any element of value arising from the accomplishment or expectation of the merger" and thus, the fair value of the company must be determined by evaluating the company as an "independent going concern." Common law has furthered this doctrine to hold that "[e]ven where such a pristine sales process was present, however, the appraisal statute requires that the Court exclude any synergies present in the deal price — that is, value arising solely from the deal."

Because the acquirer in the merger was a financial buyer, rather than strategic, few synergies, if any, were to be expected. However, the company argued that there were certain tax savings and other cost savings that would result from BMC becoming a private entity that should be deducted from the fair market value calculation. The court, however, rejected this argument, noting that the record was insufficient to prove that any portion of the savings were included in the purchase price. Thus, companies looking to defend against appraisal claims should not only demonstrate to the court that the transaction will result in synergies, but should also take care to quantify such synergies and prove to the court that such synergies were included in the final deal price.

4. A Court Will Engage in its Own Discounted Cash Flow Analysis — With Caution

Both the BMC stockholders and BMC retained experts to independently value the company and testify at trial. Each expert conducted a DCF analysis to value the company. However, they arrived at significantly different valuations resulting from the use of different inputs in their analysis. While the court in the end did not rely on the DCF calculation for determining fair value, Vice Chancellor Sam Glasscock did conduct a DCF analysis for the company based on what he considered to be the most reasonable inputs following testimony by each expert. The DCF analysis resulted in a fair value of $48 per share. However, the court noted that it was "concerned" and did not have "complete confidence" in several aspects of the analysis, and ultimately determined that the merger price was a better indicator of fair value than the DCF in this case. Nonetheless, the court's decision is evidence that in the absence of an effective and robust sale process, the court will closely analyze the valuation methodologies provided by the parties' experts and substitute its reasonable inputs in calculating such valuation, while taking into account the respective positions of the parties' experts.

5. Merger Arbitrageurs and Other Stockholders of a Target Company Must Consider the Sales Process and Synergies in Considering Whether to Exercise Appraisal Rights

While the decision may provide comfort to acquirers that a court will not second-guess a deal price derived from an arm's-length negotiation resulting from a robust marketing effort, merger arbitrageurs and stockholders should be cautioned to consider the effectiveness of the sales process prior to making a decision to "buy into" or otherwise exercise appraisal rights in connection with a merger transaction. Furthermore, stockholders should analyze the amount of synergies expected to result from the transaction and the extent to which synergies were included in the deal price, as these amounts will be deducted from the fair-value valuation of the company as a going concern. A thorough review of the proxy statement filed with the U.S. Securities and Exchange Commission in connection with the merger and other publicly available information should provide a thorough understanding of these issues prior to making a determination to exercise appraisal rights.

For a full copy of the opinion, click here.

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