CBIZ and Mayer Hoffman McCann P.C. Annual Conference

Miami, Florida
July 2012

Overview of Fair Value in an Appraisal Case
Under Delaware Law and Recent Court Decisions

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When a stockholder opposes a merger based on the claim that an insufficient price was paid for his shares, he may petition the Delaware Court of Chancery for the Court to determine the "fair value" of his stock in an appraisal proceeding. The Delaware appraisal statute establishes a method to determine the value of the shares as follows:

> (h) [T]he Court shall appraise the shares, determine their value, exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors. §262(h).[1]

Appraisal rights in Delaware are only recognized in connection with the merger or consolidation of non-publicly traded companies. The "market out" exception is set out in § 262(b)(1), which withholds appraisal rights from any "class or series of shares if that class or series is either listed on a national securities exchange, or, if not listed, held of record by more than 2,000 stockholders—that is, so widely held as to imply a substantial trading market."

Fair Value

It is important to emphasize that the Court, pursuant to §262, will determine the "fair value" of a shareholder's shares; it does not determine the fair market value. It is also helpful to

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[1] 8 *Del. C.* §262(h).

underscore that while this is a fact-based analysis to determine fair value, it is driven entirely by expert testimony. In calculating fair value, the objective is to provide the dissenting stockholder with his or her "proportionate share of fair value in the going-concern on the date of the merger, rather than value that is determined on a liquidated basis." *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996) (citing *Bell v. Kirby Lumber Corp.*, 419 A.2d 137, 142 (Del. 1980)). The valuation must exclude elements of value which arise from the accomplishment or expectation of the merger. No synergistic value is permitted in the evaluation. *Doft & Co. v. Travelocity.com, Inc.*, 2004 WL 1152338 (Del. Ch. 2004). This means valuing the corporation on an ongoing basis, as if the merger had never been conceived, and valuing the corporation as an entity first and then a stockholder's proportionate interest is determined afterwards. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

Appraisal rights arise when a dissenting stockholder alleges that he is being forced to accept an inadequate or insufficient consideration value for his stock following a merger. The Court has broad discretion when determining fair value, and should take into consideration all relevant factors.

In 1983, the Delaware Supreme Court's landmark decision in *Weinberger v. UOP, Inc.* held that a company's fair value should be based on all relevant elements, including future value based upon current business plans which is known or should be known at the time of the merger, rather than merely looking to a historical analysis of the corporation. Discounted Cash Flow (DCF) is a model of valuation which relies on the principle that firms should be valued based on expected value of their future cash flow. However, pursuant to 8 *Del. C.* §262(h), the Court may not consider the speculative elements of value arising from the "accomplishment or expectation"

of the merger. The DCF has become the dominant approach in determining fair value, however the ultimate discretion still remains with the court.[2]

Methods to Determine Fair Value

A. Discounted Cash Flow

The DCF analysis consists of: (1) cash flow projections, (2) terminal value, and (3) the discount rate. Each of these steps are addressed in expert reports and cases are often determined based on whose expert is most persuasive to the Court.

In the first step an expert projects a company's cash flow for each year into the future, typically for a five year period. *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996). The expert then uses a single value representing all subsequent cash flows to calculate a company's terminal value, which is the company's present value of all the companies future cash flow beginning after the specified period. *In re PNB Holding Co. S'holders Litig.*, C.A. No. 28-N, 2006 WL 2403999, at *31 (Del. Ch. Aug. 18, 2006). Finally, the expert derives a price per share by discounting the cash flows and terminal value by a set rate and adding the three together to derive a total present value of cash flows. *In re Radiology Assocs. Litig.*, 611 A.2d 485, 494 (Del. Ch. 1991). The total is then divided by the number of outstanding shares, and the resulting amount is the fair value per share of the company. *Id.*

It is important to note that the dissenting shareholders interest is determined only after the valuation of the entire corporation. *Id.* at 1145. Because shares are not individually appraised, Delaware courts have held that no shareholder discounts apply. *Id.*

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[2] Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital in Litigation*, 163 (2011).

Fair Value Defined

The Delaware Supreme Court has indicated that the appraisal objective is to value the corporation itself rather than individual shares, which means that no shareholder-level discounts apply.[3]

The corporation must valued as a going-concern based upon the 'operative reality' of the company at the time of the merger.[4] Because of this, the "appraisal value does not include the capitalized value of possible changes that may be made by new management after a merger."[5] "Going-concern value should be determined irrespective of the synergies involved in a merger. Moreover, "[f]air value, as used in 262(h), is more properly described as the value of the company to the shareholder as a going concern, rather than its value to a third party as an acquisition."[6]

The statute places an obligation on the Court to determine the fair value of the shares.[7] The DCF is the favored method for valuation in Delaware, however it is not the exclusive fair value method. The Delaware Court of Chancery has rejected the DCF method where it finds inadequate projections.[8] The Court can select the most appropriate representative analysis and make appropriate adjustments where needed.[9]

There are a several other fair value approaches the Court may look to.

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[3] Shannon Pratt & Alina V. Niculita, *The Lawyer's Business Valuation Handbook*, 300 (2010).

[4] Edward P. Welch, Andrew J. Turezyn, Robert S. Saunders, *Folk on the Delaware General Corporation Law*, 784 (2012 ed.).

[5] *Id.* at 785

[6] *Id.* Prior to the Delaware Supreme Court deciding *Weinberger v. UOP, Inc.*, the Delaware courts exclusively used the Delaware Block Method of valuation, which assigned a dollar value and weight to each element of value; earnings, market price, and asset value, then adding the amounts to determine the value per share.[6] Weinberger liberalized the valuation process introducing the DCF which has become the dominant approach in determining fair value.[6] The court may consider elements of future value. *Weinberger*, 457 A.2d 701, 713.

[7] Balotti, §9.45

[8] Appraisal cases often become a "battle of experts", but it is not unprecedented for the Court of Chancery to reject the reports of both experts and determine the fair value "on its own," selecting parts of each report.

[9] *Id.*

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B. Comparable Company

The Comparable Company method is an approach which the Courts have used which finds comparable publically traded and private corporations through a fact-intensive process and calculates the value through the use of earnings and other multiples. *Borruso v. Commc'ns Telesys. Int'l,* 753 A.2d 451, 457 (Del. Ch. 1999). The Comparable Company valuation is essentially valuation through analogous comparison to another company; any large differences between the companies can lead to a rejection of the comparison. *In re Radiology Assocs., Inc. Litig.,* 611 A.2d 485, 496 (Del. Ch. 1991).

C. Comparable Acquisition

The Courts also may use a Comparable Acquisition method, which derives a company's potential sale price by identifying similar transactions and calculating them as a multiple of a financial measure, such as a company's last twelve months' earnings. *See MG Bancorp. Inc. v. Le Beau,* 737 A.2d 513, 524 (Del. Ch. 1999)

D. Segmented Valuation

Segmented valuation is a method which is used in valuation of companies which have multiple subsidiaries operating independently.[10] Each subsidiary is independently valued as a separate going-concern value. *Rapid-Am Corp. v. Harris,* 603 A.2d 796, 803 (Del. 1992). If the parent company holds a controlling interest at the time of the merger, then the value of each subsidiary must accurately relate for the holding company's controlling value. *Id.* at 799.

E. Asset Value

Asset Value valuation is used particularly for valuing companies with asset-intensive industries. *Kahn v. Household Acquisition Corp.,* 591 A.2d 166, 174 (Del. 1991). It involves a

[10] Balotti and Finkelstein, *The Delaware Law of Corporations and Business Organizations*, 3ed., 9.45(B)(3).

"theoretical liquidating value to which the share would be entitled upon the company going out of business." *Tri-Cont'l Corp. v. Battye*, 74 A.2d 71, 74 (Del. 1950).

F. Earnings Value

The Earnings Value measures a company's value based upon its earnings and a capitalization rate. Company Earnings is based on a historical earning of a five year period immediately preceding the merger. *In re Creole Petroleum Corp.*, C.A. No. 4860, 1978 WL 2487, at *3-4 (Del. Ch. 1978). Then the number is used as a multiplier or capitalization rate which is measured in comparison with similar publically traded companies. *Gonzalves v. Straight Arrow Publishers, Inc.*, 793 A.2d 312, 319 (Del. Ch. 1998).

Most Recent Delaware Decision

Recently, an appraisal decision by the Delaware Court of Chancery provided useful instruction in *Gearreald v. Just Care, Inc.*, C.A. No. 5233-VCP (Del. Ch. April 30, 2012). This case involved minority shareholders who felt that the $40 million acquisition price was too low, and that $55 million was the fair value. In contrast to this, the respondent company claimed that the company was only worth $33 million, even though they acquired the company for $40 million. Each of the parties had an expert value the company. The difference between the experts for each of the parties was twofold: (1) whether cash flow projections for new planned facilities should be included in the valuations; and (2) "the appropriate small company size premium to be applied to the Company's cost of equity."[11] Each of the parties' experts relied primarily on the DCF analysis.[12] It was these differences which accounted for the discrepancy in the valuations.

[11] Francis Pileggi, *Chancery Finds "Fair Value" Less than Merger Price in Appraisal Case, Delaware Corporate and Commercial Litigation Blog* (May 7, 2012) , http://delawarelitigation.com/2012/05/articles/chancery-court-updates/chancery-finds-fair-value-less-than-merger-price-in-appraisal-case/
[12] *Id.*

While each side has the burden of proving their respective valuations through "any technique or method which are generally considered acceptable in the financial community and otherwise admissible by the Court," the DCF and the comparable transaction approach have been recognized by the Delaware court.[13] If neither side satisfies their burden, the Court has broad discretion when determining fair value, and takes into account all relevant factors, but still must determine fair value of the company as a going concern which requires the Court to "exclude any synergistic value, that is, the amount of any value that the selling company's shareholders would receive because the buyer intends to operate the subject company, not as a stand-alone going concern, but as part of a larger enterprise, from which synergistic gains can be extracted."[14]

Relevance of Fiduciary Duty Claims

An appraisal action is separate from a "breach of fiduciary duty" action, however if a "corporate fiduciaries engage in self-dealing and fix the merger price by procedures not calculated to yield a fair price, those facts will be considered in an appraisal action in assessing the credibility of the respondent corporation's valuations contentions."[15] In *Just Care*, the Court noted in footnote 26 that allegations of breach of fiduciary duty or other improper actions during the sales process are relevant to whether the merger price is credible evidence of fair value, where the merger price is relied upon as such evidence of fair value.[16] However, where the evidence of fair value is supplied through expert analysis any allegation of improper activity by the Company's fiduciaries are only relevant if they relate to an assumption or input to the valuations conducted by the expert, which would affect the credibility of the valuation.[17]

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[13] *Id.*
[14] *Id.*
[15] Edward P. Welch, Andrew J. Turezyn & Robert S. Saunders, *Folk on the Delaware General Corporation Law: Fundamentals*, 763 (2012 Edition).
[16] *Id.*
[17] *Id.*

Value as of the Date of the Merger

The Court held to the Delaware appraisal law when determining that a projected new facility in Georgia was too speculative to be included in the valuation because "the corporation must be valued as a going concern based on the "operative reality" of the Company as of "the time of the merger" and the Court is limited to factors known or knowable as of the merger date that relate to the future prospects of the Company, but should avoid including speculative costs or revenues."[18]

Capital Structure

The Court looked at the weighted average cost of capital (WACC) in order to discount the cash flow projections, and determined that the approach which was taken by the expert for the petitioner was inappropriate because the capital structure applied by the expert arose directly out of the expectation of the merger.[19] The Court of Chancery had in the past rejected the idea that the changes to a company's capital structure in relation to a merger should be included in an appraisal.[20]

Beta

The Court here, determined that neither side contested the beta calculation, and that the relevant beta was equal to 0.82.

Equity Risk Premium

The Court determined that the supply side equity risk premium and the appropriate metric to value the company was 5.73%, noting that there "has been a gravitation in recent years toward greater support for utilizing the supply side of equity risk premium." *See Global GT L.P. v.*

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[18] *Id.*
[19] *Id.*
[20] *Id.*

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golden Telecom, Inc., 993 A.2d 497 (Del. Ch. 2010). Explaining that in smaller companies, "an equity size premium" generally added to the company's cost of equity for the higher rate of return demanded by investors to compensate for the greater risk associated with small company equity."[21]

No Liquidity Discount Allowed

The Court noted that "although a liquidity discount related to the marketability of a company's shares is prohibited, that does not mean that the use of any input that is correlated with a company's illiquidity is per se invalid."[22] (emphasis in original.) In this case, the liquidity effect relates to the ability of the company to obtain capital at a certain cost and this effect is related to the intrinsic value of the company as a going concern and should be included when calculating the cost of capital.[23]

Compounded Interest

The general rule, as noted by the Court, is that an award of interest is routinely made unless the petitioner brought the action in bad faith, which was not the case here.

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[21] *Id.*
[22] *Id.*
[23] *Id.*

Conclusion

The Court, taking into account all relevant factors, found that the "fair value" of the company was $34 million, which is $6 million less than the $40 million acquisition price.[24]

Recent Articles

The Delaware appraisal law has been held the subject of much scholarly debate. Most recently for example, Professor Stephen Bainbridge, a corporate law expert often cited in Delaware court decisions, wrote about his frustration in the current status of Delaware appraisal law, starting with the adoption of the word "speculative" in the *Weinberg* decision; and in May 2012 he came to the conclusion the "best thing to do would be to toss out current law in its entirety and start over with a blank sheet of paper."[25] He noted that the Court held only "speculative elements of value that may arise from the 'accomplishment or expectation' of the merger are excluded" from the determination of fair value. *See Weinberger* 457 A.2d at 713.

Professor Bainbridge, in response to the most recent Delaware Chancery Court decision in *Gearreald v. Just Care, Inc.* raises several questions and arguments with the fair value cases in Delaware, including: "given that appraisal is now a crap shoot in which one can end up with less than the price offered in the merger, why would any sane investor invoke appraisal rights?"[26] He suggested that the real issue should be "whether the dissenting shareholders received fair premium over market. In order to answer that question, one must start with the price paid in the merger and, if appropriate, work up from there."[27]

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[24] *Id.*

[25] Stephen Bainbridge, *Elements of Value Arising From the Accomplishment or Expectation of the Merger*, ProfessorBainbridge.com (May 25, 2012, 11:05 AM), http://www.professorbainbridge.com/professorbainbridgecom/2012/05/elements-of-value-arising-from-the-accomplishment-or-expectation-of-the-merger.html.

[26] *Id.*

[27] *Id.*

Professor Bainbridge asked Francis Pileggi and others for comments on his perspective. Professor Lawrence Hamermesh offered some remarks in reply to these statements, disagreeing with a number of Professor Bainbridge's opinions. Professor Hamermesh stated; "We would respectfully disagree: for one thing, and as we point out in our most recent article, most appraisal cases arise where there is no meaningful market for the shares being appraised. We also doubt that share prices in efficient markets necessarily and systematically yield prices below 'fair value,' measured by the 'going concern value' standard."[28]

[28] Lawrence Hamermesh, *Valuation Standards in Appraisal Proceedings – a Reply to Steve Bainbridge,* The Institute of Delaware Corporate & Business Law (May 29, 2012), http://blogs.law.widener.edu/delcorp/2012/05/29/valuation-standards-in-appraisal-proceedings-a-reply-to-steve-bainbridge/.