The value of US mergers-and-acquisitions (M&A) volume was $379 billion during the first quarter of 2014, up 24% compared with the same period last year and representing the highest first-quarter volume since 2007, according to Dealogic. Coinciding with that deal growth is the increasing number of M&A disputes that have pitted shareholder activists against public companies. Most commonly, such disputes have involved preclosing disclosure issues or postclosing accounting issues or breach-of-fiduciary-duty claims. Recent cases, however, have increasingly involved litigation in which shareholders exercised appraisal rights to contest the deal prices offered in the transactions.

In several recent high-profile transactions such as those of Dell Inc., Dole Food Company, Inc., and 3M Cogent, Inc., institutional investors such as hedge funds and other large investors have announced their intention or have indeed sought to exercise their appraisal rights. Such actions—or even the mere threat of a suit in which a shareholder refuses to accept a merger price—may have significant implications for corporate boards of directors and senior management.

Dissecting Appraisal-Rights-Action Cases

At issue in an appraisal rights action is the fair value of the shares of a company at the time of the company’s proposed sale. Appraisal rights allow shareholders to object to the consideration offered in a merger or purchase transaction and in turn require corporations to pay shareholders the fair value of their stock as determined in an appraisal proceeding. Under Delaware law, for instance, shareholders must deliver a timely and written appraisal demand to the corporation in order to exercise their appraisal rights.

To determine a price that represents fair value—as well as any premium in excess of a proposed deal price—the parties may each develop an independent expert valuation to be assessed by the court. The court, which may or may not accept either expert’s analysis in full, nonetheless considers the analyses, along with the merger price, in determining the fair value of the stock at issue. Given that more than half of all US publicly traded companies are incorporated in Delaware, it is not surprising that the Delaware courts are the standard bearers for appraisal rights and that most appraisal cases have been brought in Delaware.

The increased frequency of appraisal rights actions and the presence of increasingly active hedge funds have raised the stakes for both buyers and sellers in transactions—in particular, when it comes to the approach to determining a valuation. Not only are companies potentially subject to shareholder claims,
but opportunistic investors may now seek to exploit a perceived weak price or valuation. Furthermore, certain investment firms appear to be increasingly utilizing these actions to capitalize on arbitrage opportunities. Under Delaware law, shareholders may receive statutory interest on the appraisal award at the federal discount rate plus 5% compounded quarterly from the transaction closing date until the award. The interest rate is paid regardless of the ultimate appraisal decision, thereby enabling investors to extract higher returns in such buyouts.

**Determining Fair Value**

Recent cases such as the sale of Dell and the takeover of Dole Food point out that the current operating performance and the prospective operating performance of the company in question are critical in determining a merger price and the fair value.

When conducting a valuation, it is important to examine the company’s current fundamentals as well as its future prospects based on a variety of company and industry-specific factors. Fair value determination can also depend on (1) the methodologies applied to calculate fair value and (2) the weights and assumptions assigned to each variable in the analyst’s assessment of value.

Multiple valuation methods are usually used in a determination of fair stock price and the value of the acquired company. Traditionally, the most commonly accepted valuation methodology in Delaware appraisal actions has been the discounted-cash-flow approach. That method involves discounting a company’s expected future cash flows back to their present value equivalent by using a discount rate that reflects the risk of achieving those expected cash flows. Market-based approaches to valuation, such as the precedent-transaction and guideline-company methods have most often been used to supplement and confirm the discounted-cash-flow approach. Occasionally—and typically only for specific types of asset-heavy companies—asset-based methods may have been used.

The factors considered in the determination of a company’s fair market value may include:

- Market value as determined by current and historical pricing of the company’s own publicly traded stock
- Price of the stock as paid by the purchasing company in the transaction
- Price of any fully formed competing bids to the transaction
- The company’s earnings prospects
- Asset value
- Dividend capacity and payments
- Value of intellectual property such as patents, trademarks, trade secrets, and other proprietary information

A valuation that looks only at, for example, market price and that doesn’t account for other issues that could influence the price of a company might have an adverse effect on company stakeholders—in the form of a flawed valuation. For example, the analyst performing a valuation on behalf of the company may have access to better and more-thorough information regarding the company’s prospects—including, say, detailed projections—than outside market participants do. That disparity could lead to a mispricing of the stock due simply to, say, ignorance of a significant new product or a pending geographic expansion, because the analyst—as well as potential purchasers who have done extensive due diligence—may have the inside edge on assessing the value expansion associated with those new planned endeavors.

**What Is It Worth? Is the Market Price Fair?**

Previously, the courts in Delaware have ruled that appraisal rights would be based on the value of the company as of the merger date “exclusive of any element of value arising from the accomplishment or expectation of the merger.” In fact, recent cases have shown that the merger price may not always be a measure of fair value. For example, in the Golden Telecom, Inc., and 3M Cogent decisions, Delaware courts placed no weight on the merger price and instead looked first to the valuation experts hired by the petitioners and respondents and ultimately to the court’s own analyses of the fair value of the stock in question.

An illustrative case of a dispute about the debated fairness of a buyout offer is that of Dole Food, in which shareholders of this fresh fruit and vegetable producer were offered $13.50 per share in cash, up from an initial offer of $12.00 per share plus the assumption of debt, in a management buyout by a company controlled by the company’s chairman and CEO. Prior to the transaction, the CEO and his affiliates already held roughly 40% of the company and shareholders holding 50.9% of the shares not held by the CEO voted to accept the buyout price, slightly above the 50% needed to approve the transaction.
billion transaction closed on November 1, 2013, however, several hedge funds considered the buyout group’s proposed $13.50 per share offer to be too low and exercised their appraisal rights covering approximately 25% of the outstanding shares of Dole. The large block of holdout shares makes the Dole appraisal case one of the largest such cases ever and the case is currently pending in Delaware.

**Conclusion**

As these cases demonstrate, even the mere threat of an appraisal action can cause concern for a company and its shareholders and could potentially result in litigation. The spate of cases is such that the Delaware courts are likely to begin giving greater attention to this issue. When they do, valuations will continue to play a critical role, because the courts may rely on such analyses to make determinations about whether shareholders received fair prices. And as a result, (1) financial and valuation analyses may effectively become subject to closer scrutiny in the event that litigation occurs, and therefore, (2) companies may want to enlist an expert to perform independent analyses. By developing a thoughtful, independent valuation based on sound analyses and modeling that together account for industry-specific factors and broad economic trends, a company is more likely to find its valuation accepted by the court and thus mitigate the risk of an unfavorable outcome.
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