Fair Value in Shareholder Dissent in the U.S.

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Introduction

The points I will be discussing are:

- What is fair value for dissenting shareholders in an appraisal?
- What valuation methods are used?
- How is fair value determined in Delaware?
- Are discounts and/or premiums permitted?
- Do all states use fair value for appraisals?

Appraisal for Dissenting Shareholders

What Is Fair Value in Appraisals?

- Fair value is the standard used by courts in most states to measure the value of securities that had been owned by dissenting shareholders
  - In addition, the courts usually apply the fair value standard in cases where there is a breach of fiduciary duty and the fairness of a transaction is challenged

What Is Statutory Appraisal?

A judicial appraisal is a "limited legislative remedy which is intended to provide minority shareholders who dissent from a merger asserting the inadequacy of the [consideration received] with an independent judicial determination of the fair value of their shares."

Alabama By-Products Corp. v. Neal
588 A.2d 255, 256 (Del. 1991)

The Role of the Courts

- Appraisal cases are governed by state law
- The courts interpret the law, giving meaning to the procedures and remedies
  - Since U.S law is based on English common law, valuation standards have evolved through court decisions
  - Since appraisals are equity cases, valuations are decided by judges, not juries

When Appraisal Rights Arise

- Shareholders customarily have appraisal rights when they are involuntarily cashed out in a merger or consolidation
- Some states also permit dissenters to seek appraisal in other circumstances, such as:
  - stock-for-stock mergers
  - sale of assets
  - recapitalizations
  - amendments to articles of incorporation
  - other major changes to the nature of a shareholder's investment

Common Statutory Definition of Fair Value

- A majority of the appraisal statutes include substantially the following language:

  "Fair value" is defined as the value of the shares immediately before the effective date of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable

  - Some states, including Delaware, do not include the phrase "unless exclusion would be inequitable"

The Standard of Value in Appraisal Is Fair Value

- Fair value is the predominant standard of value applied by state courts in appraisal (dissent) cases
- Fair value is now the standard for appraisal valuations in most states
  - However, differing interpretations have evolved through legislation and judicial interpretation

Preeminence of Delaware

- The primary focus of this presentation is fair value as applied in Delaware
  - A majority of U.S. public corporations are incorporated in Delaware
  - Delaware General Corporation Law is comprehensive and widely understood
  - Delaware has by far the most extensive body of case law
  - The Court of Chancery – the trial court for equity cases – is knowledgeable and widely respected

Fair Value in Delaware Is Proportionate Share of Equity Value

- Delaware defines fair value as the value that has been taken from the dissenting shareholder:

> *The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.*
>
> *Tri-Continental v. Battye*
> 74 A.2d 71, 72 (Del. 1950)

Most States Define Fair Value as Proportionate Share

- In recent years, most (but not all) jurisdictions have accepted the position that what has been taken from the shareholder is a *pro rata share* of the value of the company as a whole
- Importantly, defining fair value as a proportionate share of a company's value differentiates it from the other two standards of value:
  - fair market value
  - third-party sale value

Fair Value Differs from Fair Market Value

- Fair market value is the price at which an asset would change hands between a knowledgeable willing buyer and a knowledgeable willing seller
- Fair market value includes discounts for minority interest and/or lack of marketability, if applicable
- Fair market value therefore may be less than a minority shareholder's proportionate interest
  - For example, when fair market value is used in tax cases, substantial discounts are often applied to the value of minority shares

Fair Value Differs from Third-Party Sale Value

- Under a third-party sale standard, shareholders would receive a value greater than fair value
- Third-party sale price includes additional elements of value resulting from the transaction, such as operating control and synergistic values
  - Most appraisal statutes expressly exclude from fair value any increases in value resulting from the synergies accomplished by the transaction

Fair Value in Appraisal ≠ Fair Value in Accounting

- "Fair value" for appraisal differs materially from "fair value" as used by accountants
- For accounting purposes, "fair value" is the market value of a company's assets and liabilities
- Fair value, as used is accounting, is a <u>fair market value</u> standard

Valuation Methods

in Delaware

The Delaware Block Method

- Until 1983, the Delaware courts relied almost exclusively on "Delaware Block Method" for determining value in the context of appraisal rights
  - The Delaware Block Method was also adopted in numerous other states that tended to rely on Delaware corporate law

What Is The Delaware Block Method?

- The Delaware Block Method only looks at current and historical data

- It weights:
  - *investment value,* based on earnings and dividends
  - *market value,* based on its public trading price or on comparable companies and/or transactions
  - *asset value*, usually the net asset value based on current value of the underlying assets

> ➢ These values are determined and subjectively weighted by the valuator to compute the fair value

Weinberger v. UOP, Inc.

- The Delaware Supreme Court's seminal *Weinberger* (1983) decision ruled that:

  [F]air value [should] be determined by taking into account all relevant factors.

  [A]more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court.

  [T]o the extent [the Delaware block method] excludes other generally accepted techniques used in the financial community and the courts, it is now clearly outmoded.

Weinberger v. UOP, Inc.
457 A.2d 701, 712-14 (Del. 1983)

Valuation Methods Generally Accepted by the Courts

- The principal valuation methodologies used in by courts in appraisal are:
  - The income approach – discounted cash flow
  - The market approach – comparable companies
  - The market approach – comparable acquisitions
    - Courts commonly use the word “comparable” (or sometimes “selected”) rather than “guideline”

Other Valuation Methods

- Asset value is seldom considered in appraisals other than for financial and real estate companies
  - A going concern's liquidation value cannot be considered in appraisal
- The excess earnings method has not been employed in appraisal cases
- Rules of thumb are seldom accepted as a valuation method

The Courts Favor DCF

- DCF is usually the preferred method
  - Courts like to see other methods used as well
  - Courts prefer projections made by management in the ordinary course of business
- DCF is rejected when the projections are inadequate or unreliable:

> *Because I have little confidence in the reliability of [the projections], I conclude that a DCF analysis is not the appropriate method of valuation in this case.*
>
> Huff Fund Investment Partnership v. CKx, Inc.
> 2013 Del. Ch. LEXIS 269 (Nov. 1, 2013)

  - In the *CKx* case, the arms'-length acquisition price was deemed to be fair value – there were no comparables

Normalizing Earnings

- Income should be normalized to exclude nonrecurring items from valuation calculations
  - Normalizing adjustments include not only items classed as "extraordinary" by auditors, but also other nonrecurrent items in the income account
- The Delaware Court of Chancery faulted an expert for not normalizing income data:

> *The earnings figures used to derive the earnings base should be adjusted to eliminate non-recurring gains and losses.*

Reis v. Hazelett Strip-Casting Corp.
28 A. 3d 442, 470 (Del. Ch. 2011)

Valuation Date in Appraisal Cases

- Most states define the valuation date as the day of, or the day before, the effectuation of the corporate action from which the shareholder dissents
  - Some states define the valuation date as the day of or the day before the shareholder vote
- Information that is known or knowable as of the valuation date is to be considered
  - In a small number of cases, events after the valuation date have been used to check the validity of a valuation

The Four Seminal Delaware Supreme Court Decisions

1. *Tri-Continental* described fair value as that which has been taken from the shareholder and stated that fair value should be determined based on facts known or knowable at the valuation date

2. *Sterling v. Mayflower* stated that the proper test of fairness was:

> *whether ... [a] minority stockholder will receive the substantial equivalent in value of the shares he held.*
>
> *Sterling v. Mayflower Hotel Corp*.
> 93 A.2d 107, 110 (Del. 1952)

The Four Seminal Delaware Supreme Court Decisions (p.2)

3. *Weinberger* permitted the use of valuation techniques customarily accepted in the financial community and endorsed forward-looking valuation approaches

4. *Cavalier* confirmed that discounts for lack of marketability or minority interest should not be applied in calculating fair value

Cavalier Oil Corp. v. Harnett
564 A.2d 1137, 1145 (Del. 1989)

Components of Fair Value

in Delaware

Going-Concern Value

- Delaware courts hold that the measure of fair value is going-concern value
- In Delaware, going-concern value is based on:
  - earnings from existing assets, plus
  - the value of anticipated reinvestment opportunities

Value of Reinvestment Opportunities Is Included

[G]oing concern value must include not only the discounted free cash flow to be generated by the corporation's [existing] assets, but also the discounted free cash flow to be generated by the reinvestment opportunities anticipated by the corporation.

Lawrence A. Hamermesh and Michael L. Wachter,
Rationalizing Appraisal Standards in Compulsory Buyouts
50 B.C. L. Rev. 1021, 1022 (2009)

“Operative Reality”

- Going-concern value is based on how the company is being managed prior to merger
- A company being appraised is valued “as is” under its current management, not as it might be run by a different party
- This concept is known as “operative reality”

"Warts and Diamonds"

The company, with all of its warts and diamonds, is valued in terms of the discounted free cash flow generated by the company's assets and reinvestment opportunities. In measuring the value of the warts and diamonds, the warts are valued as warts and the diamonds as diamonds.

Hamermesh and Wachter
The Fair Value of Cornfields in Delaware Appraisal Law
31 J. Corp. Law 119, 1423-4 (2005) ("*Cornfields*")

Discretionary Spending Is Operative Reality

- A recent decision rejected an adjustment to earnings premised on the assertion that the company was overspending on research

[M]inority shareholders have no legal right to demand that the controlling shareholder achieve — and that they be paid — the value that might be obtained in a hypothetical third-party sale.

Hamermesh & Wachter, *Cornfields* at 154

Because a reduction in R&D expense only could be made by a new controller ..., adjustments to reflect those changes would generate a third-party sale value, not going concern value.

Reis v. Hazelett Strip-Casting Corp.
28 A. 3d 442, 471 (Del. Ch. 2011) [citing *Cornfields*]

Fair Value Includes Changes Contemplated by Management

[When] a controlling shareholder is acquiring the minority shares, the courts have interpreted "fair value" to include elements of value that arise from assets or plans that were not in place operationally at the time of the merger.

Hamermesh & Wachter, *Cornfields* at 159

- Principal examples
  - improvements not dependent on the transaction
  - usurped corporate opportunities
  - improper benefits to control shareholders

Future Plans Are Considered

- When a company has plans to open new facilities similar to existing profitable ones, the expansion plans must be considered in determining fair value.

> *[I]f the concept of opening [additional MRI centers] was part of the business plans of Delaware Radiology as of the merger date, then the value of those expansion plans must be taken into account in valuing Delaware Radiology as a going concern.*
>
> *Delaware Open MRI Radiology Associates v. Kessler* 898 A.2d 290, 313 (Del. Ch. 2006)

> *The expansion plans ... were clearly part of the operative reality of Delaware Radiology as of the merger date and ... must be valued in the appraisal.*
>
> *Id.* at 316

... Unless They Are Too Speculative

- On the other hand, the Court rejected part of a company's projection because it was conditional:

> *I find that the Georgia Case was too speculative to be included ... Just Care could not undertake the expansion unilaterally without a decision by Georgia to move forward. The fact that the Company ... had taken actions in furtherance of that goal is insufficient to make the Georgia Case part of Just Care's operative reality.*
>
> Gearreald v. Just Care, Inc.
> 2012 Del. Ch. LEXIS 91 at *24

- The court "probability-weighted" the expansion of an existing prison facility because of risk that the state might not decide to use the added capacity

Synergies Obtainable by Current Controller Are Included

- If the controller could have achieved benefits without the transaction, fair value includes the present value of those benefits

> *The cost savings attributed to the consolidation were properly includable ... because they were contemplated well before the going private merger and could have been achieved without it. [The controller] had the power to accomplish those savings without a business combination, such as by intercompany contractual arrangements.*

In re Emerging Communications, Inc. Shareholders Litig.
2004 Del. Ch. LEXIS 70 (May 3, 2004) at *48-49

Improvements Not Dependent on Transaction Are Included

- Future events that are not speculative are part of going-concern value
- The Court ruled that it was not speculative to consider the prospective conversion of a cellular network to higher future industry standards

> [*The expert] should have incorporated the effects of this expected capital improvement in his projections.*

In re United States Cellular Operating Co.
2005 Del. Ch. LEXIS 1 (Jan, 6, 2005) at *56.

Plans of Third-Party Acquirors Are Normally Not Considered

- Delaware normally excludes actions planned by a third-party acquirer before it acquires control

- However, there is an important exception to this rule:

  - If control changes hands after control is acquired by a third party *but before a second-stage squeeze-out merger*, the new controller's actions may be taken into account

The Exception to the Rule

- The Supreme Court ruled in 1996 that dissenters were entitled to benefit from actions taken by a third party that took control in a two-stage transaction*
- The minority was squeezed out at the same price previously paid for control in a friendly tender offer
- The Court ruled that the acquiror's actions toward divesting certain unprofitable operations was operative reality
  - Therefore, the valuation should be based on projections that included the acquiror's plan

* *Cede & Co. v. Technicolor*
684 A.2d 289, 298-9 (Del. 1996)

A Usurped Corporate Opportunity: *ONTI v. Integra Bank*

- In the *ONTI* case, the controller merged the company with a public company a few days after a squeeze-out merger
- Plaintiffs asked for a pro rata portion of the added market value received by defendant
- The court ruled for plaintiffs, stating:

> *I think it is clear that it is "not the product of speculation" that the [subsequent] Transaction was effectively in place at the time of the Cash-Out Mergers.*
>
> *ONTI, Inc. v. Integra Bank*
> *751 A.2d 904, 917-18 (Del. Ch. 1999)*

Improper Benefits to Controller: *Dobler v. Montgomery Cellular*

- In the *Montgomery Cellular* case, the Court adjusted for understated earnings due to:

> *excessive management fees, an unexplained inter-company loan, an unexplained corporate allocation, and an overcharge by a vendor [as well as] the sale and leaseback of Montgomery's cell sites and towers [which] was clearly an inappropriate exaction by [the control party] due to its corporate control.*
>
> *Dobler v. Montgomery Cellular Holding Co.* 2004 Del. Ch. LEXIS 139 (Oct. 4, 2004) at *69

Excess Compensation

- Excess compensation may be deemed to be an improper benefit to the control shareholder

- In one case, the Supreme Court rejected adjustments for the controller's excess compensation

> ***[I]n the absence of a derivative claim attacking excessive compensation,*** *the underlying issue of whether such costs may be adjusted may not be considered in an appraisal proceeding* [emphasis added].

Gonsalves v. Straight Arrow Publishers
701 A.2d 357, 363 (Del. 1997)

Taxes Are Considered Only If They Are “Operative Reality”

- Potential taxes on a sale of assets are taken into account when a company intends to sell the assets
- The Supreme Court applied the operative reality concept to exclude deferred taxes on investment assets that management had no intent to sell:

> *[S]ale of its appreciated investment assets was not part of Okeechobee’s operative reality on the date of the merger. Therefore, the Court of Chancery should have excluded any deduction for the speculative future tax liabilities.*
>
> *Paskill Corp. v. Alcoma Corp.*
> 747 A.2d 549, 552 (Del. 2000)

Discounts and Premiums

Most States Reject Discounts at the Shareholder Level

- In most states, fair value in an appraisal excludes any discount for lack of marketability or minority interest at the shareholder level
- The discounts are rejected because the purpose of statutory appraisal is to compensate minority shareholders for what was taken from them
  - Another argument against a marketability discount in appraisals is that the judicial proceeding itself creates a market for the shares

Discounts Would Penalize Minority Shareholders

- Advocates for discounts assert that excluding marketability and minority discounts in appraisals unfairly enriches minority shareholders

- However, if minority shareholders were to lose a pro rata portion of equity value when forced out, majority shareholders would unfairly benefit

  - Indeed, controllers would be encouraged to engage in freeze-outs if they could receive a premium for mistreating the minority

Delaware Does Not Permit Discounts in Appraisals

- Delaware explicitly took the position in *Cavalier* that discounts penalize dissenting shareholders
  - Many states that had permitted discounts have reversed their positions
  - However, a few states, including New York and Pennsylvania, permit discounts for lack of marketability

Discounts Are Customary in Determining Fair Market Value

- In contrast, when determining fair <u>market</u> value, discounts for lack of control and for lack of marketability are customary

The "Implicit Minority Discount"

- Several Delaware decisions have adjusted guideline company valuations upward to compensate for an "implicit minority discount"* (IMD)
    - No case has adjusted terminal value based on guideline company multiples for IMD
- The IMD is based on the questionable premise that all publicly traded companies trade at a discount to fair value

* Also called "implied" or "inherent " or "embedded" minority discount

The Concept Underlying IMD

- What is the premise of IMD?

  1. Fair value, by definition, should exclude discounts and premiums
  2. Shares of public companies always trade at a discount to fair value
  3. *Ergo*, any fair value determination based on comparable companies requires an adjustment to eliminate this inherent discount

- The flaw: shares of public companies often do not trade at a discount to fair value

Criticism of IMD

- Numerous corporate law professors and valuation experts have criticized IMD
- A 2007 Delaware decision recognized that there is a debate about IMD
  - The decision cited professors who had questioned the concept and had argued that it was not generally accepted in the financial community

IMD Should Not Be Based on Premiums in Other Transactions

- The Courts have calculated IMD based on average premiums paid in other acquisitions
- However, acquisition premiums are upwardly biased
  - The data consists primarily of companies for which acquirers are willing to pay premiums
- IMD (if any) should be based on an analysis of acquisition multiples compared to market multiples

Discounts at the Corporate Level

- Corporate-level discounts are those that apply to the value of a company as a whole

- Corporate-level discounts have been applied in a limited number of situations

  - In *Tri-Continental*, the Court applied a discount to the asset value of a closed-end investment company at the corporate level before valuing the minority shares

  - A 1992 Delaware appraisal of a private company accepted a 20% key-man discount, concluding that the company would not survive if the founder left*

* *Hodas v. Spectrum Technology*
1992 Del. Ch. LEXIS 252, at *14

Control Premiums Are Rarely Applied at the Corporate Level

- Most states reject control premiums in appraisals
    - Although a number of decisions in Delaware and elsewhere discuss applying control premiums, most of these decisions are merely making an adjustment to eliminate a perceived IMD
- A couple of states have accepted corporate level control premiums in appraisals, and then only in certain cases

A Few States Accept Control Premiums at the Corporate Level

- The Vermont Supreme Court approved a control premium:

  > *[T]o find fair value, the trial court must determine the best price a single buyer could reasonably be expected to pay* ***for the corporation as an entirety*** *and prorate this value equally among all shares of its common stock* [emphasis added].
  >
  > *Trapp Family Lodge, Inc*., 725 A.2d 927, 931 (Vt. 1999)

- The New Jersey Superior Court supported a limited control premium at the corporate level:

  > *[I]n a valuation proceeding, a control premium should be considered in order to reflect market realities, provided it is not used as a vehicle for the impermissible purpose of including the value of anticipated future effects of the merger.*
  >
  > *Casey v. Brennan*, 780 A.2d 553, 571 (N.J. Super. 2001)

Delaware Applied a Control Premium to the Value of Subsidiaries

- Delaware rejects control premiums at the parent level
- However, the Delaware Supreme Court ruled in 1992 that control premiums should be applied to the valuations of a holding company's subsidiaries
    - It concluded that the Court of Chancery had treated the parent "as a minority shareholder in its wholly-owned subsidiaries" and that guideline companies' market prices "do not reflect a control premium"*
- Delaware applied control premiums twice more to valuations of subsidiaries in the 1990s

* *Harris v. Rapid-American Corp.* 603 A.2d 796, 804 (Del. 1992)

Illogic of Adding Control Premium to Value of Subsidiaries

- The Court of Chancery has expressed concern that valuing a subsidiary differently elevates form over substance:

  > *It seems a fine point to conclude that the value of the entity as a going concern includes the potential to sell controlled subsidiaries for a premium but not the potential to sell the entity itself.*
  >
  > *Agranoff v. Miller*
  > 791 A.2d 880, 898 n. 45 (Del. Ch. 2001)

  - Since 1998 no Delaware decision has applied a control premium to a subsidiary, even when subsidiaries were separately valued

Three States Do Not Use the “Fair Value” Standard

"Fair Cash Value" in Louisiana

- The Louisiana statute says:

  "[F]air cash value" means a value not less than the highest price paid per share by the acquiring person in the control share acquisition

- Thus, a dissenter may be awarded a value higher than the transaction price, but not less than the transaction price

  - Louisiana is the only state whose law is based on the Napoleonic Code, not English common law

Ohio's Unfavorable Standard of Value in Appraisals

- Ohio's appraisal standard is "fair cash value" – in practice, fair market value
  - This differs materially from "fair cash value" in Louisiana
- If there is an active market, Ohio appraisal value can be no more than market price
- Moreover, the market price must be adjusted to eliminate any market impact in reaction to the merger proposal

Ohio Shareholders Are Harmed

- The Ohio Court of Appeals conceded that dissenters would likely receive less than shareholders who accepted the merger terms

  [Appraisal] is likely to produce a fair cash value to be paid dissenting shareholders different from that received by assenting shareholders unless the fundamental corporate change is found to have had absolutely no effect on the market price of the stock, an unlikely possibility.

  Armstrong v. Marathon Oil Co.,
  583 N.E.2d 462, 467 (Ohio App. 1990)

- Private company shareholders are harmed because Ohio allows discounts that would not be permitted in calculating fair value

  The concept of "fair value" is far different from the "fair cash value" concept.

  English v. Artromick Intl., Inc.,
  2000 Ohio App. LEXIS 3580 (Aug. 10, 2000) at *14

California Is Also Unfavorable

- The California standard is "fair market value"
  - It is determined as of the day <u>before the first announcement</u> of the proposed action
  - It excludes any appreciation or depreciation resulting from the proposed action
- Given this definition, dissent is not an attractive option for California shareholders
  - It is not surprising that there are no reported California dissent cases

I would like to thank
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for inviting me again
to this professional gathering

Your questions are welcome.