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Weight Of Merger Price, Process In Del. Appraisal Actions

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On April 30, 2015, the Delaware Court of Chancery issued a post-trial opinion in which it rejected an attempt by dissenting shareholders to extract extra consideration for their shares above the merger price through appraisal rights. See Merlin Partners LP v. AutoInfo Inc., Slip. Op. Apr. 30, 2015, Case No. 8509-VCN (Del. Ch. Apr. 30, 2015). Vice Chancellor John Noble's decision in AutoInfo offers important lessons for companies, directors and their counsel when considering strategic transactions and/or defending against claims that they agreed to sell the company at an inadequate price. AutoInfo reaffirms that a negotiated merger price can be the most reliable indicator of value when it is the product of a fair and adequate process.

Background

AutoInfo Inc. was a small transportation services company that provided nationwide brokerage and contract carrier services through a network of independent agents. In August 2011, the board began shopping the company to potential purchasers and retained Stephens Inc., an investment bank with expertise in the transportation industry, to serve as its financial adviser. At Stephens' instruction, AutoInfo's management prepared an "aggressively optimistic" five-year financial forecast. Preparing multi-year financial projections was a first for AutoInfo management, which "questioned how to go about a process it had never before attempted." The company's chief operating officer described the process as "a bit of a chuckle and a joke."

By October 2012, Comvest Partners emerged as the highest bidder at $1.26 per share. During its due diligence, however, Comvest uncovered accounting irregularities, poor financial record-keeping, and concerns over AutoInfo's ability to recruit new agents that would grow the company's business. As a result, Comvest lowered its offer to 96 cents per share. After negotiations, the parties settled on a price of $1.05 per share.

Two of the company's shareholders petitioned for an appraisal of their shares pursuant to 8 Del. C. § 262. The petitioners' expert valued the company at $2.60 per share based on a discounted cash flow analysis using management-prepared projections and two "comparable companies" analyses. The company's expert valued AutoInfo at $.0967 per share based on the $1.05 merger price and after deductions for certain merger-related savings. The court ultimately agreed with AutoInfo's expert that the $1.05 merger price was the best indicator of the company's value at the time of the deal.

Takeaways and Analyses

The court rejected the valuation arrived at by petitioners' expert for several reasons: (1) his discounted cash flow analysis was entitled to no weight because it relied on the highly optimistic management-prepared projections, which management acknowledged it had never done before and had no confidence in preparing; (2) the companies he used as purported "comparables" were "all significantly larger than AutoInfo," ranging "from more than twice, to more than 300 times, AutoInfo's size," notwithstanding that the increased risk associated with smaller companies contributed to AutoInfo trading well below its peers; and (3) he did not distinguish between companies using AutoInfo's agent-based business model and those using their own employees even though the market perceived the agent-based model as inferior.

A valuation analysis is only as reliable as the inputs used. Financial projections prepared solely for the purpose of pursuing strategic transactions are unlikely to be accorded the same weight as projections that are routinely prepared in the ordinary course of business. In addition, companies that operate in the same industry may nonetheless be unreliable indicators of value if the market perceives them differently based on differences in business model, size or other relevant considerations.

The court found that the $2.60 per share valuation offered by petitioners' expert did not accord with reality. AutoInfo's stock had not reached as high as $1 in the prior two years, and the $1.05 merger price, which was the highest offer made by any bidder in the sales process, exceeded the highest price that AutoInfo's stock reached in the past five years. The $2.60 value also failed to account for the serious issues with AutoInfo's accounting and internal controls.

In determining fair value in appraisal proceedings, courts may test the reliability of the dissenting shareholder's claimed value by measuring it against real-world factors, such as the company's historical trading price, the bidding history for the company in the sales process, any deficiencies in the company's controls and processes, and the competitive realities of the industry in which the company operates. Valuations that are meaningfully out of sync with these types of reality checks will be accorded little weight.

The court seemed to have no issue with Stephens' decision, in issuing its fairness opinion, to use a multiple range below the median and mean of the range for its selected comparable companies. While Delaware courts are typically skeptical of an expert who "chooses his own multiple in a directional variation from the median and mean that serves his client's cause," the court recognized that AutoInfo's smaller size and riskier agent-based business model supported Stephens' decision to use a lower multiple than that applied to the company's larger store-based peers, and, importantly, "Stephens's choice of a multiple was not a post hoc determination made during litigation, but a reasoned selection based on industry experience."

Delaware courts have issued numerous decisions over the past few years critical of what they perceived as result-oriented financial analyses. See In re: El Paso Pipeline Partners LP Deriv. Litig., No. 7141-VCL (Del. Ch. Apr. 20, 2015); In re Rural/Metro Corp. S'holders Litig., No. 6350-VCL (Del. Ch. Oct. 10, 2014); Chen v. Howard-Anderson, No. 5878-VCL (Del Ch. April 8, 2014); In re Orchard Enter. Inc. S'holder Litig., No. 7840-VCL (Del. Ch. Feb. 28, 2014). Here, although not formally opining on Stephens' fairness opinion, the court at least suggested a situation where an adviser's discretionary decisions that skew in favor of *its client's desired outcome nevertheless might be able to withstand scrutiny, namely, where the decision is supported by objective, verifiable justifications and the analysis is made outside of the litigation context*.

The court found that the $1.05 merger price was a reliable indicator of fair value because: (1) it was the product of an adequate process, as the board was considering a sale even before the company's larger institutional shareholders began pressuring the board for improved performance, the company was "shopped quite a bit," and negotiations with Comvest were conducted at arm's length by an independent special committee; and (2) the "base case" discounted cash flow analysis performed by Stephens for its internal use in evaluating the deal, which was based on projections prepared by Stephens rather than the unreliable management-prepared projections, generally supported the merger price.

"The dependability of a transaction price is only as strong as the process by which it was negotiated." Where a dissenting shareholder has not offered any reliable analysis of comparable companies or cash flow projections, "the merger price [may be] the most reliable indicator of value," and the "Court may assign 100% weight to the negotiated price." Directors should take care to ensure that a sales process is negotiated at arm's length, free of any self-interest or disloyalty. A fair process will go a long way toward substantiating the reliability of the merger price as the indicator of fair value.

In any appraisal action, "the Court must value Petitioners' shares 'exclusive of any element of value arising from the accomplishment or expectation of the merger.'" To that end, AutoInfo's expert adjusted his fair value opinion downward to account for "(i) public company costs that Comvest could eliminate once AutoInfo ceased trading as a public company, and (ii) executive compensation costs that Comvest planned to eliminate." The court declined to adjust the merger price downward to reflect this theorized cost savings because those figures were based on an internal Comvest analysis that was not subject to outside objective assessment. The court observed in dicta that potential cost savings that an acquirer discovers in due diligence should not be subtracted from a merger price where the seller could have achieved those cost savings on its own as a stand-alone company.

Just as dissenting shareholders are expected to come to the table with reliable fair-value estimates in appraisal proceedings, any attempt by the company and its directors to obtain a downward adjustment to the appraisal value based on merger-specific value must be based on reliable analyses. If the seller could have achieved the cost savings on its own, it does not matter that the potential for those savings were discovered by the acquirer in connection with the merger negotiations — no downward adjustment is warranted if cost savings could be achieved by the seller on its own.

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