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Gibson Dunn M&A Report:

***PetSmart* and *SWS Group* Are Welcome News for Buyers Facing Appraisal Actions in Delaware—Case Summary Addendum**

I. *In re Appraisal of PetSmart, Inc.*[i]

Under Delaware law, "the Court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger."[ii] As the statute places the duty to determine fair value on the court, the burden of proof is not specifically allocated to either of the litigating parties, and so "the burden to establish fair value by a preponderance of evidence rests on both" the petitioners and the company.[iii] This construct presents what Vice Chancellor Slights described in *In re Appraisal of PetSmart, Inc.* as the "unique challenges to the judicial factfinder" presented by appraisal cases, because the court must reach its own determination of fair value by considering "all relevant factors," which itself entails an analysis of the particular facts and circumstances in each appraisal action.[iv] Recent Delaware Court of Chancery cases have explained that the deal price "may be the best and most reliable indicator of fair value" where the evidence reveals "a market value 'forged in the crucible of objective market reality,' meaning that it was 'the product of not only a fair sales process, but also of a well-functioning market.'"[v]

Applying this standard, the Delaware Court of Chancery determined in *PetSmart* that the deal price constituted the best evidence of fair value. The *PetSmart* litigation arose from the March 2015 going-private transaction of PetSmart, Inc. ("PetSmart"), in which private-equity firm BC Partners, Inc. ("BCP") paid $83.00 per share, or $8.7 billion in total cash consideration. The petitioners argued that the fair value was $128.78 per share, or $13.2 billion in total cash consideration, on the basis of a DCF analysis conducted using management projections contained in PetSmart's proxy statement.

The Court determined that the deal price constituted the best evidence of fair value. Several factors pertaining to the sales process informed the Court's analysis:

- To address declining stock prices and concerns articulated by certain activist stockholders regarding PetSmart's declining performance, the PetSmart board established an *ad hoc* committee to consider multiple options for the company, including selling to a third party, remaining a standalone entity while pursuing new revenue-generating and cost-saving initiatives or pursuing a leveraged recapitalization. In addition, the PetSmart board was prepared to walk away from the process if the outcome was not satisfactory and to engage in a proxy fight if activist stockholders objected to the PetSmart board's decision.

- When the PetSmart board determined to pursue an auction, it conducted a robust process that included contacting twenty-seven financial and strategic bidders, permitting fifteen bidders to conduct due diligence and making in-person management presentations to thirteen bidders. Although

the PetSmart board decided not to invite the company's largest competitor into the process on account of antitrust and commercial risk, the Court determined that this decision was reasonable.

- BCP's price was a "best and final" offer that was increased over competing offers after BCP was encouraged to do so by PetSmart's financial advisor, and the price offered represented a 39% premium over PetSmart's unaffected stock price. Although PetSmart's proxy statement contained management projections on which a DCF analysis could be conducted that would yield a higher share price, no topping bids emerged and PetSmart's stockholders voted overwhelmingly to approve BCP's offer.

By contrast, the Court found that the petitioners had not carried their burden of proving that the fair value of their shares was $127.78 per share. The Court's principal rationale for rejecting the petitioners' proposed valuation was that the management projections upon which the DCF analysis was conducted were not reliable indicators of the company's expected cash flows. The Court explained that projections have been found to be unreliable where "the company's use of such projections was unprecedented, where the projections were created in anticipation of litigation, where the projections were created for the purpose of obtaining benefits outside the company's ordinary course business, where the projections were inconsistent with a corporation's recent performance, or where the company had a poor history of meetings its projections."[vi] Here, the Court found the management projections presented in PetSmart's proxy statement to be unreliable because (i) PetSmart management did not have a history of creating (or any experience with) long-term projections, (ii) PetSmart management's short-term projections were frequently inaccurate, (iii) the management projections presented in the proxy statement were not created in the ordinary course of business but rather for use in the auction process and (iv) PetSmart management created the projections while under pressure to be aggressive, on the expectation that potential bidders would discount such projections.

II. *In re Appraisal of SWS Group, Inc.*[vii]

In *In re Appraisal of SWS Group, Inc.*, the Delaware Court of Chancery did not defer to the deal price, but instead conducted a DCF analysis and concluded that the fair value of the petitioners' shares was below the deal price. The *SWS Group* appraisal action arose from the January 2015 merger of SWS Group Inc. ("SWS") into Hilltop Holdings, Inc. ("Hilltop"), itself a substantial creditor of SWS. Stockholders of SWS received a mix of cash and stock worth $6.92 per share. Both the petitioners and the company took the position that the deal price did not constitute fair value, albeit for different reasons—the petitioners argued that the sales process was fundamentally flawed while the company argued that the deal price was inflated due to large synergies that, under the Delaware appraisal statute, should not be included in determining fair value. The petitioners and the company proposed DCF valuations of $9.61 per share and $5.17 per share, respectively, and the Court determined (using its own DCF analysis) that the fair value fell in the middle at $6.38 per share—below the deal price of $6.92 per share.

In conducting its DCF analysis, the Court started with the three-year projections prepared by SWS management, which was the initial input used by the petitioners and the company in their respective

analyses as well. The Court rejected the petitioners' proposal to extend the management projections by two years, declaring that such "*post hoc* extensions to management's projections" were improper.[viii]

Next, the Court considered whether the exercise by Hilltop and other SWS creditors of certain warrants in exchange for the cancellation of a material amount of debt after the announcement of the merger transaction should be considered in the company's valuation—that is, whether the exercised warrants constituted excess regulatory capital distributable to stockholders of the company. Although Delaware law requires the court to exclude speculative elements of value that arise from the "accomplishment or expectation" of a merger, the Court noted that this exception is narrow and "does not encompass known elements of value, including those which exist on the date of the merger."[ix] Here, while the facts adduced at trial suggested that Hilltop and the other creditors exercised their warrants to vote in favor of the merger, the Court found that the creditors made the economic decision to exercise in their own self-interest and so the proceeds of the exercise were part of the company's "operative reality" as of the merger date. Further, the Court found that the exercise of the warrants and concomitant cancellation of debt only changed the capitalization of the company rather than increasing the cash on its balance sheet. On this basis, the Court discounted the petitioners' contentions that the warrant exercise provided for excess regulatory capital that could be distributed to stockholders and that the company could make such distributions without affecting its ability to generate cash flow consistent with its projections.

The Court agreed with the terminal value growth rate on which the petitioners' and the company's experts ultimately agreed at trial, but performed its own analysis of the proper discount rate. To calculate the cost of equity, the Court applied the capital asset pricing model. The parties and the Court agreed on the risk-free rate of return, but differed on the other inputs. With respect to the equity risk premium, the Court selected the supply-side equity risk premium proposed by the petitioners, rather than the historical equity risk premium proposed by the company. With respect to *beta*, the Court adopted the position of the petitioners, who proposed a *beta* that was lower than the *beta* proposed by the company—the Court found the *beta* selected by the company to be unreliable because it covered a particularly volatile period of merger speculation that affected the company's stock price. With respect to the size premium, the Court adopted the midpoint of the positions proposed by the petitioners and the company, who debated whether the size premium should reflect a public company approach focusing on market capitalization or a private company approach incorporating the significant number of outstanding warrants.

On this basis, the Court calculated the fair value of SWS shares to be $6.38 per share, which was less than the $6.92 per share price paid by Hilltop. The Court noted that "the fact that [its] DCF analysis resulted in a value below the merger price is not surprising: the record suggests that this was a synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."[x]

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[i] *In re Appraisal of PetSmart, Inc.*, Consol. C.A. No. 10782-VCS, 2017 WL 2303599 (Del. Ch. May 26, 2017).
[ii] 8 Del. C. § 262(h).
[iii] *Laidler v. Hesco Bastion Envtl., Inc.*, C.A. No. 7561-VCG, 2014 WL 1877536, at *6 (Del. Ch. May 12, 2014).
[iv] 8 Del. C. § 262(h).

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[v] *PetSmart*, 2017 WL 2303599, at *2 (quoting *Van de Walle v. Unimation, Inc.*, Civ. A. No. 7046, 1991 WL 29303, at *21 (Del. Ch. Mar. 7, 1991) and *In re Appraisal of DFC Global Corp.*, Consol. C.A. No. 10107-CB, 2016 WL 3753123, at *21 (Del. Ch. July 8, 2016)).
[vi] *Id.*, 2017 WL 2303599, at *32 (quoting *Huff Fund Inv. P'Ship v. CKx, Inc.*, C.A. No. 6844-VCG, 2013 WL 5878807, at *9 (Del. Ch. Nov. 1 2013) and *In re Nine Sys. Corp. S'holders Litig.*, Consol. C.A. No. 3940-VCN, 2014 WL 4383127, at *41 (Del. Ch. Sept. 4, 2014) (internal quotation marks omitted)).
[vii] *In re Appraisal of SWS Grp., Inc.*, C.A. No. 10554-VCG, 2017 WL 2334852 (Del. Ch. May 30, 2017).
[viii] *See, e.g.*, *Merion Capital, L.P. v. 3M Cogent, Inc.*, C.A. No. 6247-VCP, 2013 WL 3793896, at *11-12 (Del. Ch. July 8, 2013) (describing "Delaware's long-standing preference for management projections" and accepting such projection "as a reliable starting point for the DCF analysis in this case" rather than expert-created projections).
[ix] *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983); *Allenson v. Midway Airlines Corp.*, 789 A.2d 572, 581 (Del. Ch. 2001).
[x] *SWS Grp.*, 2017 WL 2334852, at *18.

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