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Hurdles in Appraisal Actions for Companies Sold in 'Robust' Auction

By Brian M. Lutz and Jefferson E. Bell

In a recent ruling, the Delaware Court of Chancery underscored the hurdles that petitioners face in gaining above-market compensation for their shares in an appraisal action when the underlying company was public and sold in a "robust" auction process. This decision comes just weeks after another appraisal decision in the same case that upheld the standing of stockholders who engage in "appraisal arbitrage" to bring appraisal actions in their own name. While the impact of these new decisions on the growing appraisal arbitrage industry is yet to be determined, the most recent ruling's reliance on the actual sales price as a principal indicator of fair value may dampen the resolve of arbitrageurs to bring appraisal actions.

On Jan. 30, Vice Chancellor Sam Glasscock III issued a memorandum opinion in *In re Appraisal of Ancestry.com*, C.A. No. 8173-VCG. The petitioners were three hedge fund arbitrageurs, Merion Capital L.P., Merlin Partners L.P. and the Ancora Merger Arbitrage Fund L.P. (together referred to as "Merlin"), which together owned about 1.4 million shares of common stock in Ancestry.com, a genealogy service. Ancestry.com was acquired for $32 per share in cash by a private equity buyer. The record date for share ownership was Nov. 30, 2012, and the transaction closed Dec. 28, 2012. Merion and Merlin bought shares in Ancestry.com apparently for the purpose of seeking a valuation in an appraisal action above $32 per share. Merion, for example, first began purchasing shares Dec. 4, after the record date, and made its intent to exercise its appraisal rights known Dec. 12.

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In an appraisal action, the court is required by statute to determine the "fair value" of shares in Ancestry.com on the basis of "all relevant factors." Glasscock noted the problems a judge faces in making this determination. First, a judge's training may not be particularly well suited to the complex and subjective financial analyses that can be required in determining fair value through a discounted cash flow or DCF analysis. Second, a judge is often faced with two competing experts, each of whom, the vice chancellor recognized, has an incentive to calculate fair value of the company's shares in a way beneficial to its own client. Finally, the statute provides neither a default fair value nor an uneven burden of proof, either of which would make the analysis simpler. As Glasscock noted, "Both parties bear the burden of establishing fair value by a preponderance of the evidence, which effectively means that neither party has the burden, and the burden instead falls on this court."

Glasscock was faced with all three of these issues in making his determination of the fair value of Ancestry.com. Principal among them were two competing experts who had arrived at "wildly" different per-share valuations of the company using standard DCF calculations: $30.63, on one hand, and at least $42.81, but potentially as high as $47, on the other. The experts disagreed on a wide range of technical inputs to the calculations, including which management projections to use as the most

reliable indicator of the company's finances; whether to normalize the company's earnings margin; the "plowback ratio," which indicates the reinvestment rate of profit into capital expenditures; and the appropriate discount rate to use, which alone accounted for a more than $4-per-share difference in the two valuations.

Faced with the task of determining which, if any, of the two experts' analyses to adopt, Glasscock opted instead to emphasize the importance of the $32-per-share market price at which Ancestry.com was sold. Ancestry.com had been a public company, and there had been a robust, public sales process run by a financial adviser, which included multiple strategic and financial sponsors. The merger agreement included a fiduciary out, and no topping bids emerged in the two months between the announcement of the agreement and closing. Ultimately, 99 percent of voting shares approved the merger. The court accordingly found that the fair value of Ancestry.com was $32 per share. Glasscock did perform his own DCF analysis using parts of each expert's opinion, which resulted in a value of $31.79 per share. However, he used this calculation only as a "check" to "give [him] comfort that no undetected factor skewed the sales process" and the resulting market price.

While Glasscock's ultimate decision may be seen as a setback for investors engaging in appraisal arbitrage, an earlier decision in the same case upheld the ability of appraisal arbitrageurs to continue bringing these cases. In a Jan. 5 decision, Glasscock made clear that investors had standing to pursue appraisal actions despite purchasing shares only after the record date. According to the vice chancellor, a plain reading of the appraisal statute requires only that the record holder must not have voted the shares at issue. The statute "imposes no requirement" that a later purchaser of those shares, such as an appraisal arbitrageur, demonstrate "that previous owners … refrained from voting in favor" of the transaction.

Thus, while arbitrageurs face increased challenges in demonstrating that the fair value of a company exceeds the market price after the vice chancellor's Jan. 30 decision, cases of appraisal arbitrage will no doubt continue so long as these investors are deemed to have standing to bring such claims, as the vice chancellor found in his Jan. 5 decision, and the favorable statutory interest rate that applies in these cases continues to present arbitrage opportunities.

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