

Appraisal Arbitrage Risk: Delaware Court Finds Fair Value to be Lower than Merger Price

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On May 30, 2017, the Delaware Court of Chancery delivered a rare opinion, stating an appraisal price may be lower than a merger price, to a plaintiff recognized as an appraisal arbitrager.

In re Appraisal of SWS Group, Inc. arose out of the January 1, 2015, acquisition of SWS, a financially struggling bank and broker-dealer firm, by one of its principal creditors, Hilltop Holdings, Inc. The plaintiffs argued that SWS was worth a fair value of \$9.61 per share, a 50% premium against the \$6.92 merger price. The defendant argued that the merger price was based heavily upon synergies, while the going concern had a fair value of \$5.74. The plaintiffs had bought their shares as part of a transparent arbitrage strategy. After a four-day trial, the court determined a fair value of \$6.38.

Vice Chancellor Sam Glasscock III first ruled that merger price was an inadequate measure of fair value because the acquirer/creditor effectively held a veto against other potential bidders through its credit agreement, also noting that the acquirer did not assert the merger price was fair value. The vice chancellor then briefly rejected the plaintiffs' comparable companies analysis, finding a lack of record evidence to support the proffered comparables.

The court then turned to the parties' conflicting DCF measures of fair value. There the court made numerous legal rulings, walking through DCF elements: (a) management projections of rapid, straight-line growth should not be expanded from three to five years to reach a supposed "steady state"; (b) Hilltop's exercise of warrants in order to vote for the merger with the associated reduction in interest expense was part of the company's "operative reality" on the merger date; (c) an increase in regulatory capital was not properly treated as an increase in distributable free cash; (d) the defense expert's terminal growth rate was correct; (e) Chancery precedent endorsed the supply-side equity risk premium absent a factual reason to instead employ a historic ERP; (f) though both sides' beta proffers were flawed, the defendant's was unreliable for incorporating periods of merger speculation "froth"; and finally, (g) the size premium should be the midpoint of the two expert analyses, because the company bore similarities to a private company based on its large number of outstanding exercisable warrants.

In closing, the court observed that a fair value lower than the merger price “is not surprising” because the evidence proved a synergy-driven transaction in which some synergy value was shared with the target via the merger price.

SWS exemplifies the risks inherent in an appraisal arbitrage strategy and demonstrates the Court of Chancery’s willingness to declare an appraisal fair value lower than a merger price.