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Finance in the Courtroom: Appraising Its Growing Pains

Eric L. Talley
Columbia Law School, etalley@law.columbia.edu

FEATURE

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Isidor & Seville Sulzbacher Professor of Law, Columbia Law School.

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Increasingly complex and technical M&A economic tools have become essential in the modern courtroom.

The command *Eat your broccoli*, long a linchpin of the prudential parenting handbook,[1] carries added symbolic weight among mergers and acquisitions (M&A) lawyers. For them, a metaphorical species of broccoli has been dominating the menu of late — one whose intellectual consumption is no less compulsory: the tools of modern financial economics.

Signs are easy to spot. Rapidly proliferating continuing legal education panels and executive education programs, first-year associate "boot camps," and targeted professional journals are all increasingly geared towards fomenting greater literacy in modern finance among the practicing bar.

Law students, too, have taken note: over 90 percent of my students who plan seriously to practice in the M&A field, for example, will take at least one class in corporate finance before graduation.

The influence finance enjoys in the courtroom is hardly news anymore. In fact, the field's enduring bear hug of M&A practice was all but *solicited* more than three decades ago with a cluster of watershed cases that would collectively usher it in — opening a door that has yet to be shut. Many of these opinions — such as *Weinberger v. UOP*,[2] *Smith v. Van Gorkom*[3] and *Revlon v. MacAndrews & Forbes*[4] — remain to this day as beacons on the M&A landscape.[5]

And yet, notwithstanding its considerable success in reshaping courtroom discourse, finance is increasingly greeted with a tinge of apprehension, even among its ardent supporters. While this reception no doubt has many drivers, key among them are:

1) The necessarily generalist backgrounds of most legal practitioners and judges;

2) The progressively specialized nature of finance, often manifest in highly technical (and seemingly impenetrable) debates about assumptions, methodologies and techniques; and

3) The ever-widening gulf between (1) and (2).

Perhaps no topic better embodies the mid-life crisis facing courtroom finance than the post-merger appraisal proceeding, long a sleepy practice area that has come recently to command center stage in Delaware corporate litigation.[6] In many ways, appraisal constitutes a perfect storm for jurisprudential *ennui:* its authority emanates from statute rather than common law[7]; the text of the statute is (at best) syntactically tormented[8]; there is not a clear allocation of burdens[9]; claims trading is widespread, even after the record date for the merger[10]; buyer-specific deal "synergies" are excluded, though often difficult to isolate[11]; experts on both sides invariably stake out extreme ends of the valuation spectrum[12]; and courts are prohibited from implementing incentive mechanisms designed to elicit greater moderation.[13]

And, unlike highly trained (and highly remunerated) investment bankers — whose job requires generating a "football field" *range* of discounted cash flow (DCF) valuations — a judge presiding over an appraisal proceeding must conjure up a *single number* at the end of the process.[14]

The confluence of these factors can leave a presiding factfinder at sea, with little guidance, sketchy support, and no assurance that later cases are destined to get any easier.[15]

Viewed against this backdrop, it is hardly surprising that Delaware courts and practitioners have long foraged for a "broccoli substitute" of sorts — something that channels fair value while sidestepping the need to interrogate, decipher and ultimately reconstitute the messy layers of experts' DCF opinions.

And as it happens, a seemingly alluring candidate has persistently stepped forward of late: the merger price itself. As the product of arm's-length bargaining, forged in the "crucible of objective market reality"[16] (the argument goes), the negotiated deal price delivers a ready (and convenient) reference point — one that ostensibly obviates the need to grapple with tedious financial valuation metrics.

But as the great American playwright Arthur Miller demonstrated over a half century ago, for those who seek a reckoning with objective truth, there are crucibles … and then there are *Crucibles.*[17]

In game-theory terms, the merger price is best able to deliver a reliable reflection of fair value when — somewhat ironically — courts can *credibly threaten to eschew it.*

From which does the merger price emanate? As of this writing, the Delaware Supreme Court is considering two significant appeals[18] that take on this question in two stages: First, in the context of a qualifying arm's-length sale process, should the Court of Chancery be *required* to defer to the deal price? And if so, how does one determine whether the sale process in any given case qualifies it for such deference?

In the interests of full disclosure, I helped author an *amicus* brief in one of these matters on behalf of myself and 20 other professors of law, economics and finance (including a Nobel laureate).[19]

On the one hand, our brief specifically endorses the idea that deal price may well reflect fair value, at least in appropriate circumstances.[20] Nevertheless, it also argues that: (a) current doctrine already gives the Chancery Court adequate discretion to embrace the merger price when such circumstances are present; (b) a strong deal price deference requirement is functionally equivalent to a judicial repeal of the appraisal statute, improperly bypassing the Delaware General Assembly; and (c) merger price deference, if anticipated in advance by buyers, can cause them to soften their bidding strategies, undercutting the probative value of deal price as a reflection of fair value.

In game-theory terms, the merger price is best able to deliver a reliable reflection of fair value when — somewhat ironically — courts can *credibly threaten to eschew it* in an ensuing appraisal proceeding (even if they don't ultimately follow through).

But regardless of what happens in the cases on appeal, the ongoing kerfuffle over appraisal has important implications that deserve our reflection — implications about both the proper scope of finance and its relationship to law.

Among most M&A practitioners, modern finance likely conjures up the concept of *valuation*, and specifically DCF analysis: the process by which an expert (or a reluctant judge) cobbles together a present discounted valuation of a business entity combining forward looking cash flow projections, risk/tax/capital-structure adjusted discount rates, and terminal value projections. (Diving into the details of this process occupies a large fraction of my own corporate finance course at Columbia.) The pivotal role of valuation theory is self-evident in the M&A litigation context — both inside and outside of appraisal.

But valuation is only half the story. Another major area of financial economics — and one that has received relatively less judicial focus by comparison — concerns *auction design*. Auction theory has been one of the most fertile and interesting areas in economics for decades, with significant advances made in the last quarter century. It holds obvious relevance in the M&A context too, delivering important insights into (*inter alia*): how to design bidding protocols that maximize revenue and/or efficiency; how to adapt such protocols for different sorts of bidder configurations (*e.g.*, private versus common valuations); how best to share information among prospective bidders; how to set an optimal reservation price; the effects of ownership toeholds; and the extent to which market tests and deal protections can encourage bidder competition.

At the same time, an acknowledged downside of auction theory is that it, too, has evolved into a technical and complicated field — one that can seem inaccessible even to sophisticated generalists. That complexity may well have induced Delaware courts to resist engraving auction design desiderata into legal doctrine. In *Paramount v. QVC*, for example, the Delaware Supreme Court specifically recognized the complexity of designing sales processes, noting that even under *Revlon*, courts will not scrutinize directors' business judgment if the process was, on balance, within a range of reasonableness.[21]

This approach has been reaffirmed many times over, most recently in *C&J Energy Services*,[22] which similarly held that "Revlon and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks."[23]

Delaware courts have likewise rebuffed auction theory when invoked by defendants. In *Omnicare v. NCS Healthcare*,[24] the Delaware Supreme Court (in) famously rejected a competitive sales process that appeared — by nearly all objective measures — to be strongly consistent with textbook tenets of optimal auction design.

The jurisprudential stiff-arming of auction theory is perhaps understandable from a broader perspective. In many real-world disputes, optimal auction design may simply be a heavier lift than DCF analysis. And thus, a finance-wary court could easily prefer — if confronted with the choice — to adjudicate valuation over auction design. Such a preference might also shed light on why the Chancery Court has frequently resisted enjoining a deal on *Revlon* grounds (thereby sidestepping auction theory) if the transaction is also eligible for appraisal or quasi-appraisal later on (where valuation takes center stage).[25]

But that's just the point. Suppose (for argument's sake) that the cases now pending before the Delaware Supreme Court culminated in an interpretation of the appraisal statute *mandating* merger price deference — at least for qualifying arm's length transactions. While such an outcome might no doubt deliver a

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reprieve to the judiciary as to valuation matters, fact-finders would hardly be out of the woods. Rather, they would now have to navigate a less familiar grove in the metaphorical broccoli forest: auction theory.

Indeed, a merger-price deference rule of the sort posited above would almost necessarily train judicial attention on assessing whether the predicate conditions for a "qualifying" transaction are present in each case. And that determination, in turn, would seemingly require courts to deploy the lens of auction design to scrutinize (with possibly unaccustomed vigor) the sales process itself, its timing, bidding rules, bidder recruitment protocols, the permissibility of alternative deal/financing structures, information disclosure protocols, reserve pricing, post-bidding market checks, deal protection, the incentives of target directors and financial advisers, and so forth.

At a higher level, the merits of embracing the merger price may ultimately boil down to singling out one's judicial weapon of choice from corporate finance's cruciferous arsenal: valuation versus auction design. Delaware law currently vests substantial discretion over this choice with the Chancery Court — discretion that makes considerable sense in the fact-intensive milieu of appraisal proceedings. And it bears noting that the Chancery Court has been anything but bashful about utilizing its discretion to embrace the deal price (or even less) when facts support doing so.

Indeed, a sizable majority of appraisal valuations issued by the Chancery Court the last four years have produced valuations either at or a *little below* the deal price.[26] A timely example can be found in Vice Chancellor Slights' well-reasoned opinion in *PetSmart*,[27] where the record reflected a robust and well-organized pre-signing auction process, motivated competition, numerous bidders of all flavors and little evidence of market failure[28] — all factors that should weigh heavily in favor of the deal price.[29]

The petitioner expert's DCF valuation, in contrast, utilized cash flow projections that either (i) reflected impermissible buyer-side synergies, or (ii) embodied hockey-stick-shaped cash-flow chimeras designed more to bolster negotiation leverage than to divine value.

On the basis of the factual record as he determined it, the Vice Chancellor's embrace of the merger price seems both theoretically defensible and empirically sound — and, it is an outcome he reached easily under existing doctrine.

While I remain skeptical of the merits of a merger price deference "rule" for appraisal cases, there is still significant room to improve how such cases are tried and adjudicated. For example, the now two-decade-old prohibition on the judicial use of incentive devices such as "baseball" arbitration to moderate extreme expert opinions perhaps deserves to be reconsidered.[30] (Here it merits observing that a variation of baseball arbitration still often occurs, whereby the judge sequentially selects between the experts' competing opinions on an *item-by-item* basis (as to the equity risk premium, estimated beta, de-leveraging techniques, discounting stages, perpetuity growth rates, applicable tax rates, and so forth.))

In addition, the Chancery Court may choose to experiment once again with retaining an independent expert to advise and consult in such matters, both as to valuation and auction design. Though reputed to be an unsatisfying experiment when previously attempted, the nature of the disputes has changed too.[31]

Finally, judges should be mindful of their own staffing decisions: as noted above, an increasing number of law graduates (and prospective clerks) now receive serious training in financial economics — skills that can be helpful in navigating future appraisal cases. Each of these measures (and perhaps others) is consistent with the common-sense goal of affording Chancery Court judges the flexibility to ascertain fair value in a manner consistent with the facts and circumstances of each case.

After all, if you *have* to eat broccoli, you best be the one who chooses the recipe. ◆

NOTES

1. Some, of course, have notoriously dissented from this edict. *See* Daniela Diaz, *George H.W. Bush still hates broccoli*, CNN Online (6/25/2016) (http://www.cnn.com/2016/06/25/politics/george-h-w-bush-broccoli-twitter/).

2. 457 A.2d 701 (Del. 1983).

3. 488 A.2d 858 (Del. 1985).

4. 506 A.2d 173 (Del. 1986).

5. *See generally* Roberta Romano, *After the Revolution in Corporate Law*, 55 J. Legal Ed. 342 (2005).

6. *See* Albert Choi & Eric Talley, *Appraising the 'Merger Price' Appraisal Rule*, U. Va. Law & Econ. Research Paper No. 2017-01 (2017) (https://ssrn.com/abstract=2888420); Guhan Subramanian, *Using the Deal Price for Determining 'Fair Value' in Appraisal Proceedings* (2017) (https://ssrn.com/abstract=2911880).

7. DGCL § 262.

8. *See, e.g.*, Robert Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 Geo. L.J. 1, 30 (1995).

9. *In re Appraisal of Ancestry.com*, C.A. No. 8173-VCG (Del. Ch. 2015).

10. *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC (Del. Ch. 2007).

11. *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 n.8. (Del. 1988).

12. *In re Appraisal of SWS Group, Inc.*, C.A. No. 10554-VCG, at 2 (Del. Ch. May 30, 2017).

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

14. Choi & Talley, *supra* note 7, at 2.

15. *See, e.g., In re Ancestry.com, supra* note 10, at 1 ("this task is made particularly difficult for the bench judge, not simply because his training may not provide a background well-suited to the process, but also because of the way the statute is constructed").

16. *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 42 (Del. Ch. 2007).

17. Arthur Miller, *The Crucible* (1953) (dramatizing the 17th-century Salem witch trials).

18. *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd. et al.*, Supreme Court of Delaware (Case No. 565, 2016); *DFC Global v. Muirfield Value Partners et al.*, Supreme Court of Delaware (Case No. 518, 2016).

19. *See* Brief of Law, Economics and Corporate Finance Professors as Amici Curiae in Support of Petitioners-appellees and Affirmance, DFC Global v. Muirfield Value Partners et al., Supreme Court of Delaware (No. 518, 2016) (Feb. 3, 2017) (http://lawprofessors.typepad.com/files/dfc-holdings---appraisal.pdf).

20. *Id.* at 5, 15-16. These circumstances include robust bidding among multiple buyers, supermajority conditions, and easily comparable bids. For a formal theoretical development of this idea, see Choi & Talley, *supra* note 7.

21. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46 (Del. 1994).

22. *C&J Energy Services v. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust*, 107 A.3d 1049 (Del. 2014).

23. *Id.* at 1053.

24. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

25. *See, e.g., In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1023 (Del. Ch. 2005) (denying an injunction and noting that stockholders' alleged harm "can be rectified adequately in a later appraisal proceeding").

26. These include *Huff v. CKx* (2013), *In re. Ancestry.com Inc.* (2015), *Merlin Partners v. AutoInfo, Inc.* (2015), *LongPath v. Ramtron* (2015) (very slightly below deal price), *Merion Capital v. BMC Software* (2015); *In re Lender Processing Servs., Inc.* (2016); *In re PetSmart, Inc.* (2017); and *In re SWS Group, Inc.* (2017) (10 percent below deal price).

27. *In re Appraisal of PetSmart, Inc.*, C.A. No. 10782-VCS (Del. Ch., May 26, 2017).

28. *See Id.* at 4, 108.

29. *See* Choi & Talley, *supra* note 7, at 24-25.

30. In baseball arbitration, the judge pre-commits to selecting the most reasonable side's account hook-line-and-sinker, with the intended effect that the parties will moderate their arguments to increase the chance of their side being ultimately adopted by the adjudicator. Such processes were invalidated as inconsistent with the court's duty under DGCL § 262 to produce an independent valuation. *See Gonsalves, supra* note 13.

31. The changes are many, and include the frequency of litigation, the stakes involved, the sophistication of petitioners, the role of appraisal arbitrage, and the prevalence of claims trading. *See* Michael Greene, *M&A Deal Price Challenges Spiking in Delaware*, Bloomberg News (1/17/2017) (https://www.bna.com/ma-deal-price-n73014449766/).