The practice of a hedge fund buying shares in a Delaware corporation upon the announcement of a cash-out merger to then exercise appraisal rights, sometimes referred to as “appraisal arbitrage,” has generated controversy. Some argue that this practice is inconsistent with the appraisal remedy that should be available only to allow long-term shareholders who disagree with the cash-out price to have the Delaware Court of Chancery determine the fair value of their shares. Others argue, and the Delaware courts have agreed, that the appraisal statute permits the appraisal remedy to those who hold the shares on the merger date, even if, like the petitioners in this case, they (1) became owners only after the announcement of a merger solely to exercise appraisal rights and (2) could not demonstrate that the shares they purchased had not been voted in favor of the merger.

Regardless of the merits of this debate, if the Delaware courts continue to recognize that a merger price that results from a full and fair sale process may be the best evidence of fair value, it is likely that the incentives for hedge funds to engage in appraisal arbitrage will diminish. The recent Court of Chancery decision in *Merion Capital LP v. BMC Software*, C.A. No. 8900-VCG (Del. Ch., October 21, 2015), is the latest Delaware decision to so hold, which likely will cause appraisal petitioners in this circumstance carefully to evaluate whether to bring appraisal actions in the first place as the prospects of a huge return are diminished.

Not only is an appraisal petitioner potentially at risk for receiving only the merger price but also the *BMC Software* decision highlights that an appraisal petitioner may receive less than the merger price where that price derives from a well-run auction. That is because the Delaware courts have interpreted the statutory mandate to determine fair value, "exclusive of any element of value arising from the accomplishment or expectation of the merger" (8 Del. C. Section 262(h)), to mean fair value as a "going concern." This means that the court is required to exclude any cost or other synergies realizable by the buyer that enable and result in the buyer paying a merger price higher than the seller’s fair value as a going concern. The rationale for excluding synergy values is that such values are based on assets of the buyer that are not part of the property of the seller exclusive of the merger. As the *BMC Software* court explained, *"Assuming that the record showed that the acquisition price paid by [the winning bidder] included a portion of this synergistic..."*
value, this court, if relying on the deal price to establish statutory fair value, would be required to deduct that portion from the appraisal award."

Here, the court rejected the respondent’s argument that the savings from tax benefits and cost reductions that the buyer, a financial as opposed to a strategic acquirer, expected to receive by taking the company private, should not be included in fair value. Despite testimony from a principal of the buyer that without those expected savings the buyer would only have paid $36 per share instead of $46.25 per share, the court found that testimony did not suffice to establish that those savings were a part of the purchase price. Lacking from the trial evidence, for example, was testimony from the respondent’s expert on the fair value of the company using a deal-price-less-synergies valuation. The court found the respondent could not meet its burden to establish that the market price should be adjusted downward as it found no evidence in the record "sufficient to show what quantum of value should be ascribed to the acquisition, in addition to going-concern value; and if such value was available to the buyer group, what portion, if any, was shared with the stockholders."

Significantly, the court relied on the merger price even though its own DCF analysis resulted in a value of $48 per share, or $1.75 greater than the merger price. It did so because: the seller’s projections historically were not always accurate and the record did not reflect a reliable method to adjust the projections; it did not have confidence in determining the appropriate discount rate in light of the unsettled scholarship concerning the use of a supply side instead of historical equity risk premium; and it had uncertainty over how most reliably to calculate the terminal growth rate.

This decision reflects the Delaware courts’ common-sense recognition that the best measure of the fair value of an entity on the merger date as a going concern is what the prevailing buyer in a well-run sale process is prepared to pay. To the extent a respondent can demonstrate that the purchase price reflects synergies paid to the selling stockholders for value inherent in the property or assets of the buyer exclusive of the merger, then that value must be deducted from any appraisal award. The net effect of this decision is to increase the risk to an appraisal petitioner where the merger price it is contesting as inadequate has resulted from a well-run auction. Petitioners here had purchased their shares in the belief that the merger price was inadequate. Whether appraisal awards that are based on the merger price result in less appraisal arbitrage remains to be seen.

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