

Examining The Role Of Market Price In Appraisal: Part 1

By **Dirk Hackbarth and Bin Zhou** (September 10, 2018, 12:15 PM EDT)

Several recent appraisal decisions in Delaware’s Supreme Court and Chancery Court have reignited an important legal and policy debate about the fair value statute. In contrast to court decisions between 2012 and early 2017 that determined fair value primarily by discounted cash flow, or DCF, estimates, the Delaware Supreme Court’s decisions in DFC and Dell appeals in the second half of 2017 gave greater deference to deal prices and market evidence. Vice Chancellor J. Travis Laster’s February 2018 decision in Verition Partners v. Aruba Networks further ruled that the most reliable estimate of the fair value of Aruba’s stock was the company’s 30-day average pre-announcement stock price.[1]



Dirk Hackbarth

After reaching his conclusion, however, VC Laster cautions that “[t]his approach does not elevate ‘market value’ to the governing standard under the appraisal statute.”[2] This caveat begs at least three related finance questions. First, why can’t market price be considered relevant for appraising fair value of publicly traded companies where there is no controlling shareholder? Second, should market price in such circumstances be given exclusive reliance for fair value determination? Third, if not exclusively, what evidence should be used to assess the weight given to market price, relative to other indicators of fair value?



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Our responses to the above questions and our article are organized in two parts. Part one addresses the first two questions.

Is Market Price Relevant for Fair Value Determination?

We argue that the answer to the first question is an unequivocal “yes.” Decades of empirical finance research establish that in the U.S. stock market, publicly available information about companies is quickly reflected in stock prices. Although courts acknowledge stock markets are in general efficient, they insist that fair value under Delaware statute is a jurisprudential, rather than purely economic, construct and this concept has certain nuances that neither an economist nor market participant would usually consider when either valuing a minority block of shares or a public company as a whole. Because the average investors have no influence over the company’s business strategies and operations, Delaware courts have frequently held that, relative to Delaware’s fair value, there is an implicit minority discount in the U.S. market price. This view, however, is misconceived.

Minority Discounts Cannot Be Inferred From Control Premiums

Courts and practitioners often derive minority discounts as the inverse of acquisition premiums.[3] However, there is not a one-to-one or even a negative relation between a control premium and a minority discount. Consider the relationship among deal price, fair value and market price when the target stock trades in a liquid stock exchange. Both deal price and market price are observable from the marketplace, and typically deal prices are higher than market prices. In contrast, fair value is unobservable. In Delaware appraisal actions, control premium can mean two different things: (a) a buyer-specific premium embodied in the deal price that is in excess of the unobserved fair value but distinct from the synergy value and (b) a buyer-unspecific premium embodied in the deal price that should be included in fair value. The control premium defined this way is different from:

- The premium of deal price over market price, or the acquisition premium. It is often mistakenly called a control premium, because the buyers in mergers and acquisitions acquire control of the target companies. This is a misnomer, however, as acquisition premiums represent a variety of factors — synergies with the acquiring company, undervaluation of the target company and overpayment by the acquiring company — that have nothing to do with implicit minority discounts in the market prices.
- The price differential of a controlling share over a noncontrolling share. Some investors pay a premium to the market price for a control block of stock if they anticipate receiving benefits that do not flow to other (noncontrolling) shareholders. These benefits are commonly referred to as private benefits of control and control premiums in economics literature.

Minority discount is a buyer-unspecific reduction of the market price below the statutory fair value. Proponents of minority discounts point to ineffective containment of agency costs as sources for the minority discounts. Such agency costs can arise from either between shareholders and management or controlling shareholders and minority shareholders. The presence of such agency costs does not mean that minority shareholders are necessarily hurt financially simply because they do not participate in the company's management. First, controlling shareholders or managers can provide valuable services to other shareholders that can offset or even surpass any pecuniary private benefits diverted from cash flows that should go to minority shareholders. Second, many internal and external mechanisms exist to curtail agency costs: board monitoring, incentive compensation, disclosure of related-party transactions and executive compensation, proxy rights, shareholder voting rights, M&A (market for corporate control), and most recently shareholder activism. Lastly, since most of the agency costs are just parts of the business reality, only excessive agency costs harm the companies, including their minority shareholders.[4]

Minority Discounts Should Be Close to Zero as a Base Case in the U.S.

Because any private benefits of control need not harm minority, noncontrolling shareholders and because controlling shareholders can provide valuable benefits for minority shareholders, it is an open question whether in a particular target company there should be any minority discount and, if so, what its magnitude should be.

Financial economists primarily use two approaches to measure minority discounts. The first approach examines the relationship between firms' market-to-book ratios and their ownership concentration. A low market-to-book ratio would be consistent with uncompensated expropriation of cash flows by a dominant shareholder. It would mean that the firm has invested assets (book value) that are not highly

valued by the market (market value). The second approach is to measure the relationship between firms' accounting rates of return and ownership concentration. The rationale is that if a large shareholder is expropriating cash flows, it will be reflected in lower accounting cash flows.[5] A survey article stated that "the current learning on blockholders and firm value [is] as follows. First, it has not been definitely established whether the impact of blockholders on firm value is positive or negative. Second, there is little evidence that the impact of blockholders on firm value — whatever that impact may be — is pronounced." [6] These conclusions have been confirmed by other surveys of the scholarly work.

Without the link between minority discounts and control premiums, and in light of these broad empirical regularities on the lack of systematic evidence on minority discounts, and wide acceptance of market efficiency, we recommend that the Chancery Court consider market price as evidence for fair value. However, this is not to say that stock prices are the sole determinant of appraised fair value.

Should Market Price Be Considered Exclusive Evidence?

As VC Laster emphasized in his May 2018 Aruba opinion, using market price as an indicator of fair value does not mean that there can never be an appraisal for a public company receiving a premium offer.[7] We believe that there are certain exceptions such that deviations from exclusive reliance of market price are warranted. The Delaware statute requires taking into account all relevant factors in determining fair value. So there will be a continuum of possible combinations of market prices, adjusted deal prices and DCF estimates. The reliability of market price as indicator of fair value should be evaluated against its own merits, and against the merits of other fair value measures. In particular, in deciding the best indicator of fair value, the court acknowledges the latter two indicators are subject to human errors and judgement.

At one end of the spectrum, when the target stocks are actively traded in the U.S. stock exchanges with well-informed investor base and where there is no controlling shareholder, market price could be relied upon as a more reliable measure of fair value. However, when credible evidence exists to show that certain nonpublic information has not been fully disclosed to the market, and the information is material and can be reliably priced, the dissenting shareholders could be entitled to a fair value above the market price.[8] As another example, the target company may not be run as efficiently by the current management as one would expect from a typical company in the industry; in other words, there might be excess agency costs that could be reduced by a more efficient owner. The market price therefore may incorporate a discount. The fair value might include a premium for reversing the discount to the extent that it is not buyer-specific. However, if a strategic buyer is more efficient than the average operator and shares the efficiency gain with the target shareholders, the efficiency gain may be excluded from the fair value.

At the other end of the spectrum, when the target stock is not traded in a stock exchange and the deal price is compromised by the existence of controlling shareholders or managers with side employment transactions with acquirers, market prices and deal prices are of lower probative value, and the fair values are better obtained from DCF estimates. In other cases, when market prices are shown to be inefficient but the deal price can be shown to result from robust market competition, deal price could be considered as the ceiling of fair value. In this case, additional adjustments for synergies and reduced agency costs from the deal prices may be required.

In all likelihood when synergies have to be estimated and DCF modeling has to be performed, many model inputs and assumptions are subject to estimation errors and expert judgments. The reliability of

these results needs to be taken into account in fair value determination. Much has been written about the reliability of deal prices and DCF estimates, but we propose, in part 2 of this article, empirical tests to gauge the reliability of market prices for fair value determination.

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[1] Verition Partners Master Fund Ltd. v. Aruba Networks Inc., Del. Ch. Feb. 15, 2018 (Aruba Feb. 2018 Opinion).

[2] Aruba Feb. 2018 Opinion, at p. 128.

[3] For example, if the acquisition premium is 40 percent, then the minority discount is derived as $1 - 1 / (1 + 40 \text{ percent}) = 28.6 \text{ percent}$.

[4] The notion that deal price includes a component for reduced agency costs needs to be treated with caution. In an acquisition, the agency costs at the target company are replaced by the agency costs at the acquirer. Unless the acquirer is more efficiently managed than the target, reduction in agency costs may not exist.

[5] Of course, a low market-to-book ratio or accounting rate of return could be caused by factors other than expropriation by a dominant shareholder. Thus, a depressed market-to-book ratio or accounting rate of return is a necessary but not a sufficient condition to support a minority discount.

[6] Clifford Holderness, "A Survey of Blockholders and Corporate Control," Economic Policy Review 9, 51-63 (2003). For a recent survey, see Alex Edmans and Clifford Holderness, "Blockholders: A Survey of Theory and Evidence," Chapter 8 in The Handbook of the Economics of Corporate Governance (2017).

[7] Verition Partners Master Fund Ltd. v. Aruba Networks Inc. (Del. Ch. May 21, 2018), at p. 48.

[8] Conceptually, the impact of the nonpublic information could be either positive or negative. Positive revision to the market price should be typical in appraisal actions.