

May 31, 2017

Delaware Court of Chancery Appraises Public Company
at Nearly 20% Below Merger Price

In an important appraisal decision issued this week, the Delaware Court of Chancery held that the fair value of SWS Group, Inc. was \$6.38 per share — a valuation 19% below the merger price at announcement and 7.8% below the merger price at closing. *In re Appraisal of SWS Group Inc.*, C.A. No. 10554-VCG (Del. Ch. May 30, 2017). This is the first decision in the modern era of “appraisal arbitrage” to fix fair value meaningfully below the sale price, marking a significant departure from recent appraisals that have hewn closely to market valuation.

The case arose from Hilltop Holdings’ 2014 acquisition of SWS, a Dallas-based regional bank and broker/dealer. Due to anticipated synergies and cost savings from the transaction, Hilltop paid a premium to SWS’s pre-offer share price of \$6.06, agreeing to a mix of cash and stock worth \$7.88 per share when the deal was announced on March 31, 2014 and \$6.92 per share when the merger closed on January 1, 2015. After the merger was announced, arbitrageurs raised funds solely to finance an appraisal action, wooing investors with assurances that the Delaware courts were extremely unlikely to assign fair value below deal price. After raising tens of millions on that basis, the arbitrageurs acquired 7.4 million shares after the deal announcement and before the merger closing — approximately 15% of total shares outstanding — over a period in which SWS traded at an average share price of \$7.22. Had the arbitrageurs simply voted for the merger, their investors would have received merger consideration now worth \$8.30 per share.

The arbitrageurs argued that SWS should be valued at \$9.61 per share, relying upon the valuations of purported peer companies and a discounted cash flow (DCF) analysis that departed upward from the revenues projected by SWS’s management. Hilltop, chaired by legendary financial services investor Gerald Ford, refused to be coerced by the arbitrage appraisal funds.

The Chancery Court roundly rejected the arbitrageurs’ valuation, instead adopting a DCF analysis largely consistent with that proposed by Hilltop and SWS. Noting that this analysis resulted in a value below the merger price, Vice Chancellor Glasscock concluded that such a result was “not surprising” because SWS had demonstrated that its acquisition was a “synergies-driven transaction whereby the acquirer shared value arising from the merger.”

In re Appraisal of SWS Group offers a practical demonstration that “when the merger price represents a transfer to the sellers of value arising solely from a merger, these additions to deal price are properly removed from the calculation of fair value.” The decision thus serves as a reminder that sale price does not serve as a floor on fair value — and that the Delaware courts do not guarantee a positive return on investment to appraisal arbitrageurs.

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