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Appraisal Litigation in Japanese and Delaware Courts - Trends of Decisions on the Fair Price

A Common Trend of Placing Weight on the Merger Price is Observed While Differences Remain on How to Assess the Fair Procedure

July 20, 2020

Executive Summary

Like Delaware and other U.S. State laws, Japan's Company Act provides shareholders opposing the reorganization the right to request the company to purchase shares at a "fair price", and if the negotiation cannot be concluded within a certain period of time, the opposing shareholders can request the court to determine the fair price. In this paper, we first compare the trends in the number of cases filed in Japan and Delaware, and then analyzed the trend of (1) the premium of the court decision price over the “merger price” (or a price agreed between the parties during transaction), (2) the approaches deciding the fair price, and (3) the total amount of award using our database of decisions by Japanese and Delaware courts up to 2019. Based on these analyses, we observed a trend that both Japanese and Delaware courts have recently placed more weight on the merger price, which is believed to have accelerated the declining trend in number of cases and the level of premiums in the two jurisdictions. In Japan, this tendency is considered to be greatly influenced by the Supreme Court's decision in *Jupiter Telecom*[1] that the merger price should be adopted as a fair price if there are generally accepted fair procedures. However, we will discuss at the end of this paper whether this trend will continue in the future and a few important issues around verifying the fairness in procedure, including how the third-party valuation is prepared and discussed during the procedure.

1. Trends in number of filing

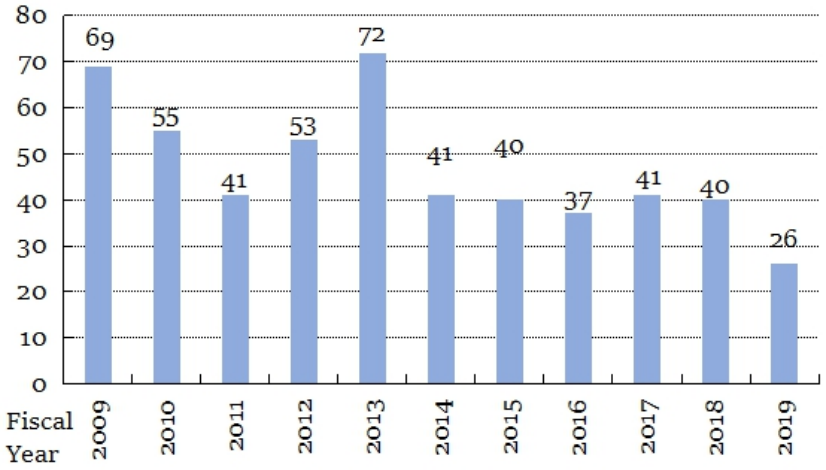
Japanese courts do not regularly publish statistics of filing or judgment, but according to Okamoto (2019)[2], the number of new cases of petitions for stock price determination accepted by the Tokyo District Court, including cases other than the stock purchase request, has been at a level of 40 or more per year since FY2009, except for FY2016. The number of new cases was particularly high at around 70 in FY2009 and FY2013. The cases in FY2016 and thereafter include the so-called two-stage cash-out cases under the new procedure established by the revised Companies Act in 2014, where if 90% or more of the voting rights of all shareholders are obtained by the tender offer the buyer, or “special controlling shareholder”, can request the remaining shareholders to sell out shares, and if the ratio is less than 90%, the

[1] The Supreme Court decision, July 1, 2016, Kinsho 1507, 19p

[2] Yohei Okamoto “Overview of Commercial Cases in the Tokyo District Court”, Shojihomu No. 2209, pages 28-44

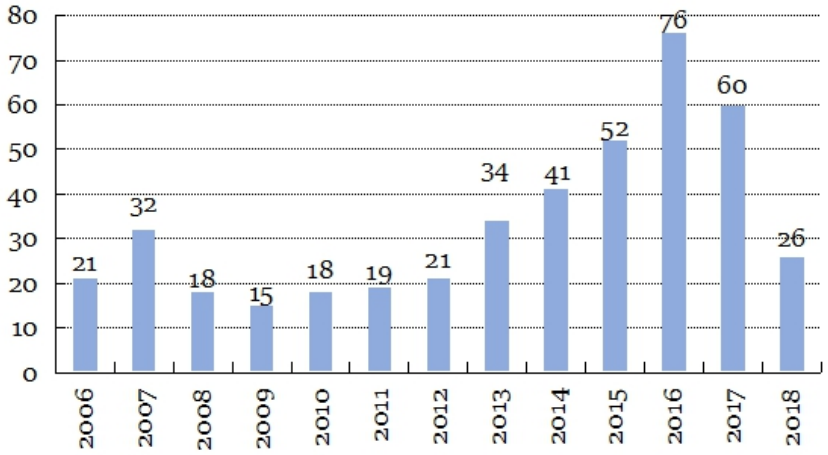
ordinary share consolidation procedure is used to acquire all remaining shares.

Figure 1: The number of new cases of petitions for stock price determination accepted by the Tokyo District Court



Statistics from Okamoto (2019) as of FY2019, Alpha Financial Experts

Figure 2: The number of appraisal petitions filed in the Delaware Court of Chancery



Partial excerpt from Cornerstone Research "Appraisal Litigation in Delaware: Trends in Petitions and Opinions 2006-2018", p4

On the other hand, the Figure 2 shows the trend in the number of appraisal petitions filed in the Delaware Court of Chancery from 2006 to 2018, an excerpt from the Cornerstone Research study. According to this statistics, it is clear that the number of cases has continued to increase from around 2009, peaking in 2016 (76 cases), and then rapidly decreasing during the two years of 2017 and 2018.

The use of the appraisal arbitrage by hedge funds or private equity funds is believed to be the reason behind the rapid increase in the number of complaints up to 2016[3]. The appraisal arbitrage is an investment method to purchase shares after the resolution of the general meeting of shareholders related to the merger, expecting that the court awards a price higher than the purchase price plus statutory interest rates of fed funds rate plus 5%. The investors using this method exercise the opposing shareholders' right to demand the buyback of shares at fair price and invite other investors to exercise the same. These funds tend to select reorganization deals where controlling shareholders have incentives to keep prices low and the consideration for minority shareholders merger price is believed to be too low.[4] On the other hand, the decrease in the number of filing after 2017 is explained by the general decline of price premium over the merger price, as discussed below, with which the appraisal arbitrage method became economical unfeasible.

2. The premium over the merger price

Regardless of presence of the appraisal arbitrage, the trend in the number of filings of appraisal petitions depends on whether a price higher than the merger price can be expected in the appraisal litigation. We studied 56 appraisal litigation cases[5] in Japan since 2007 where the decision was made public and by excluding 13 cases in which necessary data were not available, we created the pool of 43 cases for further study on the premium, not including statutory interest rates, of the decision price per share[6] over the merger price (in many cases means the tender offer price). Figure 3 provides a time-series distribution of the premium in Japan.

According to this analysis, there has been a number of positive premium cases in Japan, with 14 out of the 43 cases having a positive premium, but 28 cases having a zero premium. The premium was negative in one case. As a result, the average premium is only 3.8%. Until around 2013, the price was relatively high compared to the

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[3] Cornerstone Research, "Appraisal Litigation in Delaware: Trends in Petitions and Opinions 2006-2018", p5

[4] Andrew Barroway, founder and CEO of Merle Investment Management, said in the Wall Street Journal on April 13, 2014 that most deals were fair and the company had at least 30 deals. It states that it targets exceptional cases (especially MBO cases) that are undervalued by more than 30%.

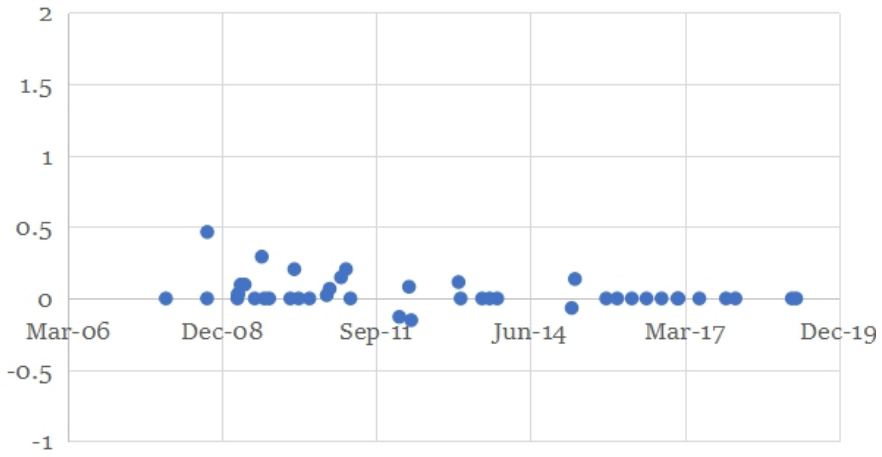
[5] The original court case and the appeal case are treated separately when the separate decisions are available.

[6] Premium = (court decision price ÷ Merger price)-1

merger price, and there were cases where the premium was around 50%, but in recent years, it has been almost zero, that is, the court has adopted the merger price as a fair price.

Similarly, we studied 34 Delaware court cases that reached decisions after trial in the period from 2010 to 2019[7]. Unlike Japan, Delaware court cases are mostly settled or withdrawn before or in the middle of the trial, resulting relatively fewer number of decisions for study despite large number of filings. Of the above 34 decisions, we selected 32 in view of data availability and conducted an analysis of the price premium, not including the statutory interest rate, over the merger price as shown in Figure 4. Of the total 32 cases, 14 cases, or 44%, had positive premiums, with a maximum of 158%. The average value is 16.7%, indicating that a higher price than the merger price is tend to be awarded as a fair price in Delaware compared to Japan. However, from a time-series point of view, as in Japan, the number of zero premium cases has increased in recent years, and several negative premium cases have been observed in Delaware. This provides a background of recent decrease in the number of filings that may be related to the declined feasibility of appraisal arbitrage.

Figure 3: Premium of court decision price over the merger price (Japan)



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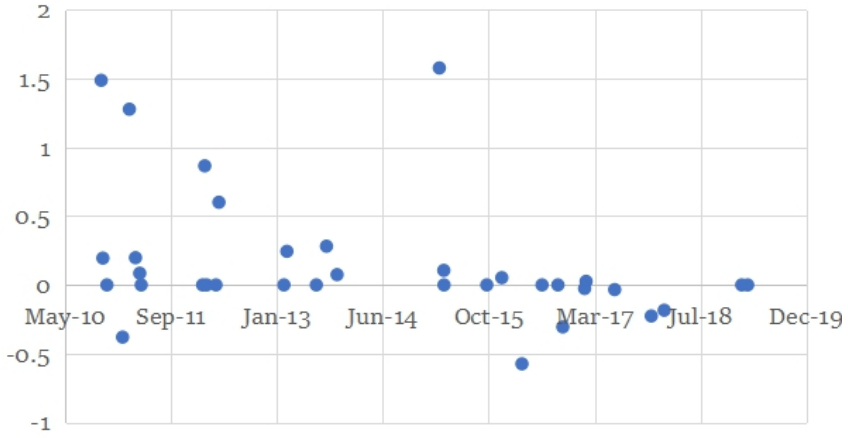
[7] The original trial and the appeal trial are treated separately if the separate decisions are available.

Figure 4: Premium of court decision price over the merger price (Delaware)



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3. Trends in valuation approach

There are also similar trends in Japan and Delaware with regard to the type of valuation method used as a base for determining the fair price. Figure 5 summarizes the number of cases for each of the above 54 cases in Japan by the main method for deriving the result adopted by the court as a fair price. According to this statistics, Japan had many decisions based on the unaffected market price, or a method relying on the market share price unaffected by the information of merger or reorganization, until around 2015, but the adoption of the merger price has been dominant since then. Decisions based on other methods such as the DCF method are very limited. This tendency is inextricably linked with the increasing number of zero premium cases in recent years, as seen in Figure 3, that became apparent since the Supreme Court decision in the *Jupiter Telecom* in July 2016 in which the court placed greater importance on the merger price over other methods compared to the previous court decisions.

Figure 6 shows a similar analysis for the Delaware cases. Compared to Japanese courts, Delaware courts often adopts the DCF method, but in recent years, as in Japan, the tendency to adopt merger prices has become more apparent, particularly after the Supreme Court decisions in *Dell*[8] and *DFC Global*[9] in 2017, which provided a guidance regarding the conditions courts can accept the merger price as a basis

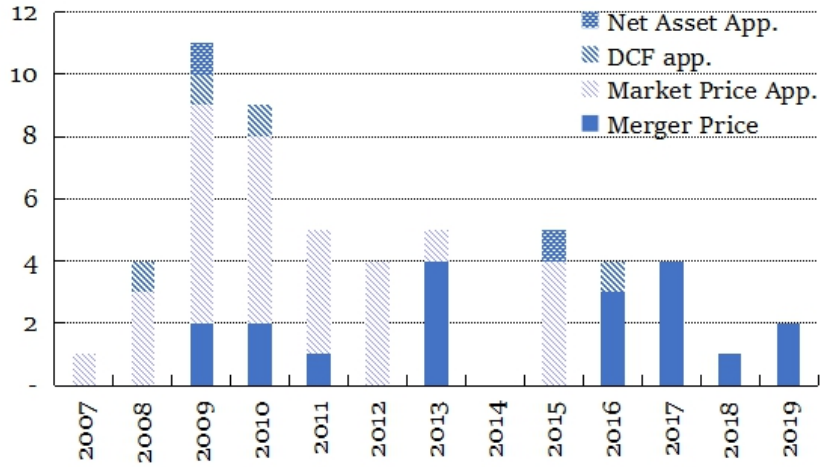
[8] Dell, Inc. V. Magnetar Global Event Driven Master Fund Ltd. (Del. Dec. 14, 2017)

[9] DFC Global Corp. v. Muirfield Value Partners, L.P., 172 A. 3d 346 (Del. 2017)

for the fair price. According to the Court of Chancery decision in *AOL*[10], the essence of this guidance is that if the merger price "represents an unhindered, informed, and competitive market valuation" and "(w)here information necessary for participants in the market to make a bid is widely disseminated, and where the terms of the transaction are not structurally prohibitive or unduly limiting to such market participation", the trial judge must give particular and serious consideration to the merger price.

It is also noteworthy that since 2018 we have seen a few cases in Delaware adopting unaffected market price as a base for the fair price. Delaware courts had historically distrusted the market price, but in *Aruba* decision[11] in 2018, though later denied by the Supreme Court, the Court of Chancery decided that the fair price should be based on the unaffected market share price for the first time in recent years. Preceding Supreme Court decisions in *Dell* [12]and *DFC Global*[13] provided the basis for the above *Aruba* decision since the two decisions admitted the superiority of the market price under certain conditions based on the efficient market hypothesis.

Figure 5: Main evaluation approach adopted by courts (Japan)



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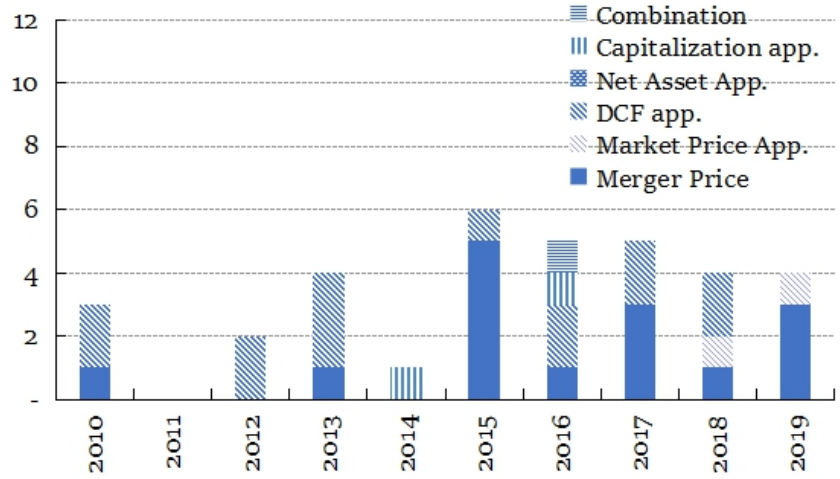
[10] In re Appraisal of AOL Inc., C.A. No. 11204-VCG (Del. Ch. Feb. 23, 2018)

[11] Verition Partners Master Fund Ltd. v. Aruba Networks Inc., C.A. 11448-VCL (Del. Ch. Feb. 15, 2018)

[12] Dell, Inc. V. Magnetar Global Event Driven Master Fund Ltd. (Del. Dec. 14, 2017)

[13] DFC Global Corp. v. Muirfield Value Partners, L.P., 172 A. 3d 346 (Del. 2017)

Figure 6: Main evaluation approach adopted by courts (Delaware)



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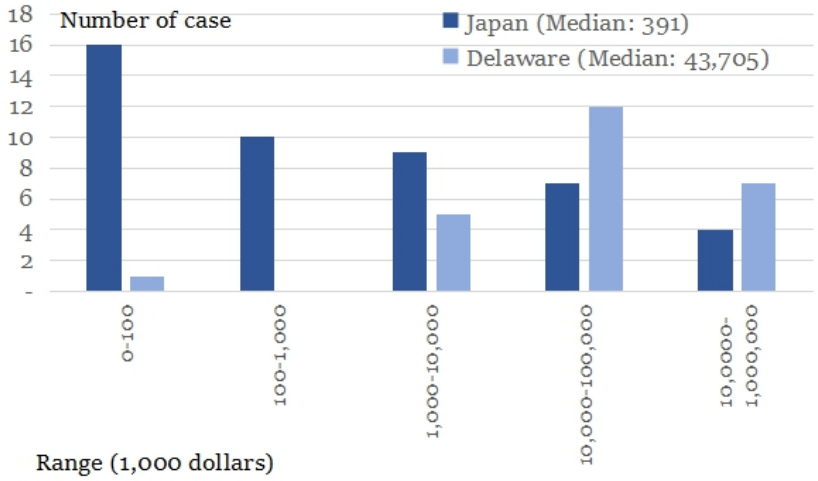
4. Comparison of total award amount

Next, in order to compare the level of monetary amount disputed in the appraisal litigation in Japan and the U.S., we have studied 46, out of above 54, cases in Japan where data were available and 25, out of above 34, cases in Delaware. Figure 7 compares the distribution of the total award amount, that is, the amount determined by multiplying the number of claimed shares by the decision price. For comparison, the exchange rate of 1 dollar = 110 yen was applied. According to this analysis, most cases in Japan award less than 100,000 dollars, while most cases in Delaware award more than 10 million dollars. The median value in Japan was 391,000 dollars, while the median value in Delaware was 43,705,000 dollars. In Japan, the highest amount was awarded in the *Rakuten v. TBS*[14] at about 445 million dollars and in Delaware the highest amount case was *Merion Capital, LP et al., v. 3M Cogent, Inc.*[15] at about $963 million.

[14] The Tokyo District Court Decision, March 5, 2010, Kinsho 1339, p. 44

[15] Merion Capital, LP et al., v. 3M Cogent, Inc., CA 6247-VCP (Del. Ch. 2013)

Figure 7: Comparison of total award amount in Japan and Delaware



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5. Future outlook

As we have seen above, there is a common trend in recent years of placing weight on the merger price in appraisal litigation both in Japan and Delaware courts. This trend has been supported by the Supreme Court decisions in the both jurisdictions, namely the *Jupiter Telecom* decision in Japan and the *Dell* and *DFC Global* decisions in Delaware, which made clear the idea that the price agreed between the parties is acceptable as the fair price if the process leading to the transaction is generally regarded as fair.

On the other hand, there are some differences between court decisions in Japan and Delaware. The *Jupiter Telecom* decision in Japan did not necessarily provide details as to how to assess “the generally accepted fair procedure" that the Supreme Court specifically referred to. The succeeding decisions has not yet fully answered the question. For example, in multiple recent cases the court admitted the fair procedure simply because the tender offer price is within the range provided by the third-party valuation firm[16]. With these as a background, there is a simplified understanding that valuation topic is no longer important as long as the formality such as the independent committee and the third-party valuation firm is in place for the court to admit the “generally acceptable fair procedure”.

On the other hand, the Delaware Supreme Court decision in *Golden*

[16] The Osaka District Court Decision Heisei 29 January 18, 2016 Kinsho 1520, page 56, Shizuoka Chi decision October 7, 2016 Westlaw Japan, etc.

Telecom ruled that "(r)equiring the Court of Chancery to defer—conclusively or presumptively—to the merger price, even in the face of a pristine, unchallenged transactional process, would contravene the unambiguous language of the statute and the reasoned holdings of our precedent" and that it would inappropriately shift the responsibility to determine "fair value" from the court to the private parties[17]. Succeeding court decisions including those in *Dell* and the *DFC Global* follow this principle and rigorously examine the sales process and valuation methodologies even if merger price is finally adopted as the fair price.

In June 2019, Japan's Ministry of Economy, Trade and Industry published "Fair M&A Guidelines" that intends to present fundamental ideals and practical measures based on these ideals to ensure fairness in M&A deals[18]. We believe that Japanese courts and parties will use this guideline in future when they verify if the sales process is truly fair beyond its formality. If so there will be more substantive discussions about the price formation processes and more vibrant debate about the valuation approaches and results, leading to more diversified decisions on the fair value.

End

[17] Golden Telecom, Inc. v. Global GT LP, 11 A.3d at 217.

[18] https://www.meti.go.jp/english/press/2019/0628_004.html

About the Author

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As economic expert in litigation, Ikeya has provided expert witness and consulting services in domestic and international litigation and arbitration on matters of commerce, securities and finance, anti-trust, intellectual property, and tax. He has also provided advisory and consulting services on matters related to antitrust, international trade, transfer pricing, M&A, etc. Ikeya previously served as Managing Director at Deloitte Tohmatsu Financial Advisory LLC's Valuation, Modeling, and Economics department. He also served as Executive Director at AlixPartners and Vice President at NERA Economic Consulting. lkeya holds a Master of International Affairs, with a concentration in international finance and business, from Columbia University, and BA in economics from Sophia University, Japan.

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