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Flaws in North Carolina Court's Appraisal of Reynolds American

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In 2017, British American Tobacco plc (BAT), which owned approximately 42% of the shares of Reynolds American Inc. (RAI), acquired the remaining 58% in exchange for a package of BAT shares and cash. A transaction committee consisting of seven independent directors negotiated the merger for RAI. "Under the Governance Agreement [between RAI and BAT], any material contract or transaction between BAT and RAI required the approval of a majority of the seven independent directors not designated by BAT."[1]

The holders of 9,641,911 RAI shares dissented from the merger with BAT and sought appraisal under North Carolina law. There are no precedential appraisal cases in North Carolina, but the definition of "fair value" under North Carolina law is similar to the definition under Delaware law.[2] The trial court cited numerous Delaware decisions and concluded that the fair value of the shares seeking appraisal was not more than $59.64 per share ($575 million in the aggregate).[3] This article critiques certain of the trial court's conclusions.

BAT Was Not Deemed to Be a Fiduciary

In litigation regarding a prior acquisition by RAI, plaintiffs claimed that BAT owed fiduciary duties to the other RAI stockholders. The North Carolina Supreme Court overruled a unanimous Court of Appeals decision and ruled by a 4-3 vote that, as a consequence of the Governance Agreement, BAT was not a fiduciary.[4] The majority decision concluded, "In several ways, the Governance Agreement placed 'contractual handcuffs' on BAT that prevented it from controlling the Reynolds board."[5]

The Valuation Date Should Be the Closing Date

In its appraisal decision, the court based its valuation of RAI on the transaction price. It concluded that "the fair value of RAI stock as of the Transaction Date was no more than the deal price of $59.64 per share."[6] However, the decision valued RAI at the wrong date.

The terms of the deal announced on Jan. 17, 2017, provided that RAI shareholders would receive, for each share, 0.526 shares of BAT and $29.44 in cash. On the announcement date, the value of the consideration was $59.64 per share,[7] the price that the court cites in its conclusion. However, the North Carolina appraisal statute requires that fair value in an appraisal proceeding

1 *Reynolds American Inc. v. Third Motion Equities Master Fund Ltd.*, 2020 WL 2029621, 2020 NCBC LEXIS 56 (N.C. Super., Apr. 27, 2020) at ¶ 82. Under North Carolina law, the company is the plaintiff in an appraisal case. A digest of the case and the court's opinion are available at *BVLaw* at bvresources.com/products/bvlaw.

2 *Compare* N.C.G.S. § 55-13-01(5) *with* 8 Del. C. § 262(h).

3 Id. at ¶ 304.

4 *Corwin v. British Am. Tobacco plc*, 821 S.E.2d 729, 743 (N.C. 2018).

5 Id. at 739.

6 *Reynolds American* at ¶ 384.

7 Id. at ¶ 173.

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is to be determined as of the closing date of the merger,[8] not the announcement date.

The merger closed on July 27, 2017, and that date (rather than January 17) is thus the statutorily mandated valuation date, as the court itself pointed out.[9] Between January 2017 and July 2017, the market trended upward, and BAT's market price had risen along with the market. The package of BAT stock and cash offered to RAI shareholders was worth $65.84 per share at the close of the market on July 27, the closing date. For the dissenting shareholders, the aggregate value of the $6.20-per-share difference between the "deal price" valuation the court used and the actual value of the deal at closing exceeds $60 million.

The company might argue that the increase in BAT's price included appreciation in anticipation of the merger, but this position would be difficult to sustain. The price of BAT in relation to the FTSE 100 (the principal London Stock Exchange index) on the date that BAT originally proposed acquiring the publicly held shares (Oct. 9, 2016) was virtually the same on the closing date. Thus, it would be reasonable to conclude that the upward movement in BAT's stock price was attributable to the upward move in the market as a whole.

Flawed Reliance on Other Cases

The court ruled: "In this case, there are numerous objective indicia of a robust deal process that led to a deal price that reliably reflected RAI's fair value."[10] It added that, "under the circumstances present here, even without more aggressive outreach and a competitive auction, the resulting deal price is reliable evidence of RAI's fair

8 Id. at ¶ 313; N.C.G.S. § 55-13-01(5) (defining "fair value" for purposes of appraisal as, among other things, the value of the corporation's shares "immediately before the effectuation of the corporate action [i.e., the merger] as to which the shareholder asserts appraisal rights").

9 Id. at ¶ 373.

10 Id. at ¶ 332.

value."[11] The decision cites several Delaware appraisal decisions in support of its conclusion; however, some of these Delaware decisions tend to undercut—rather than support—the court's conclusions regarding the RAI sale process.

The court observed that, "although the Transaction Committee did not solicit other buyers or engage in an auction process, no third-party bidders expressed interest or submitted a bid during the Merger negotiations or in the six-month post-agreement signing period despite widespread public awareness of BAT's October 20 offer soon after it was made."[12] It took this fact as proof that the transaction price was fair and quoted the Delaware Supreme Court's decision in *Dell:*

> The failure of any other party to come forward provides significant evidence of fairness, because "[f]air value entails at minimum a price some buyer is willing to pay—not a price at which no class of buyers in the market would pay."[13]

The facts in *Dell* were materially different than in this case. In that case, Mr. Michael Dell, the founder of Dell Inc., along with a financial sponsor, proposed (and ultimately concluded) a management buyout, but third parties were free to bid. The Delaware Supreme Court observed, "Michael Dell only had approximately 15% of the equity. He pledged his voting power would go to any higher bidder, voting in proportion to other shares."[14] There was no impediment whatever to a competing bid for Dell by a third party because Michael Dell had expressed his willingness to sell to any higher bidder.

In contrast, the RAI court's opinion recognized that the proxy statement for the transaction expressly stated that "BAT is interested only in acquiring the shares of [RAI] not already owned by BAT[,] and … BAT has no interest in selling any of the [RAI] shares it owns, nor would BAT support any alternative sale, merger or similar transaction involving [RAI]."[15] In contrast to Michael Dell, BAT was unwilling to sell at any price, regardless of whether a competing bidder was willing to value RAI higher than BAT did. Since BAT owned 42% of RAI and expressly refused to sell its stake, it was extremely unlikely that any other entity would have seriously considered making a hostile bid.

The RAI decision quoted a financial advisor's internal email that said, "[I]n a different world where BAT did not own its stake [Japan Tobacco] would have made a play for RAI."[16] Any third party would know that the size of BAT's holding made it virtually impossible for a competitive bidder to obtain control. Therefore, the absence of any third-party bidder was predictable; it was not indicative of a process that served as a reliable proxy for fair value.

An additional problem is that BAT had inside information with respect to RAI that was not made available to the market or to any third party. The decision observed that "BAT assessed RAI's value having access to extensive public information about the Company as well as confidential, nonpublic information shared at regular RAI Board meetings."[17] The court cited a recent Court of Chancery decision and the Delaware Supreme Court decision in *DFC Global* that had discussed the availability of nonpublic information to prospective buyers as confirmatory of the fairness of the deal price.[18] However, those two cases differed substantively; in both, the buyers were unrelated third parties, not insiders, and the

11 Id. at ¶ 347.

12 Id. at ¶ 338.

13 Id., quoting *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd*, 177 A.3d 1, 29 (Del. 2017).

14 *Dell* at 30.

15 Id. at ¶ 108.

16 Id. at ¶ 339.

17 Id. at ¶ 336.

18 Id. at ¶336, citing In *re Panera Bread Co.*, 2020 WL 506684 (Del. Ch. Jan. 31, 2020) at *18, and *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346, 349 (Del. 2017).

purpose of providing this information was to induce them to pay a higher price in a competitive environment.

The court cited *DFC Global* as "noting that deal price was 'informed by robust public information[ ] and easy access to deeper, non-public information.'" This truncated quote fails to convey the concept of the sentence in the *DFC Global* opinion from which it is excerpted:

> Although there is no presumption in favor of the deal price, under the conditions found by the Court of Chancery, economic principles suggest that the best evidence of fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, **in which many parties with an incentive to make a profit had a chance to bid**."[19] [emphasis added]

The court also observed, "RAI was able to extract four price increases from BAT during the course of the Merger negotiations. These increases—from $56.50 to $59.64 per share [5 1/2%]—resulted in an additional $4.5 billion for RAI's shareholders."[20] This fact does not negate the absence of any effort to shop RAI to third parties. In related-party transactions, the initial bid seldom is the final price, and it is common practice to start with a bid that leaves room for negotiation. The RAI opinion cited *Dell* and two recent Court of Chancery cases where increases in the deal price were considered as supporting deal price as fair value.[21] The two Chancery cases differ from the RAI deal in that they were arm's-length transactions. *Dell* was open to a competing bid; the independent directors were able to negotiate a deal price that was 15% above the top end of the initial proposal.[22]

DCF: Terminal Value Ignored RAI's 10-Year Projection.

The court gave no weight to comparable companies in determining fair value.[23] It considered only one comparable transaction, RAI's acquisition of Lorillard two years earlier, which it said "provide[d] support that the deal price is a reliable indicator of the fair value of RAI's shares as of the Transaction Date."[24]

The court viewed DCF as confirmatory of its fair value determination. It did not rely on the expert witnesses' DCF calculations, but it "conclude[d] that the DCF analyses performed by the Financial Advisors [involved in the transaction] were reliable and constitute persuasive evidence that the fair value of RAI's shares as of the Transaction Date was at or below the deal price of $59.64 per share."[25] The three major investment banks that were engaged as financial advisors prepared these DCF analyses; one advised the transaction committee, and two were advisors to RAI.

The court observed, "In the Financial Advisors' DCF analyses, the vast majority of the total value of RAI was comprised by the terminal value."[26] The growth rates used for determining terminal value were a substantive issue in the case.

RAI developed financial projections monthly covering the year in progress and the next two years. Once a year, it produced a strategic plan that included "projections for the current year plus nine years, providing quarterly projections for the current year and the next two years and more generalized annual projections for the remaining

19 *DFC Global* at ¶349.

20 *Reynolds American* at ¶337.

21 Id. at ¶337, citing *Panera* at *35, and *In re Appraisal of Columbia Pipeline Group, Inc.*, 2019 WL 3778370 (Del. Ch. Aug. 12, 2019) at *23.

22 The initial proposal was a range of $11.22 to $12.16; the final deal was $13.75 plus a $0.21 dividend.

23 Id. at ¶ 368.

24 Id.

25 Id. at ¶ 363.

26 Id. at ¶ 265.

years."[27] The June 2016 plan projected a compound annual growth rate of 7% to 8% for years six through 10.[28]

The court said, "The fact that extrapolations provided the most fundamental inputs to years six through ten of the ten-year projections was not contradicted."[29] However, RAI's financial advisors had elected not to use the company's projections for years six to 10. They concluded that the company's long-term growth would be close to zero, and each of them chose to determine terminal value by applying this assumption from year six rather than a later date. They dropped the growth rate sharply in year six rather than tapering it off. Two of them used a perpetual growth range of -0.5% to +0.5%, and the third used 0% to +1%.[30] The midpoints of their DCF values at the announcement date were $55.74, $59.59, and $56.26 per share, respectively, and the highs were $72.17, $73.38, and $68.63, respectively.[31]

The court accepted the financial advisors' approach and rejected the dissenters' position:

> [Dissenters' expert] further testified that it was inappropriate to calculate a PGR [perpetual growth rate] of 0% after 2021 (five years), as the Financial Advisors did, when the Company projected robust growth through 2026. [His] PGR analysis ignores, however, the substantial evidence showing that these ten-year projections were not intended to create a probability-weighted value of future cash flows, disregarded significant assumptions and sensitivities that could dramatically impact RAI's business, and were largely extrapolations of current industry trends and dynamics without substantial change. And [he] **ignores that a 0% PGR can represent continued but slowing growth for a period followed by a plateau and then negative growth in the future to balance out the positive growth in the earlier years**. [emphasis added][32]

The highlighted sentence above appears not to recognize the differing mathematical impact on terminal value of a positive growth rate followed by negative growth versus a zero growth scenario, even if growth "balances out" over the long term. A dollar in year six is worth more than a dollar in a later year. Smaller longer-term numbers only partially negate the present value of the higher earlier numbers; thus, positive growth in the earlier years necessarily results in a higher terminal value.

Conclusion

North Carolina law provides that a "mandatory complex business case" can be appealed directly to state's Supreme Court.[33] Given the clear error in the valuation date, an appeal by the dissenters appears inevitable. If there is no settlement, it will be interesting to see how the North Carolina Supreme Court rules on this issue and on the other issues in this matter.

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27 Id. at ¶ 138.

28 Id. at ¶ 149.

29 Id. at ¶ 142.

30 Id. at ¶ 243.

31 Id. at ¶ 243. The investment bank using a slightly higher growth rate arrived at lower DCF values because it used a higher cost of capital.

32 Id. at ¶ 280.

33 N.C.G.S. § 7A-27(a)(2).