

Client Alert

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M&A Appraisal: DE Supreme Court Reverses *Dell* Decision, Holding That Deal Price Deserves Significant Weight

The Delaware Supreme Court recently issued its highly awaited decision in Dell Inc.'s appraisal litigation, reversing the Court of Chancery's appraisal valuation and disagreeing with the lower court's calculations to determine a fair price for Dell's stock without assigning weight to the negotiated deal price.¹ The decision indicates that Delaware courts will give the deal price "heavy, if not dispositive, weight" in an appraisal action when there is an efficient stock market and a competitive and open bidding process for the sale of the company.

Background

The *Dell* case traces back to 2013, when Dell Inc. ("Dell") founder Michael Dell partnered with private equity firm Silver Lake Partners to finance a management buyout (an "MBO") of the struggling computer company. Silver Lake Partners ultimately offered a price of \$13.75 per share, a bid that had increased six times during negotiations and that represented a 37 percent premium to the company's 90-day average unaffected stock price. This bid was approved by 57 percent of Dell's stockholders.

Unsatisfied former stockholders exercised their statutory appraisal rights under Delaware law, which allow stockholders to petition the court to receive "fair value" for their shares instead of the deal consideration. The appraisal process requires the Court of Chancery to assess the fair value of the shares by taking into account "all relevant factors."

In a post-trial ruling by Vice Chancellor J. Travis Laster, the Court of Chancery determined that it would not assign weight to the deal price in its appraisal and would instead use its own discounted cash flow ("DCF") method.² The lower court used its DCF method to reach a fair value calculation of \$17.62 per share, implying that the MBO had undervalued Dell by nearly \$7 billion.

In his opinion, Vice Chancellor Laster cited three main reasons for his decision not to assign weight to the deal price: (i) there was a "valuation gap" between Dell's stock trading price and its true value; (ii) Dell's primary bidders were financial buyers driven by their own internal rate of return goals; and (iii) MBOs have features that may undermine the probative value of the deal price by creating a disincentive to potential bidders.

The Supreme Court's Opinion

The Supreme Court held that the lower court had erred in not assigning weight to the deal price, which the Supreme Court found, based on the trial court record, "deserved heavy, if not dispositive, weight."

In its analysis, the Supreme Court addressed each of the three main problems the lower court had

¹ *Dell v. Magnetar Global Event Driven Master Fund Ltd. et al.*, No. 565, 2016 (Del. Dec. 14, 2017).

² *In re Appraisal of Dell, Inc.*, C.A. No. 9322-VCL (Del. Ch. 2016).

identified with the sale process that contributed to its decision not to rely on market-based value indicators.

1. **Valuation gap:** The Supreme Court disagreed that there was a valuation gap between the true value of the company and its sale price. The Court of Chancery had found that short-sighted analysts and stockholders were focused overwhelmingly on Dell's short-term profit and were thus undervaluing the stock. The Supreme Court disagreed, citing the efficient market hypothesis, which holds that the price produced by an efficient market is a reliable assessment of fair value. The record showed that the market responded quickly to new information about Dell, there were over 30 analysts covering the company, and the public was actively trading Dell stock.
2. **Lack of strategic bidders:** The Court of Chancery's decision relied in part on the fact that the primary bidders in the pre-signing phase of Dell's sale process were financial buyers focused on achieving certain returns rather than on the intrinsic value of Dell. Affirming its statements from its recent *DFC Global Corp.* decision, the Supreme Court held that there is no "rational connection" between a buyer's status as a financial buyer and the question of whether a deal price is fair, considering that both strategic and financial buyers are ultimately seeking a return on equity.³ The Supreme Court also noted that Dell had canvassed the interest of 67 parties during the post-signing go-shop phase of its sale process, including 20 strategic buyers who decided not to bid or dropped out due to doubts about the personal computer market and Dell's chances of success. As the Supreme Court stated, "if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one."
3. **Structural problems related to MBOs.** The Court of Chancery found that in MBOs, the management-bidder typically has more information about the company than other bidders. This theory, called the "winner's curse," suggests that other bidders may be reluctant to outbid the management-bidder, believing that management would pay more if the company were worth it. The Supreme Court, however, found that Dell had mitigated the likelihood of the winner's curse through its extensive due diligence process. The Supreme Court also disagreed with the lower court's holding that Mr. Dell's value to the company was so great that the MBO discouraged potential rival bidders from trying, the idea being that the bidders would not want the company if Mr. Dell were to leave. The record showed that other bidders did not regard Mr. Dell as essential to their bids and had even investigated possible replacements for him. In addition, Mr. Dell did nothing to suggest he would not remain with the company if his bid lost and had shown good faith in working with other potential buyout groups.

The Supreme Court remanded the case to the Court of Chancery, giving it the discretion to either enter judgment at the deal price or weigh "a variety of factors in arriving at fair value" based on reasoning "that is consistent with the record and with relevant, accepted financial principles."

Conclusion

The Supreme Court has declined to create a mandatory rule or presumption in favor of the deal price in appraisal cases. Consistent with the Supreme Court's recent ruling in *DFC Global*, however, the *Dell* decision indicates that Delaware courts will give the deal significant weight when generated from a fair sale process allowing the market to establish the value of the company.

³ *DFC Global Corp. v. Muirfield Value Partners, L.P., et al.*, C.A. No. 10107 (Del. Aug. 1, 2017).

Throughout its opinion, the Supreme Court emphasized the open, competitive bidding process Dell had created. For example, the Supreme Court highlighted Mr. Dell's good faith and willingness to work with other buyers while pursuing an MBO; the company's creation of a special committee of independent directors which had exclusive authority to negotiate and recommend a transaction; a negotiation record in which the special committee got the winning bidder to increase its bid six times; the extensive due diligence offered by Dell; and the actions of the company during the go-shop period in canvassing 67 potential bidders. If the reward for adopting best practices such as Dell did is to risk the court's adding a premium to the deal price based on DCF analysis, the Supreme Court rationalized, the incentive to adopt best practices will be greatly reduced.

The *Dell* decision also cautions against courts' reliance on DCF analyses in appraisals when there is credible market information available. Although Delaware courts have long favored DCF analyses, a DCF analysis involves many different inputs and a fair amount of discretion, which the *Dell* Supreme Court said landed the expert witnesses' fair value determinations "on different planets." Ultimately, when the market is efficient and the seller has utilized best practices throughout the bidding process, the Supreme Court seems to view the price at which the company is sold as a very strong indicator of what the company is worth. As the Supreme Court stated, "[w]hen an asset has few, or no, buyers at the price selected, that is not a sign that the asset is stronger than believed—it is a sign that it is weaker. This fact should give pause to law-trained judges who might attempt to outguess all of these interested economic players with an actual stake in a company's future."

Lastly, private equity buyers should take increased comfort from the *Dell* decision. After the Court of Chancery's decision, there was concern that private equity buyers were assuming more appraisal risk given the lower court's views on internal rates of return relative to intrinsic value and the effects MBOs may have on competitive bidding. While acknowledging the contextual nature of the inquiry, the Supreme Court rejected those concerns as creating any general presumptions in appraisal proceedings resulting from private equity buyouts.

Contacts

Steven M. Haas
shaas@hunton.com

Meghan Garrant
mgarrant@hunton.com

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