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In re Appraisal of Dell Inc.: The Continuing Relevance of Deal Price in Delaware Appraisal Proceedings

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In a recent opinion, *In re Appraisal of Dell Inc.*, the Delaware Court of Chancery awarded the appraisal petitioners fair value for their shares well in excess of the price paid to the other public stockholders of Dell Inc. when it was acquired via a management-led buyout in 2012. Immediately following this decision, some practitioners noted that it broke with several recent appraisal opinions in which the Court of Chancery adopted the merger consideration as the best evidence of fair value and expressed concerns that *Dell* might signal a shift in Delaware appraisal law away from deferring to a negotiated merger price in appraisal cases. A closer review of the decision, however, indicates there is no cause for alarm. While the *Dell* court did not ultimately defer to the merger consideration, the opinion's thorough analysis of the underlying deal process should be read as affirming that Delaware courts will continue to routinely and carefully consider merger price in appraisal proceedings and "often," but not always, find that such price is representative of fair value. At most, *Dell* establishes that MBOs present special issues in the appraisal context and warrant careful consideration by the court when deciding whether the deal price should influence its determination of fair value.

Statutory and Decisional Law Regarding Delaware Appraisal Proceedings

Section 262 of the DGCL provides stockholders who did not vote in favor of a cash out merger a right to have the "fair value" of their shares determined by the Court of Chancery by way of an appraisal proceeding. In determining fair value, the court must consider "all relevant factors" and exclude "any element of value arising from the accomplishment or expectation of the merger. . . ." Fair value in the appraisal context has been interpreted by the Delaware Supreme Court as "the value of the company to the stockholder as a going concern." In practice, the appraisal statute gives the Court of Chancery broad discretion in determining the fair value of the shares at issue and the court may choose to accept a valuation submitted by either party or make its own independent determination of fair value.

For the past two decades, Delaware courts have considered, to varying degrees, the deal price as a relevant factor and in a number of cases have found it to be the best indicator of a company's going concern value. In *Union Illinois 1995 Investment Limited Partnership v. Union Financial*, decided in 2003, then-Vice Chancellor Strine gave 100 percent weight to the price resulting from an auction of Union Financial Group (UFG). In finding that the merger consideration was the best indication of fair value, then-Vice Chancellor Strine noted that UFG "was marketed in an effective manner, with an active auction following the provision of full information to an array of logical bidders." Relying on the merger consideration as the sole evidence of fair value was appropriate, according to the court, because the merger resulted from an effective process with third-party bidders, as opposed to a squeeze-out merger, and the process had no material flaws. The court gave no weight to the expert-generated discounted cash flow (DCF) analyses, finding that method inferior to the value resulting from the sale process undertaken by UFG. Accordingly, the court found fair value to be the merger price less the value of merger-related synergies.

Between 2003 and 2010, the issue of merger consideration influencing the Court of Chancery's determination of fair value was addressed in a handful of appraisal cases. In *Highfields Capital Ltd. v. AXA Financial Inc.*, for example, the court gave significant weight to the merger price because it found that the merger, consistent with *Union Illinois*, "resulted from an arm's length bargaining process where no structural impediments existed that might prevent a topping bid." On the other hand, in *Global GT LP v. Golden Telecom, Inc.*, the court rejected the argument that the merger price was a reliable indicator of fair value because the special committee formed by the target's board had not engaged in any efforts to sell the company, but had instead "concentrated solely on getting as good a deal as it could" from the acquirer. The court therefore accorded no weight to the merger process and instead relied upon a DCF analysis to determine fair value. On appeal, the Delaware Supreme Court affirmed. In its affirming opinion, the Supreme Court declined to adopt a presumption that merger price is indicative of fair value in appraisal proceedings, reasoning that "requiring the Court of Chancery to defer . . . to the merger consideration would contravene the unambiguous language of the statute"—which requires the court to consider "all relevant factors"—and would "inappropriately shift the responsibility to determine 'fair value' from the court to private parties." Some post–*Golden Telecom* opinions, such as *Merion Capital v. 3M Cogent*, appeared to read *Golden Telecom* as diminishing the relevance of the negotiated merger price to the determination of fair value in the appraisal context.

More recently, however, the Court of Chancery issued a string of opinions in which it substantially, if not entirely, relied upon the merger price in determining fair value. The first of these opinions, *Huff Fund Investment P'Ship v. CKx, Inc.*, described the court's task, post–*Golden Telecom*, as deciding which recognized method of valuation provides the most reliable evidence of fair value. Those methods, according to the *Huff* court, are the DCF method, a comparable companies analysis, a comparable transactions analysis and the merger price itself "so long as the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded." The *Huff* court ultimately determined that, in that case, the DCF and comparable companies and transactions analyses could not be relied upon as accurate indicators of fair value of the acquired company and that the merger price was the best, and indeed only, accurate evidence of fair value. Subsequently, in *Merlin Partners LP v. Autoinfo, Inc.*, *Longpath Capital, LLC v. Ramtron Int'l Corp* and *Merion Capital LP v. BMC Software, Inc.*, the court relied primarily on the merger consideration to determine fair value after finding that other methods employed by the parties' experts to value the targets, most prominently the DCF method, were flawed or contained uncertainties. Importantly, in each of these cases, the Court also found no reason for concern in relying upon the merger price given the evidence regarding the effectiveness of the processes leading to the transactions at issue. In yet another case—*In re Appraisal of Ancestry.com*—the court gave great weight to the merger consideration, even though it found the DCF method reliable, based upon its view that the sale process was "reasonable, wide-ranging and produced a motivated buyer." The *Ancestry* court also relied upon its earlier dismissal of a complaint challenging the transaction as a breach of the target board's fiduciary duties but noted that "a conclusion that a sale was conducted by directors who complied with their fiduciary duties is not dispositive of the question of whether that sale generated fair value."

The *Dell* Decision

As noted above, in *Dell*, the court declined to rely upon the merger price of $13.75 per share as an indicator of fair value, relying instead upon a DCF analysis that indicated fair value was $17.62 per share, a 28 percent difference. The fact that the transaction was a management buyout, led by Michael Dell the founder and longtime CEO of the company, featured prominently in the court's consideration of the deal price as evidence of fair value. Citing the "vast amount of case law and scholarship" addressing MBOs, the court opined that "a claim that the bargained-for price in an MBO represents fair value should be evaluated with greater thoroughness and care than, at the other end of the spectrum, a transaction with a strategic buyer in which management will not be retained." With that framework in mind, the court thoroughly analyzed the process, finding the following aspects of both the pre- and post-signing phases undercut the reliability of the deal price as an indicator of fair value: (1) the heavy influence of the LBO pricing model on the bidding process; (2) lack of meaningful competition among prospective bidders; and (3) evidence of a significant gap between the company's intrinsic value and the market's perception of the company's value.

The LBO pricing model is employed by financial sponsors to "determine whether and how much to bid" when proposing a leveraged buyout, like an MBO, and "solves for the range of prices that a financial sponsor can pay while still" achieving its target internal rate of return (IRR). According to the court, the range of prices resulting from an LBO model can differ significantly from fair value because of both the financial sponsor's need to achieve significant IRRs and "limits on the amount of leverage that the company can support and the sponsor can use to finance the deal." During the pre-signing phase, the committee handling the merger negotiations on behalf of Dell's board engaged with only financial sponsors, meaning that the "price negotiations during the pre-signing phase were driven by the financial sponsors' willingness to pay based on their LBO pricing models rather than the fair value of the Company." Indeed, the committee's financial advisors advised the committee that the financial sponsors involved in the process would determine their offering prices based upon their LBO models and that a going concern (DCF) analysis using the same inputs indicated a higher range of prices for the company. Accordingly, the court found that because the merger consideration resulting from the pre-signing phase of the process was "dictated by what a financial sponsor could pay and still generate outsized returns," it necessarily "undervalued the Company as a going concern."

The *Dell* court also found a lack of meaningful competition among bidders during the pre-signing phase of the transaction. As noted above, the committee engaged with only financial sponsors during the pre-signing phase of the process and did not contact any strategic bidders. Involving strategic bidders would have not only meant additional parties submitting bids, but would also have introduced into the process an alternative form of transaction to the LBOs proposed by the financial bidders. The lack of such competition, according to the court, deprived the committee of a more meaningful bidding process, the "most powerful tool" a committee has to extract value from a potential acquirer. The court found the lack of pre-signing competition especially problematic here because post-signing market checks "rarely produce topping bids" in the MBO context, due in part to the reluctance among larger private equity sponsors to interfere with each other's signed deals. Given the "critical" nature of the price established in the pre-signing phase of MBO transactions, the limited competition during this phase of the Dell process further undermined the reliability of the deal price as evidence of fair value.

Finally, the court found that the price generated by the pre-signing phase was negatively impacted by a "valuation gap between the market's perception and the Company's operative reality." Over a period of several years, the company had spent approximately $14 billion to acquire several businesses that Michael Dell believed would complete the company's transformation from primarily a producer of personal computers to a provider of software and services to enterprise customers. But because, as of the pre-signing phase, this transformation had yet to bear fruit in the form of operating results, these expected results were not reflected in Dell's market price. The court found ample evidence of such a gap, including that the committee's advisors determined the standalone value of the company was well above Dell's trading price. Relying on precedent, the court noted that appraisal proceedings can and should address opportunistic timing and found that the evidence of the valuation gap was so compelling in this case that it further served to weaken the case for accepting the merger consideration as evidence of fair value.

The court also found flaws in the post-signing phase of the transaction that undercut the reliability of the merger consideration as fair value. The deal reached with the management group provided for a 45-day go-shop. Despite the go-shop having attracted two higher bids and caused a $0.10 per share increase in the merger consideration, the *Dell* court found structural issues with the go-shop such that it could not remedy the pre-signing deficiencies. According to the court, the emergence of two additional bids, which it acknowledged are rare in the context of MBO go-shops, indicated the original merger consideration undervalued the company, even using LBO metrics. The court also found that although the go-shop may have been adequate in the abstract, the size and complexity of the company itself made the diligence necessary to submit a topping bid foreboding. The court found that the magnitude of such a task likely had a chilling effect on potential bidders. The court expressed further concerns about the value-reducing impact of a "winner's curse;" that is, the perception that a bid above the price management had agreed to pay meant that the bidder was paying more than management, with its superior knowledge, thinks the company is worth. In addition, the court noted that any potential buyer faced a unique problem in potentially purchasing Dell without Mr. Dell's full participation post-acquisition. The court indicated that it, and likely other potential bidders at the time, believed that if Mr. Dell left the company after a sale, the company would lose significant value, as it had in the past when Mr. Dell temporarily left the company. Mr. Dell's unique role was considered another impediment to potential bidders during the go-shop period.

In light of these findings regarding the pre- and post-signing process, the court declined to give any weight to the merger consideration in determining the fair value of Dell. The court instead found that a DCF analysis, based on projections the court found reliable, was the best indicator of fair value.

Conclusion

Dell does not appear to signal a shift in Delaware appraisal jurisprudence. As the *Dell* court recognized, Delaware courts are required to consider the deal price as one of the relevant factors in determining fair value, and, importantly, will "often" find the merger consideration is the best evidence of fair value, particularly where the merger consideration results from a robust sale process in which the board negotiates with potential bidders at arm's length. *Dell* does, however, indicate that MBO transactions will be subject to more rigorous scrutiny in the context of appraisal proceedings and, given certain inherent realities, may be less likely to be found to have produced a price equal to fair value. Even so, *Dell* does not foreclose a finding that the deal price in an MBO transaction equals fair value.

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