Delaware Supreme Court Reverses Court of Chancery's Dell Appraisal Decision: "Deal Price Deserved Heavy, If Not Dispositive, Weight"

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On December 14, 2017, in a much-anticipated decision in the appeal from the Court of Chancery's above-deal price appraisal of Dell Inc.'s stock following a buyout of the company by its founder and a private equity firm, the Delaware Supreme Court, sitting *en banc*, held that the Court of Chancery, which had given no weight to the $13.75 per share deal price and instead used exclusively a discounted cash flow analysis to find that the fair value of Dell was $17.62 per share (or 28 percent higher than the deal price), "erred in not assigning any mathematical weight to the deal price"[2] because "the record as distilled by the trial court suggest[ed] that the deal price deserved heavy, if not dispositive, weight."[3]

The Supreme Court's *Dell* opinion caps a noteworthy seven years of appraisal jurisprudence since its 2010 decision in *Golden Telecom Inc. v. Global GT LP*,[4] in which the Court rejected the respondent corporation's request that Delaware courts employ "a standard requiring conclusive or, in the alternative, presumptive deference to the merger price in an appraisal proceeding," at least where that price resulted from a "pristine, unchallenged transactional process."[5] While the Delaware courts historically had relied on the deal price as evidence of fair value of appraised stock when the sale process leading to the transaction was robust and free of fiduciary misconduct,[6] following *Golden Telecom*, opportunistic hedge funds increasingly utilized statutory appraisal proceedings as a form of investment strategy, purchasing substantial blocks of shares in publicly traded target corporations after the announcement of mergers for the purpose of pursuing appraisal and attempting to secure fair value awards significantly above the deal price by proffering litigation-driven DCF valuations employing aspirational sale-case financial projections and questionable assumptions made or altered by their experts. But, notwithstanding this rise of "appraisal arbitrage," which resulted in a significant increase in appraisal litigation in the Court of Chancery, the court largely continued the practice of relying on the deal price as the primary or sole evidence of fair value of appraised stock when that price resulted from arm's-length negotiations in an open market.[7]

In *DFC Global Corp. v. Muirfield Value Partners, L.P.*,[8] an appeal from one of the few decisions in which the Court of Chancery did not rely heavily on the deal price for its fair value determination, the Supreme Court reversed the trial court's above-deal price appraisal award, holding that it abused its discretion by giving only one-third weight to the deal price despite finding that the sale process was robust and free of conflicts of interest.[9] In so holding, the Supreme Court confirmed that the Court of Chancery should give significant (if not dispositive) weight to the deal price in such circumstances.[10] The Supreme Court explained that, "[a]lthough 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."[11] Pertinently, the Court rejected the trial court's two principal reasons for not affording more weight to the deal price—the facts that the company "faced increasing regulatory constraints that could not be priced by equity market participants" and that "the prevailing buyer was a private equity rather than strategic buyer"[12]—explaining that there was no evidence in the record to suggest that market participants could not price the regulatory risk facing the company and that "all disciplined buyers, both strategic and financial, have internal rates of return that they

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[2] In re Appraisal of Dell Inc., 2016 WL 3186538, at *1 (Del. Ch. May 31, 2016) ("Dell I").

[3] Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd, 2017 WL 6375829, at *16 (Del. Dec. 14, 2017) ("Dell II").

[4] 11 A.3d 214 (Del. 2010).

[5] Id. at 217-18.

[6] See, e.g., Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340 (Del. Ch. 2004).

[7] See, e.g., In re PetSmart, Inc., 2017 WL 2303599 (Del. Ch. May 26, 2017); Merion Capital L.P. v. Lender Processing Servs., Inc., 2016 WL 7324170 (Del. Ch. Dec. 16, 2016); Merion Capital LP v. BMC Software, Inc., 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); LongPath Capital, LLC v. Ramtron Int'l Corp., 2015 WL 4540443 (Del. Ch. June 30, 2015); Merlin P'rs LP v. AutoInfo, Inc., 2015 WL 2069417 (Del. Ch. Apr. 30, 2015); In re Appraisal of Ancestry.com, Inc., 2015 WL 399726 (Del. Ch. Jan. 30, 3015); Huff Fund Inv. P'ship v. CKx, Inc., 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

[8] 172 A.3d 346 (Del. 2017).

[9] Id. at 372.

[10] Id. at 349.

[11] Id.

[12] Id. at 362.

expect in exchange for taking on the large risk of a merger" and a buyer's focus "on hitting its internal rate of return has no rational connection to whether the price it pays as a result of a competitive process is a fair one."[13] In remanding the case, the Supreme Court instructed the trial court to "reassess the weight [it] chooses to afford various factors potentially relevant to fair value," and suggested that it should "conclude that [its] findings regarding the competitive process leading to the transaction" support the determination "that the deal price was the most reliable indication of fair value." [14]

Against this backdrop, the Supreme Court issued its *Dell* decision. By way of background, dissenting stockholders sought appraisal following a management buyout at $13.75 per share led by Dell's founder and affiliates of a private equity firm.[15] The Court of Chancery observed that the buyout resulted from a thorough sale process that "easily would sail through if reviewed under enhanced scrutiny." [16] An independent special committee negotiated with the buyout group, and evaluated alternatives through pre-signing and post-signing market checks that yielded rival bids from other PE firms.[17] Throughout the process, Dell's founder expressed willingness to partner with any of the bidders and to supply as much of his own equity as needed to complete a going-private transaction.[18]

Nevertheless, the Court of Chancery found that a confluence of factors justified assigning no weight to the deal price, and instead relied exclusively on its own DCF analysis, which resulted in a fair value of $17.62 per share.[19] The Vice Chancellor concluded that both the market and the sale process did not reflect the company's intrinsic value: the market was too focused on Dell's short-term prospects and the participation of only financial bidders in the process resulted in a deal priced to clear internal rate of return hurdles.[20] The court also found that factors "endemic" to MBO go-shops cast doubt on the reliability of the deal price,[21] because rival bidders could be discouraged from making topping bids due to perception that management had an informational advantage, fear that there was "no realistic pathway to success," or risk of overpaying for the company (i.e., the putative "winner's curse"). [22]

In its appeal, Dell argued, and the Supreme Court agreed, that the Court of Chancery's "decision to give no weight to any market-based measure of fair value [ran] counter to its own factual findings." [23] The evidence pointed to an efficient, rather than myopic, market for Dell shares. The Supreme Court observed that the lack of strategic bidders[24] during the pre- and post-signing phases suggested that the deal price was not too low: if the deal price had substantially undervalued the company, then strategic competitors would have had strong incentives to bid. [25] Furthermore, there was nothing in the trial record to suggest the presence of the putative features of MBOs that theoretically could undermine the reliability of deal price as evidence of fair value: Dell mitigated any informational asymmetry between the buyout group and other bidders by providing go-shop participants extensive due diligence and access to Dell's founder; [26] and, contrary to any "winner's curse phenomenon," two rival bidders submitted competing proposals during the go-shop period. [27] In sum, the Court found "the market-based indicators of value—both Dell's stock price and deal price—have substantial probative value" [28] and "deserved heavy, if not dispositive, weight." [29]

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Following Dell, DFC Global, and multiple decisions by the Court of Chancery deferring to the deal price, it is now clear that, in a statutory appraisal of stock of a public company acquired by merger, Delaware courts will give substantial, if not exclusive, weight to the deal price when it is derived through arm's-length negotiations in an open market. In effect, while the deal price is not presumed to be fair value as a matter of Delaware law, such a presumption may in fact exist in that context. Dell further suggests that the Delaware courts may in certain cases give heavy weight to a deal price in an interested-party buyout when the sale process is proven to have removed any putative insider advantage.

CONTINUED ON PAGE 22

[13] Id. at 375.

[14] Id. at 351.

[15] Dell II, 2017 WL 6375829, at *1.

[16] Dell I, 2016 WL 3186538, at *29.

[17] Dell II, 2017 WL 6375829, at *4-7.

[18] Id. at *5.

[19] Id. at *11.

[20] Id. at *10.

[21] Id

[22] Id. at *10-11.

[23] Id. at *12.

[24] Id. at *17.

[25] Id. at *21.

[26] Id. at *23.

[27] Id.

[28] Id. at *25.

[29] Id. at *16.

The Delaware courts' much greater willingness to give significant weight to the deal price and their expansion of the transaction contexts in which such deference will be afforded likely will hasten the decline of appraisal arbitrage or at least require that hedge funds engaging in the practice select their litigation investments more cautiously. The primacy of deal price also increases the importance for respondent corporations to establish a record to support a deduction for merger-related synergies (assuming combinatorial synergies exist).

Additional takeaways from Dell (and DFC Global) include, among others, the following:

- **No Private Equity Carve-out.** Building on its decision in DFC Global, which emphatically rejected any hint of a "private equity carve out" or notion that PE buyouts inherently result in a deal price below fair value because financial sponsors use leveraged buyout pricing models designed to achieve a specific internal rate of return, the Supreme Court in Dell held that the lack of competition from a strategic bidder was not a credible basis for the trial court to disregard the deal price, stating that "if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one,"[30] and that "[c]ompetition limited to private equity bidders does not foreclose the sale price reflecting fair value."[31] Of course, depending on the facts, a court may not give exclusive weight to a deal price in a PE buyout if, for example, the sale process favored financial sponsors or excluded strategic buyers for improper reasons.

- **Deal Price in MBOs Can Be Fair Value.** The Supreme Court in Dell similarly dispelled any suggestion that MBOs cannot result in a deal price reflective of fair value. In particular, the Court rejected multiple economic theories (i.e., possible structural barriers in an MBO go-shop process, purported information asymmetries between management and third parties, and management's perceived value to the company) that arguably create an uneven playing field between management and potential third-party bidders that is endemic to MBOs and undermines the probative value of an MBO deal price as a general matter, concluding that, even assuming the theories had validity, the trial record did not support the application of any of these theoretical characteristics of MBOs. [32]

- **Implications for Appraisals of Controller Buyouts.** The Supreme Court's decision in Dell regarding MBOs potentially can be extrapolated to controlling stockholder buyouts, which arguably involve similar dynamics. Dell indicates that, when there is a robust process, any putative structural pricing inadequacies arguably associated with MBOs can be mitigated to allow deal price to be utilized as the best evidence of fair value. Consistent with recent Delaware cases, specifically *Kahn v. M & F Worldwide Corp.*,[33] which provides for business judgment rule deference and early dismissal in the fiduciary context, if procedural protections are established to eliminate any arguable controller advantage—namely, an independent special committee and approval by a majority of minority stockholders—then it is reasonable to posit that the deal price could be afforded significant (or dispositive) weight in an appraisal because the premise of a fair value determination is that it reflects what would be paid in an arm's-length deal.

- **Market Data as Indicia of Fair Value.** The Supreme Court held that the Court of Chancery lacked a valid basis to find a "valuation gap" between Dell's market price and its fundamental value. In so doing, the Supreme Court reaffirmed the efficient market hypothesis, which "teaches that the price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client." [34] Accordingly, absent evidence demonstrating inefficiencies in the market for the stock being appraised, the trading price and deal price likely will be afforded "substantial probative value" in the court's fair value determination. [35]

- **Increased Skepticism of DCF Valuations.** In Dell, having grown extremely frustrated with the "recurring problem" of appraisal petitioners proffering "highly paid, well-credentialed experts to produce DCF valuations" that dwarf the deal price, ignore the operative reality of the company, and reflect a price no buyer would pay, the Supreme Court indicated that law-trained judges "should be chary" about utilizing "less-than-surefire DCF analyses" because a DCF value inherently is less reliable evidence of fair value than a price an arm's-length buyer is willing to pay in an open market and can fluctuate wildly based on small changes in its numerous underlying inputs and assumptions (in the case of Dell, for instance, there were "enormous valuation chasms caused by the over 1,100 variable inputs in the competing DCFs"). [36]

30 Id. at *21.

31 Id. at *25.

32 Id. at *23-25.

33 88 A.3d 635 (Del. 2014).

34 Dell II, 2017 WL 6375829, at *16-17.

35 Id. at *25.

36 Id. at *25-28.

- Increased Reliance on Comparables-Based Valuation Methods. Conversely, in DFC Global, the Court rejected the petitioners' cross-appeal challenging the trial court's decision to give weight to a comparable companies analysis,[37] suggesting (consistent with its reliance in both DFC Global and Dell on market-based indicia of value) that comparables-based valuation methods may regain traction. Though the Delaware courts sometimes have declined to rely on comparable companies and precedent transactions valuation analyses because of a perceived lack of sufficiently comparable peers, finance professionals rely every day on these approaches when making investment decisions with real money, and any potential error resulting from reliance on imperfect comparables may now be viewed by Delaware courts as less of a concern than the inherent flaws in "garbage in, garbage out" DCF analyses.

By confirming the primacy of deal price and other market evidence in appraisal proceedings challenging acquisitions of public companies that resulted from robust processes, the Delaware Supreme Court has provided a powerful incentive to transaction planners to engage in best practices when selling companies.[38] In so doing, the Court establishes the appropriate rule for Delaware law to produce the most value for all long-term target company stockholders rather than reward a limited number of short-term opportunists who rent-seek

37 DFC Global, 172 A.3d at 386-88.

38 See Dell II, 2017 WL 6375829, at *28.