

Appraisal Risk Back In The Spotlight After Dell

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Authors: [Oliver Brahmst](#), [Matthew Hendy](#)

The Delaware Court of Chancery (the “Court”) recently ruled that the fair value of Dell Inc. shares at the time of the 2013 US\$24.9 billion buyout of Dell Inc. by CEO Michael Dell and Silver Lake Partners was US\$17.62 per share, rather than the US\$13.75 per share paid to the company’s stockholders. As a result of the decision, the stockholders who dissented to the transaction and exercised their appraisal rights will be entitled to the difference in price, plus statutory interest. The decision highlights the potential exposure buyers have in connection with appraisal proceedings and confirms that while, under certain circumstances, deal price will be given significant weight as an indicator of fair value, other factors may undermine its persuasiveness.

Appraisal Exposure Continues to be Real

The Court’s decision comes amid an increase in recent years of “appraisal arbitrage,” a practice whereby institutional investors invest in a company upon a takeover announcement with the intention of exercising appraisal rights. Such investors take advantage of the relatively high default interest rate under the Delaware General Corporation Law (5% over the Federal Reserve discount rate) earned on the value of shares held by dissenting stockholders pending disposition of an appraisal claim and payable even if the final appraisal award is less than the merger consideration paid to non-dissenting stockholders.

In response to this increase in appraisal claims, amendments recently have been proposed to the Delaware General Corporation Law which would limit *de minimis* appraisal claims in certain public company transactions and would allow surviving corporations to pay those seeking appraisal earlier in the process, terminating the accrual of statutory interest. In addition to this legislative response, several recent appraisal decisions from the Delaware Court of Chancery have found deal price to be the most reliable indicator of a company’s fair value.¹

Despite these developments, the *Dell* decision serves as a reminder that appraisal proceedings could pose significant risks. Despite conducting a sale process in which, according to the Court, the special committee of the board and its advisors did “many praiseworthy things” and no breach of fiduciary duty could be found, the Court held that the price paid by a buyer in a merger transaction, while potentially relevant to an appraisal analysis, does not necessarily reflect fair value. In fact, the Court disregarded deal value in its valuation analysis, concluding that deal value on the facts of the case was an unreliable measure of fair value.

¹ See *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, 2015); *Huff Fund Inv. P’ship v. CKx, Inc.*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013).

The leveraged buyout pricing model as an unreliable methodology for producing fair value

According to the Court, a valuation based primarily on the leveraged buyout pricing model may not accurately reflect a company's fair value. The leveraged buyout model solves for the range of prices that a financial sponsor can pay while still achieving particular internal rates of return. The Court contrasted the leveraged buyout model with a discounted cash flow analysis which solves for the present value of the target. Finding that price negotiations were driven by the financial sponsors' willingness to pay based on their leveraged buyout models and not the fair value of Dell, the Court held that there was a strong indication that the deal price undervalued Dell as a going concern.

In an appraisal proceeding, a court may fill a "valuation gap"

A significant valuation gap between the market's perception of a company and the company's operative reality could result in a divergence between deal value and fair value, according to the Court. As the Court explains, given analysts' focus on short-term results, a valuation gap may occur soon after a company engages in a significant capital expenditure program and such investment has yet to pay off (as was the case in *Dell*, as the company recently had spent nearly US\$14 billion in a campaign to reorient its long term direction). The existence of a valuation gap may enable potential buyers to offer an attractive premium over the trading price of a company's shares while keeping purchase price at a significant discount to the company's intrinsic value. In an appraisal analysis, therefore, a court may intervene to compensate for a valuation gap.

Pre-signing competition may be critical to achieving fair value

Limited pre-signing competition can be an impediment to achieving fair value even if a robust post-signing market check is undertaken during a "go-shop" period given numerous disincentives facing would-be topping go-shop bidders, according to the Court. In particular, the ability for the incumbent buyer to make at least one matching bid in the event of a superior proposal from a third party – a common feature of a go-shop – may have a chilling effect on go-shop bids, especially when the target company is large and complex and therefore requires significant and costly due diligence by the go-shop bidder. The chilling effect may be accentuated in the context of a management-led buyout, in which the incumbent buyer presumably has the best knowledge about the company's prospects and therefore presumably has priced the company properly; moreover, a go-shop bidder in this context must overcome the lack of support from management, which support may be an asset impacting valuation in and of itself. Indeed, in the *Dell* case, evidence showed that only three financial sponsors and no strategic bidders were involved in the pre-signing sale process, and even though 60 potential buyers were contacted during the go-shop phase, the Court still found that the lack of pre-signing competition rendered the merger consideration unreliable. The fact that the go-shop process in the *Dell* transaction attracted two higher bids, which ultimately led to a 2% increase in merger consideration, did not change the Court's analysis. According to the Court, the two higher go-shop bids (from financial sponsors using a leveraged buyout model) was another indicator that the transaction was undervalued.

Conclusion

The *Dell* decision highlights the fact that appraisal exposure remains an important consideration for buyers. As we learn from the decision, courts may not consider deal value to be a reliable indicator of fair value – particularly in a management-led buyout – when a purchase price is derived primarily from a leveraged buyout model, the target company's stock price suffers from a "valuation gap" and/or there is limited pre-signing competition.

White & Case LLP
1155 Avenue of the Americas
New York, New York 10036-2787
United States

T +1 212 819 8200

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