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Delaware Chancery Court Grants Appraisal Petition After Finding Dell MBO Transaction Provided Stockholders Less Than Fair Value

Vice Chancellor Laster of the Delaware Chancery Court recently issued an important opinion in *In Re: Appraisal of Dell Inc.* C.A. No. 9322-VCL (May 31, 2016), holding that merger consideration offered to Dell, Inc's common stockholders did not reflect the "fair value" of Dell's shares. The decision will require the company to pay dissenting stockholders a 28% premium as compared to the consideration that was received by stockholders who did not exercise their appraisal rights. The opinion is notable for several reasons, including because the Court declined to accept that the negotiated market price for the deal was the best available indication of the fair value of the company. Instead, the Court challenged the accuracy of prevailing stock market valuations of Dell, and after criticizing several aspects of the sale process, ultimately concluded that neither the stock price nor the price negotiated during the sale process fairly reflected the fair value of the company.

The appraisal action was commenced by dissenting stockholders exercising their Delaware law appraisal rights in connection with Dell, Inc.'s 2013 "go-private" merger, which was structured as a "management buyout," or "MBO" transaction. The deal was sponsored by the company's founder and CEO Michael Dell with the support of private equity firm Silver Lake. The Court's lengthy decision paid close attention to all stages of the sale process, tracing the transaction from inception, through the formation of a special committee, a preliminary marketing stage, the negotiation of an initial bid and a subsequent go-shop period.

During the initial marketing period, private equity firms Silver Lake and KKR both expressed interest in a transaction and submitted proposals that valued Dell's shares between $11 and $13 per share. KKR ultimately dropped out, leaving Silver Lake as the only bidder during the initial marketing phase. No strategic buyers were involved in these early stage negotiations. After extensive negotiation between the special committee and the Silver Lake group, the parties reached a proposed deal that valued Dell at $13.65 per share. During a subsequent "go-shop" period, two additional suitors emerged, with groups backed by Carl Icahn and Blackrock Management Partners LLC both submitting proposals, although neither of these ultimately went forward. Nonetheless, faced with weak voting support from stockholders, the Silver Lake group ultimately agreed, at the behest of the special committee, to a modest price increase of $0.10 per share, resulting in a final offer of $13.75 (the "Final Merger Consideration"). This offer was ultimately accepted by the special committee and approved by 70% of Dell's voting stockholders. The Final Merger Consideration reflected a very substantial premium compared to the trading price of Dell stock (*e.g.*, a 44% premium over the one-day trading price prior to the date on which Dell was first reported to have been an LBO target). The final pricing was also consistent with the range of values that the company's financial advisors had determined a private equity firm would be willing to pay.

In response to petitioners' argument that this $13.75 per share did not reflect Dell's "fair value," the Company argued that the Final Merger Consideration was the best evidence of the Company's fair value on the closing date. But the Court rejected this view, breaking ranks with several recent Delaware decisions that had supported such arguments. Instead, the Court held that while deal price was a relevant factor, it is not dispositive when determining fair value, particularly when other valuation evidence suggests that the deal price may have been inadequate. The Court identified a number of general reasons why deal prices might not fully reflect fair value, including: (i) the time typically elapsed between the date on which a deal price is agreed and the closing date of a transaction (which is the relevant date for assessing fair value in a Delaware appraisal action); and (ii) the relative inefficiency of markets for corporate control as compared to markets for individual shares.

Turning to the more specific facts of the case at hand, the Court identified several reasons to be skeptical that the MBO transaction price reflected Dell's fair value. The Court was unmoved by the significant premium that the transaction price offered compared to recent trading prices, pointing to significant evidence that Mr. Dell, the company and the company's financial advisors all believed that the market had been significantly undervaluing Dell's stock. The Court primarily attributed this "investor myopia" to market participants' focus "on the short term" and on the difficulty associated with assessing a substantial shift in business strategy then underway at Dell. The Court was also unpersuaded by the fact that the deal price fell within the range of prices that the company's financial advisors believed would provide a private equity firm with an attractive internal rate of return, or IRR. Indeed, the Court was highly critical of the special committee's reliance on "an LBO pricing model." In rejecting these methods as indicia of fair value, the Court suggested that valuations premised on private equity firm IRR targets would in most cases reflect a potentially significant discount compared to the fair value that a strategic bidder might be willing to pay.

Specific aspects of the sale process were also highlighted as evidence of a gap between deal price and fair value. The Court's most serious concern was a perceived lack of meaningful competition prior to signing the original deal with Mr. Dell and the Silver Lake group. The Court was particularly critical of the decision to not reach out to Hewlett-Packard, which the Court viewed as a natural strategic bidder for Dell (and perhaps the only viable strategic bidder). The Court felt that the absence of a potential offer from a strategic bidder had hamstrung the ability of the special committee to extract superior offers from leading financial bidders. The Court also expressed considerable skepticism as to whether a 45 day go-shop period provided an adequate corrective for this limited pre-signing competition. Drawing on empirical studies showing that go-shop periods rarely produce superior proposals, the Court expressed doubts over whether even the most sophisticated buyers could adequately get up to speed during a typical go-shop period, particularly when analyzing a company as large and complex as Dell. The Court also queried whether potential buyers would be adequately incentivized to pursue a topping bid in the first place, particularly when faced with obstacles such as break fees and matching rights. In addition to these fact-specific concerns, the Court gave significant weight to industry and academic concerns regarding the supposedly perverse incentives that are frequently thought to underlie many MBO transactions as a result of the informational advantages typically enjoyed by participating management teams. As a result, the Court cautioned that MBOs should generally receive enhanced scrutiny as compared to other types of deals.[1]

After concluding that the deal price did not provide convincing evidence of fair value, the Court ruled that a discounted cash flow valuation method was the most appropriate means of ascertaining the company's fair value. During the course of the appraisal litigation, both the petitioners and the company had relied on competing expert testimony concerning DCF valuations. The Court pointed to the vast gap between the two expert valuations as a "recurring problem" in valuation litigation, and proceeded to discard the more aggressive valuation assumptions of both experts. Pointing to Delaware courts' tendency to give greater weight to DCF valuations that rely on financial projections that were prepared in advance of litigation, or which exhibit other indicia of reliability, the Court identified two sets of internal projections (one prepared by the company's consultants and the other which had been presented by the company to its bank lending group) as the most appropriate projections to be used in connection with a DCF analysis. The Court then addressed a number of other disputed technical inputs to the DCF valuation, and ultimately completed two alternative valuations, which it then averaged to conclude that Dell's fair value as of the closing date of the merger was $17.62 per share. This court-determined valuation was approximately 28% higher than the $13.75 Final Merger Consideration received by non-litigating stockholders.[2]

Although this decision was highly fact-specific in several regards, it is nonetheless likely to further fuel the increasing frequency of appraisal rights litigation in the context of MBOs and other significant transactions. Risks will be particularly acute where there is reason to believe that current market valuations may not accurately reflect long-term value. Moreover, if Vice Chancellor Laster's holdings are upheld on appeal, or are echoed in future Chancery decisions, they will undoubtedly give market participants a great deal to think about. Management teams anticipating imminent transactions might feel compelled to limit public and private discussion concerning gaps between share prices and true value. Financial advisors will also need to consider whether LBO-based modeling will increase litigation risk and will now have even greater incentives to ensure that available strategic bidders are canvassed in the early stages of the marketing process. Finally, prospective buyers themselves may give enhanced consideration to whether strong deal protections might come at a significant future cost, because while they may enhance deal certainty and provide other important protections, they could also be used in future appraisal rights litigation to support arguments that go-shop periods failed to ensure that deal prices adequately reflected fair value.

1 Mr. Dell's own participation in the process was also closely examined, and although the Court found his openness to other bidders to be positive, the Court also implied that future courts should look unfavorably on management teams that might chill bidding by refusing to cooperate with other bidders.

2 Notwithstanding the fact that the Court was critical of the sale process in many regards, and found a substantial disconnect between the transaction price and the fair value of the company, the Court was clear that no breach of fiduciary duty would have been found on these facts. To the contrary, the Court stressed that the special committee "did many praiseworthy things" and that its process "easily would sail through if reviewed under enhanced scrutiny." The Court also spent considerable time distinguishing between the courts' task in an appraisal proceeding (*i.e.*, to assess a precise "fair value") as compared to the pertinent inquiry in a fiduciary duty proceeding, which should be more focused on assessing whether an adequate process was implemented for the purpose of ensuring that transaction value falls within the range of reasonableness.

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