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Implications of the Recent Dell Appraisal Decision

On May 31, Vice Chancellor Laster of the Delaware Court of Chancery held that, for purposes of Delaware's appraisal statute, the fair value of the common stock of Dell Inc. at the time of its sale to a group including the Company's founder Michael Dell was $17.62 per share, almost a third higher than the $13.75 deal price.[i] The decision has received a good deal of attention from the press and commentators, largely because the Court rejected the use of the transaction price as compelling evidence of fair value, despite several recent Delaware appraisal decisions that have relied heavily or exclusively on the transaction price. While the ruling may encourage some stockholders of Delaware companies to seek appraisal – particularly in management buyouts – there are powerful reasons why the decision should be limited to its particular facts.

In October 2013, Dell was taken private by a group led by Michael Dell and the investment firm Silver Lake. The transaction followed years of disappointing performance attributable, in part, to competition from low-margin producers and shifts in consumer preferences towards smartphones and tablets. Although management expressed confidence in the Company's prospects, the stock price declined significantly. A special committee of the Dell Board negotiated and approved the transaction, and the Company's disclosures to stockholders emphasized that the deal price represented a large premium over the common stock's trading price. A consolidated class action challenging the transaction and asserting breach of fiduciary duty claims was voluntarily dismissed by the lead plaintiffs without any consideration or concession from the defendants.

In the appraisal action, Dell argued that the transaction price was the best evidence of the fair value of the shares. The Court acknowledged that, "[i]n at least five" recent decisions, the Court of Chancery "has found the deal price to be the most reliable indicator of the company's fair value, particularly when other evidence of fair value was weak." And the Court noted that the Company's sale process "easily would sail through if reviewed under enhanced scrutiny."

Nevertheless, the Court found the deal price was not a reliable proxy for fair value, for a number of reasons. Among the most significant:

- The transaction was a management buyout. "Because of management's additional and conflicting role as buyer, MBOs present different concerns than true arms' length transactions."

- Where the only active bidders were financial, rather than strategic buyers, the price reflected the constraints of an "LBO pricing model." In the Court's view, financial bidders focus on short term internal rates of return, rather than on the fair value of the shares. Fair value under the appraisal statute normally requires consideration of a range of factors, including market value, asset value and likely prospective earnings.

- There was "extensive and compelling" evidence of a "valuation gap between the market's perception and the Company's operative reality." The Court found an "anti-bubble" – due to "[m]arket myopia," investors and analysts focused on Dell's "short-term, quarter-by-quarter results" although the Company had made $14 billion in investments that had yet to generate anticipated results.

- There was limited pre-signing competition for the Company, and the effectiveness of the post-signing go-shop period was limited by the size and complexity of the Company.

- The special committee that negotiated the deal did not consider fair value – instead, it focused on the market price of the Company's common stock, and "negotiated without determining the value of its best alternative to a negotiated acquisition."

Even considering all these factors, the Court found the outcome of the sale process sufficiently probative to rule out a large undervaluation, such as the former stockholders' claim that Dell shares were worth $28.61, over twice the transaction price.

What is the likely impact of the Dell ruling?

- Acquirers may find it more difficult to argue that the transaction price is compelling evidence of fair value, but that effect may be limited to cases where the factors listed above are present. Significantly, the Dell Court distinguished Chancery decisions relying on the transaction price because those cases did not involve MBOs, and "either involved a more active pre-signing market check or the process was kicked off by an unsolicited third-party bid." In such cases, or where the target company can show that the pre-transaction market price of its stock reflected legitimate doubts about the target's prospects, as opposed to "myopia," the transaction price might well be regarded as compelling evidence of fair value.

- To reduce the risk of a large appraisal award, target boards may wish to make a record of their focus on the company's intrinsic value, as opposed to the premium to market represented by the transaction price.

- Many transaction agreements allow the buyer to abandon the deal if a specified percentage of shares seeks appraisal. Acquirers concerned about the risk of a significant appraisal award might consider negotiating for a lower threshold.

- The Dell Court's view that financial buyers focus on their own rate of return rather than fair value may aid those acquirers in resisting or limiting discovery of their internal communications in appraisal litigation. If those buyers are not basing their bids on fair value, then their own analyses and estimates may well be irrelevant.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[i] *In re: Appraisal of Dell Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016).