June 13, 2016

In re: Appraisal of Dell Inc.

Delaware Court of Chancery Determines Fair Value Is 28% Higher Than Merger Price Following an Auctioned Arm's-Length MBO

SUMMARY

In *In re: Appraisal of Dell Inc.*,[1] the Delaware Court of Chancery (Laster, V.C.) held in an appraisal proceeding that the fair value of Dell Inc. was 28% higher than the price paid for it by Michael Dell and Silver Lake Partners and approved by a majority of the unaffiliated shares after a lengthy, public and well-run arm's-length sale process. The Court concluded that the deal price undervalued Dell because there was a significant "valuation gap" between the long-term value of Dell and the market's short-term focus, and the agreed-upon price was the product of a competition among like-minded financial bidders who were price-constrained by targeted internal rates of return in LBO pricing models. Even though the deal price represented a nearly 30% premium to market and was within the range of DCF values provided by the Dell special committee's financial advisors, the Court held that a DCF valuation, using the Court's inputs, produced a better approximation of the "fair value" of Dell than the results of the sales process.

Although the *Dell* Court at times attributes its conclusion to the unique circumstances involving a management-led buyout, the implications of the decision, if not narrowed or reversed on appeal, are potentially far reaching. The Court fails to give weight to the result of a full and fair sale process or the market's expectations for Dell's future performance and value. While the facts include some unusual circumstances, its reasoning could be applied to any transaction where the public markets and markets for corporate control do not give full credit for a company's business plans and projections. The logic of the decision, while most obviously applicable to financial buyers bidding on the basis of traditional leverage and return based models, could equally apply to a strategic buyer who discounts some of the target company's projections and business plans.

The reasoning of the case calls into question the ability of financial sponsors, and to some extent, all buyers, to reliably estimate their exposure to appraisal claims, undermining the certainty that buyers and sellers need to optimize sales of corporate control. This uncertainty will cause significant issues for parties planning mergers. Buyers may seek closing conditions on the number of shares seeking appraisal, stockholders will see appraisal as a potentially valuable option and, by voting against mergers they might otherwise think should be approved, seek to preserve their right to obtain appraisal, appraisal arbitrageurs will be emboldened, and buyers will hold back some amount to deal with potential appraisal claims (or insist on complex corporate structuring to avoid appraisal). The economic frictions created may be considerable and will affect even the many transactions where the appraised value likely would not exceed the merger price.

The Dell decision also includes a thoughtful discussion concerning the challenges for a jurist of correctly determining "fair value," noting that "the statutory obligation to make a single determination of a corporation's value introduces an impression of false precision into appraisal jurisprudence."[2] Given the transaction issues and resulting price reducing friction likely to be created by the *Dell* decision, it may be wise for Delaware to again consider joining with the significant number of other states that do not provide appraisal rights for mergers involving publicly traded companies (or at least consider doing so for transactions not involving buyers who are controlling shareholders). In such a regime, stockholders will retain the judicial protections afforded by the extensive Delaware precedents regarding fiduciary duties, including those applicable to disclosure. As Vice Chancellor Laster noted, "fair value" determinations are inherently imprecise.[3] The limited benefits of appraisal in arm's-length, public company transactions would not seem to justify use of the considerable judicial resources needed to make such imprecise, indeed necessarily inaccurate, determinations in mergers where the economic costs will be significant to the overall market for corporate control and where stockholders have significant other protections.

BACKGROUND

Between 2010 and 2012, Dell spent approximately $14 billion acquiring 11 new businesses that Michael Dell, who owned approximately 15.4% of Dell, believed would transform Dell into a company with less reliance on declining PC sales and increased sales of enterprise software and services. In a sum of the parts analysis in 2011, management valued Dell at $22.49 per share (by line of business). However, the company's revenues and earnings continued to decline, as did its stock price (to approximately $12 per share in June 2012). After having been approached by a number of financial sponsors about a possible MBO and believing that the market failed to appreciate his long term vision, Mr. Dell approached the Dell Board about a possible buy-out. The Dell Board formed a special committee with full powers with respect to any proposed transaction, as well as any other strategic alternatives or any other matters it determined to be advisable. In July, 2012, management presented the Dell Board with its projections which indicated that management thought the company was worth $25 billion more than the then current market capitalization of $15 billion. In September, 2012, management revised the projections downward somewhat to reflect Dell's poor performance during the period. The Dell special committee thought that even the September projections were overly optimistic but included them in the sale data room. The Dell special committee's financial advisors provided a preliminary stand-alone valuation of Dell at the time that included a DCF range of $20 to $27 per share using the September projections, and a DCF range of $15.25 to $19.25 per share using the Street's consensus case. It also included its view that a financial buyer applying an LBO pricing model at 3.1x leverage and assuming a 20% five-year IRR would likely pay a price of approximately $14 per share. KKR and Silver Lake submitted initial proposals, but KKR dropped out following Dell's disappointing third quarter 2013 results. Silver Lake submitted improved proposals in December 2012 and January of 2013 of $12.70 and $12.90 cash per share, respectively. Mr. Dell did not participate in the pricing. The Dell special committee eventually determined that it would target a sale price of $13.75 per share. On February 6, 2013, after rejecting Silver Lake's lower offers, the Dell special committee agreed with Silver Lake to a transaction at $13.65 cash per share, with Mr. Dell agreeing with Silver Lake to roll over his shares at a lower per share valuation and to invest additional cash. Under the deal, Mr. Dell would own approximately 75% of Dell following the transaction. At the time, one of the Committee's financial advisors had provided DCF ranges of $11.50 to $16 per share using the Street consensus and $12 to $16.50 per share, using the projections produced by the Committee's own advisor, assuming 25% of management's projected cost-savings could be realized.

During the 45-day go-shop period that followed, the Dell special committee's financial advisors reached out to 60 parties, including strategics. Carl Icahn submitted a leverage recapitalization alternative and Blackstone submitted a $14 per share cash proposal but later withdrew the proposal following disappointing Dell sales results. Silver Lake eventually raised its offer to $13.75 cash per share plus a cash dividend immediately preceding the merger of $0.13 per share, an offer that was financed by Mr. Dell agreeing to a lower value for his rolled shares. The Dell special committee and Dell's Board approved the transaction. On September 12, 2013, Dell's unaffiliated shareholders voted in favor of the transaction, with 57% of the outstanding shares voting in favor and 70% of those voting approving.[4] The merger was completed on October 29, 2013. Certain Dell shareholders sought appraisal of their shares.

THE COURT'S DECISION

The *Dell* Court concluded that the sale price did not create a reliable indication of fair value even though Dell's sale process "easily would sail through if reviewed under enhanced scrutiny"[5] and Delaware Courts have recognized that a merger price resulting from arm's-length negotiations is a strong indication of fair value.[6] The Court indicated that three factors in the pre-signing phase contributed to establishing that the deal price was below fair value: (1) the use of an LBO pricing model to determine the original merger price, (2) the "compelling" evidence of a significant "valuation gap" between the long-term value of Dell in the view of Dell's management and the market price of the Dell stock, and (3) the lack of "meaningful" pre-signing competition. In the post-signing go-shop phase, according to the Court, problems endemic to MBOs resulted in a disincentive to competition and a final deal price that was also below fair value, namely: (1) the size and complexity of Dell, (2) the "winner's curse" informational asymmetry between insiders and potential bidders and (3) Michael Dell's value to Dell.

A. THE PRE-SIGNING PHASE: LBO PRICING MODEL, VALUATION GAP, AND LACK OF COMPETITION DID NOT PRODUCE FAIR VALUE

The *Dell* Court began its analysis by noting that because the Dell special committee only engaged in the pre-signing phase with financial sponsors, the price the bidders were willing to pay did not reflect intrinsic value but, rather, the sponsors' "relative willingness to sacrifice potential IRR."[7] The Court noted that one of the special committee's financial advisors at the inception of the process valued Dell as a going concern at between $20 and $27 but projected that a financial buyer would only be willing to pay approximately $14 per share to achieve a 20% five-year IRR hurdle. According to the Court, because the LBO pricing model solves backwards from a desired internal rate of return and the limit on the amount of leverage the target can support to finance the deal, the Dell special committee "as a practical matter negotiated without determining the value of its best alternative to a negotiated acquisition."[8] In arriving at this conclusion, the Court appears to have discounted the Dell special committee financial advisors' DCF valuation ranges, including a DCF range of $12 to $16.50 per share applying the committee advisor's own projections of Dell, that were provided prior to entering into the transaction.

The Court also found persuasive the "compelling" evidence of a valuation gap between the market's perception and Dell's operative reality. The Court stated that the market's emphasis on short-termism did not take into account the $14 billion in acquisitions that Dell had effected over the prior three years to transform the company that had not yet generated results, noting that even the special committee's financial advisors had commented that the market was in a "wait and see mode."[9] Despite its awareness of the valuation gap and the depressed Dell stock price, the Court noted, the Dell special committee and its advisors used Dell's market price as a key input of its going concern value and an anchor for price negotiations. Recognizing that the optimal time to take a company private is after it has made significant investments but before those have been reflected in its stock price, the Court stated that the "anti-bubble" both facilitated the MBO and undermined the reliability of the deal price. The Court cited to the Delaware Supreme Court's guidance in *Glassman* v. *Unocal Exploration Corp*.[10] that opportunistic timing should be addressed by the appraisal proceeding.

Lastly, the Court emphasized that the pre-signing process lacked real competition insofar as the Dell special committee did not contact any strategic buyers, only engaged with two financial sponsors initially and, after one dropped out of the process, essentially negotiated only with a single bidder–-the management buyout group. The Court opined that even though it was empowered to say no, the Dell special committee lacked the threat of an alternative deal, and therefore the original merger price was not a reliable indicator of fair value. Moreover, the Court noted, that because the original merger price served as the basis for the go-shop post-signing, the original merger price also undermined the reliability of the final merger price.

B. THE GO-SHOP PERIOD: LACK OF PRE-SIGNING COMPETITION AND THE BARRIERS TO OUTBIDDING MANAGEMENT DID NOT PRODUCE FAIR VALUE

Although the go-shop period produced higher bids that forced the buy-out group to increase their offer by 2%, the *Dell* Court concluded that it did not establish that the Dell stockholders received fair value. The Court stated that the emergence of the higher financial sponsor bids only indicated that the original merger price was not fair, even using LBO-pricing. While conceding that the 45-day go-shop with a single match right and a low break fee was unlikely to deter higher bids, the Court stated that the size and complexity of Dell may have affected the utility of the go-shop in determining fair value.

More significant for the Court, however, was the fact that incumbent management is perceived in the go-shop context to have an informational advantage, rendering "questionable" whether a bidder would perceive a pathway to success through the go-shop.[11] Noting that the Dell special committee sought to address the asymmetry by providing extensive due diligence and making Mr. Dell personally available, the Court concluded that the asymmetry "endemic to MBO go-shops" created a "powerful disincentive" to competition.[12] Moreover, the Court concluded that Mr. Dell's value to Dell created an impediment to competitive bidding, even though he had committed to the Dell special committee to explore working with other bidders in good faith, the record indicated, he had done so and the two post-signing bidders did not regard him as essential to their bids.

C. THE DCF ANALYSIS AS EVIDENCE OF FAIR VALUE

Having concluded that Dell failed to establish by a preponderance of the evidence that the outcome of the sale process offered the most reliable evidence of fair value, the Court turned to the DCF analysis of both sides' experts, which generated values that differed by 126%, based primarily on the different projected cash flows they used. Concluding that there were two reliable forecasts from the Company's expert, the Court, using its own determinations of the correct inputs for each of the DCF valuation factors, concluded that the fair price of a share of Dell's stock was $17.62.

* * *

ENDNOTES

[1] C.A. #9322-VCL (Del. Ch. May 31, 2016) [hereinafter *Dell*].

[2] *Dell*, at *45.

[3] *Id.*

[4] As has been widely covered, T. Rowe Price, despite its firm public opposition to the transaction, lost its rights to seek appraisal because its funds' record stockholder, Cede & Co., through a chain of automated proxy instructions, mistakenly voted in favor of the transaction even though the investment management firm directed its funds to vote against the transaction. T. Rowe Price mutual funds, trusts, separately managed accounts, and subadvised clients held, in aggregate, approximately 31 million shares. The foregone additional value from the appraisal action is approximately $194 million and T. Rowe Price has announced that it will compensate clients for the proxy voting error.

[5] *Dell*, at *67.

[6] *Dell*, at *62 (citing *M.P.M. Enters., Inc.* v. *Gilbert*, 731 A.2d 790, 797 (Del. 1999)).

[7] *Dell*, at *67.

[8] *Dell*, at *68.

[9] *Dell*, at *10.

[10] 777 A.2d 242 (Del. 2001).

[11] *Dell*, at *94.

[12] *Dell,* at *94.

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