M&A Update

Delaware Supreme Court Emphasizes Deal Price in Appraisal Litigation

December 19, 2017

On December 14, the Delaware Supreme Court released a long-awaited opinion in *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd*. that reversed and remanded a high-profile appraisal case decided by the Delaware Court of Chancery in 2016. The Delaware Supreme Court built on its recent opinion in *DFC Global Corporation v. Muirfield Value Partners L.P.* to reiterate the potential for negotiated merger consideration to constitute the most important evidence of fair value in appraisal actions. While refusing to establish a presumption equating fair value to the deal price, taken together *DFC* and *Dell* suggest that strong evidence in the factual record undermining the reliability of the deal price — such as the existence of material flaws in the sales process or an inefficient public market for the target's stock — will be necessary for petitioners to demonstrate that they are entitled to a higher price.

Background

Delaware courts have recently given significant attention to appraisal actions filed by dissident stockholders in connection with M&A transactions. Among those decisions were two notable shareholder appraisal cases decided by the Court of Chancery. Specifically, in *In re Appraisal of Dell Inc.*,[1] filed in connection with Michael Dell and private equity fund Silver Lake Partners' leveraged buyout of Dell Inc. Vice Chancellor Laster determined a fair value of the company's shares nearly $7 billion above the transaction price based solely on a discounted cash flow analysis and without assigning any weight to the final merger consideration. Despite stating that the special committee's process "easily would sail through if reviewed under enhanced scrutiny," the court held that the final merger consideration was an unreliable indicator of fair value due to multiple factors, including a lack of strategic bidders, "investor myopia" focused on short-term profit, and the structure of the transaction as a management-led buyout. Two months later, in *In re Appraisal of DFC Global Corp.*, filed in connection with Lone Star Funds' leveraged buyout of DFC Global Corp., Chancellor Bouchard weighed the final merger consideration equally with a discounted cash flow analysis and a comparable companies analysis in determining fair value, similarly stating that merger consideration was an unreliable indicator of fair value due to the buyer being a financial

[1] C.A. No. 9322-VCL (Del. Ch. May 31, 2016).

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sponsor. In both cases, the corporations appealed the appraisal decision, arguing that the merger consideration was in fact the best evidence of fair value.

In August 2017, the Delaware Supreme Court reversed and remanded the Court of Chancery's decision in *DFC Global Corporation v. Muirfield Value Partners L.P.* Writing for a unanimous court, Chief Justice Leo E. Strine Jr. held, that under the circumstances of the case, the best evidence of fair value was the merger consideration because it was the result of an open process with robust public information and easy access to non-public information. Though the court declined to create a judicial presumption in favor of the deal price, it made clear that the deal price should ordinarily be accorded significant weight: "the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous." The court also rejected a so-called "private equity carve out," a theory that suggests the sale price in a deal involving a private equity buyer is an unreliable indicator of fair value due to a focus on an internal rate of return.

Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.

On December 14, the Delaware Supreme Court reversed and remanded the Court of Chancery's decision in *Dell* in an opinion that echoed its holding in *DFC Global*. Writing for a unanimous court, Justice Karen Valihura held that "the trial court erred in not assigning any mathematical weight to the deal price" because the record suggested "that the deal price deserved heavy, if not dispositive, weight." Notably, however, the court again declined to establish a presumption in favor of the deal price as a measure of fair value.

The court rejected the lower court's finding that "investor myopia" caused a valuation gap between fair value and the deal price that "anchored" the bidding over Dell "at an artificially low price" and depressed the ultimate deal price below fair value. The court found, that in so holding, the Court of Chancery disregarded the well-established efficient market hypothesis without a basis in the record for doing so. To the contrary, the evidence established an active trading market for Dell's shares, transparency regarding Dell's long term strategy and no controlling stockholder. "In these circumstances, a mass of investors quickly digests all publicly available information about a company, and in trading the company's stock, recalibrates its price to reflect the market's adjusted, consensus valuation of the company."

The court again dismissed a "private equity carve out," holding that the absence of strategic bidders in the sales process was not a credible reason to disregard the deal price because there is "no rational connection between a buyer's status as a financial sponsor and the question of whether the deal price is a fair price." Indeed, the court noted that the trial court's complete discounting of the deal price due to financial sponsors' focus on obtaining a desirable IRR was in error, as "all disciplined buyers, both strategic and financial, have internal rates of return that they expect. …"

The court observed that Dell's sale process contained many of the same "objective indicia" of reliability that were persuasive in *DFC Global*, including a robust sales process, a canvassing of logical buyers, an independent and properly empowered special committee and a meaningful go-shop period with few structural barriers. According to the court, "The Court of Chancery ignored an important reality: if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one."

The court also disagreed with the Court of Chancery's findings that the structure of the deal as a management-led buyout, in and of itself, provides a basis for not giving any weight to the deal price in the determination of fair value. The trial court was skeptical of Dell receiving topping bids during the go-shop period because, in the circumstance of an MBO, potential bidders may believe "they have no realistic pathway to success.'" While acknowledging that "may be true in some MBOs," there was no evidence that such was the case here where well-financed, sophisticated potential bidders, such as Blackstone, TPG and HP, considered proposals. The court further noted that Dell took steps to mitigate the likelihood of a "winner's curse," which "describes a theory that, in outbidding incumbent management to 'win' a deal, a buyer likely overpays for the company because management would presumably have paid more if the company were really worth it." This concern, however, was "mitigated" in this case by allowing fair access to all necessary information to competing bidders thereby mitigating the information asymmetry that can lead to the winner's curse. The court also noted that there was no evidence of the Court of Chancery's assertion that Mr. Dell's value to the company imposed an obstacle to the emergence of rival bidders. In so noting, the court held that no evidence existed of Mr. Dell's value to the company, particularly in light of certain bidders expressing that his continued involvement was not essential to their bids, and even if such value were to be assumed, no evidence existed that Mr. Dell would not have continued on with a competing bidder.

The court concluded that Dell's pre-transaction stock price and the deal price had substantial probative value and found no rational reason for the Court of Chancery's decision to assign no weight to reliable market indicators. In providing the Court of Chancery the discretion to enter judgment at the deal price, the court held that "[d]espite the sound economic and policy reasons supporting the use of the deal price as the fair value award on remand, we will not give in to the temptation to dictate that result."

Takeaways

- Deal Price Should Be Ascribed Heavy Weight in Determining Fair Value Absent Specific Circumstances Supporting Otherwise. Although the Delaware Supreme Court declined to create a bright-line presumption that the deal price is always the most reliable indicator of fair value, its decision in *Dell* underscores that a properly executed sales process may render the deal price by far the most probative evidence available: "We are not saying that the market is always the best indicator of value or that it should always be granted some weight. We only

note that, when the evidence of market efficiency, fair play, low barriers to entry, outreach to all logical buyers, and the chance for any topping bidder to have the support of Mr. Dell's own votes is so compelling, then failure to give the resulting price heavy weight because the trial judge believes there was mispricing missed by all the Dell stockholders, analysts, and potential buyers abuses even the wide discretion afforded the Court of Chancery in these difficult cases."

- A Well-Executed Sales Process is Instrumental in Determining the Weight to be Ascribed to Deal Price in an Appraisal Analysis. The court highlighted the company's well-executed sales process as a critical element in determining that the deal price should be weighted heavily in determining fair value. This reflects the importance of developing a well-supported, extensive factual record regarding the quality of the sales process. In this case, the company formed an independent and duly empowered Special Committee to evaluate and negotiate any sale of the company. Furthermore, the sale process was choreographed to ensure competition with the lead bidder at every stage, resulted in the lead bidder increasing its offer price six times over the course of negotiations, included a canvassing of all potentially interested parties (either prior to the announcement of a transaction or during the post-signing go-shop period), and a meaningful post-signing go-shop the design of which "raised fewer structural barriers than the norm" and was relatively "open" and "flexible." While parties in appraisal proceedings invariably rely heavily on expert testimony regarding a company's value, *Dell* and *DFC* support the notion that the quality of the sales process may be as persuasive, if not more so, than reliance on other valuation methodologies.

  This emphasis on the sale process in appraisal actions also represents a convergence of the factors considered in determining fair value in appraisal actions with those considered in determining whether a board satisfied its fiduciary duties in approving a sale of the company. On the right facts, the results in a fiduciary duty case and an appraisal case can therefore be the same.

- A Limited Pre-Signing Market Check May be Sufficient to Demonstrate a Well-Developed Sales Process. The Delaware Supreme Court rejected the proposition that the absence of strategic bidders or a robust pre-signing market check undermines the sales process and renders the deal price an unreliable indicator of fair value. In this case, the company sought bids only from three financial buyers, and no strategic bidders, prior to execution of the merger agreement. The court held that this fact, in isolation, did not cast a negative light on the process, and that nothing in the record indicated that the pre-signing market check was inappropriate. In making this determination, the court noted that the process was choreographed to include competition at every stage, and that the Special Committee's financial advisor believed that any financial bidder would bid in the same range as the already existing bidders and that no strategic bidders were likely to make an offer. Furthermore, the existence of leaks prior to the announcement of the transaction, a meaningful post-signing go-shop (during which interest was solicited from sixty-seven additional parties, twenty of whom were strategic bidders), Mr. Dell's agreement to

vote his shares in proportion to the shares voted by all other shareholders in connection with any topping bid, and the fact that the compensation of the financial advisor to the Special Committee was tied directly to the success of the go-shop process, provided further comfort that any potentially competing bidder would have been identified and provided a fair chance to submit a topping bid. In drawing a comparison to the processes in *Dell* and *DFC*, the court stated that both companies' processes bore "objective indicia of reliability," including that "'every logical buyer' was canvassed, and all but the buyer refused to pursue the company when given the opportunity" in light of the "concerns about the company's long-term viability (and its long-term debt's place on negative credit watch) prevent[ing] lenders from extending debt; and the company repeatedly underperform[ing] its projections." In short, according to the court, the lack of interested strategic acquirers or a greater number of bidders do "not suggest a higher value, but a lower one."

- <u>Management Should Remain Accessible to all Potential Bidders in a Management-Led Buyout</u>. The simple fact that a transaction is structured as a management-led buyout does not, by itself, mean that the deal price should be considered an unreliable metric for determining fair value. The Delaware Supreme Court noted that any concern regarding the informational advantage held by the lead bidder in a management-led buyout may be mitigated by ensuring the presence of a diligence process where other buyers have access to all necessary information and access to management during all phases of the process. In this case, extensive information continued to be provided to competing bidders, and Mr. Dell remained fully accessible to such bidders, prior to the execution of a merger agreement and throughout the post-signing go-shop period. In fact, the trial court found that "Mr. Dell 'ultimately spent more time with Blackstone [a competing bidder] than any of the other participants, including Silver Lake'" and that "'[t]he record provided no reason to harbor any concern about Mr. Dell's level of cooperation or responsiveness,' and 'all of the bidders received access to the data they requested.'" Furthermore, the Delaware Supreme Court noted that Mr. Dell did not indicate to any competing bidders that he was unwilling to work with the company should his services be requested following a transaction. Therefore, the deal price may constitute the most reliable indicator of fair value even in management-led buyouts, but a seller's board should attempt to ensure that potential bidders are afforded access to all necessary information, including meetings with incumbent management, during all phases of the process.

- <u>A Stock Price Supported by an Efficient Market is a Reliable Indicator of Fair Value</u>. The Delaware Supreme Court rejected the trial court's finding that an "investor myopia" resulting from a stockholder base overwhelmingly focused on short-term profit and a "hangover" from the company's recent acquisition spree produced a valuation gap between the company's fundamental value and its market price. In rejecting this finding, the court reiterated the efficient market hypothesis long endorsed by the court, which stood for the notion 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." The court noted that the company's stock price was in fact the product of an efficient market, in that "it ha[d] many stockholders; no controlling stockholder; 'highly active trading'; and information about the company [was] widely available and easily disseminated to the market," and that no evidence was presented to the contrary. The court further found that there was no evidence that the company's stockholders were myopic or shortsighted. Therefore, the court found that the company's market price and the deal price resulting from such market price should be afforded consideration in determining fair value.

The full text of *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.* can be found here.

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