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Dell Appraisal: Delaware Supreme Court Rejects Chancery Court Valuation Giving No Weight to Deal Price in Connection with Management-Led LBO

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Reverses Chancery Court valuation that relied exclusively on a discounted cash flow analysis while giving no weight to deal price or stock market trading values.

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INTRODUCTION

Delaware General Corporation Law §262 ("*DGCL §262*") allows target-company stockholders to challenge the price payable for their shares in a corporate merger by dissenting from the merger and seeking an alternative—and hopefully higher—valuation from the Delaware Court of Chancery (the "*Chancery Court*"). As has been well-chronicled, the number of DGCL §262 challenges has spiked over the last decade, concurrent with the rise of hedge funds devoted to "appraisal arbitrage." (For a discussion of this trend, *see* Robert S. Reder & Stanley Onyeador, *Delaware Chancery Disqualifies Lead Petitioners in Dell Appraisal Who Inadvertently Voted "FOR" Management Buyout Litigation*, 69 VAND. L. REV. EN BANC 279 (2016)).

DGCL §262 authorizes the Chancery Court to determine the "fair value" of shares owned by dissenting stockholders using "all relevant factors." However, DGCL §262 directs the Chancery Court not to take into consideration "any element of value arising from the accomplishment or expectation of the merger," essentially eliminating any synergistic value the dealmakers may have factored into the merger consideration. Due to the vague evaluative criteria of DGCL §262, the Chancery Court has significant leeway in determining fair value. While the Delaware courts often have appeared to favor the negotiated deal price as the basis for determining fair value, they have consistently declined to adopt a bright-line rule to that effect.

In the most recent episode of the "long-running appraisal saga" over the management-led leveraged buyout ("*MBO*") of Dell, Inc. ("*Dell*" or the "*Company*"), the Supreme Court of Delaware (the "*Supreme Court*") ruled once again in *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, 117 A.3d 1 (Del. 2017) (hereinafter "*Dell Appraisal Appeal"*), that the negotiated deal price is *not* a presumptive indicator of fair value for purposes of DGCL §262. Nevertheless, in light of the thorough sale process employed by the Dell board of directors (the "*Board*"), the Supreme Court advised that "heavy, if not dispositive, weight" should have been given to the negotiated deal price, while rejecting the Chancery Court's exclusive reliance on its own discounted

cash flow ("*DCF*") analysis. As such, the Supreme Court rejected the lower court's hypothesis that deal price is not a reliable indicator of fair value in connection with leveraged buyouts led by financial sponsors, particularly when target company management has a significant stake in the buyout group.

I. BACKGROUND

A. The Dell MBO

In June 2012, the CEO and founder of Dell, Michael Dell ("*Mr. Dell*"), found the Company "on the brink of crisis." Although the "traditional PC-maker" remained "a Fortune 500 behemoth," its stock price had fallen to $12 per share due to the "advent of new technologies such as tablet computers" and the continued global economic "hangover" from the 2008 financial crisis. Some years earlier, Mr. Dell had refocused the Company on "enterprise software and services" through $14 billion of acquisitions. Although the stock market did not react favorably to this transition, Mr. Dell, the owner of 13.9% of the outstanding shares, remained optimistic, emphasizing the long-term nature of his plan and arguing the market just "didn't get" the Company. Despite management's optimism, the Company continued to experience declines in revenues and earnings and was forced, on several occasions, to announce downward revisions of its earnings targets. Rejecting management's explanation that the Company was "amid a 'long-term strategy' expected to 'take time' to reap benefits," one analyst described Dell as a "sinking ship."

At about the same time, Mr. Dell began consultations with several parties concerning a potential MBO of Dell. After Mr. Dell notified the Board of this possibility, the Board created a special committee of four independent directors (the "*Committee*") to evaluate Mr. Dell's proposal, consider proposals from other parties, and explore strategic alternatives. The Board authorized the Committee to select legal counsel and financial advisors (initially, JP Morgan Chase & Co. ("*JPMorgan*"), and later joined by Evercore Partners ("*Evercore*")). The Committee was granted "full and exclusive authority to recommend to the Board a course of action regarding any proposed transaction, and the Board vowed not to recommend . . . a transaction without receiving a prior favorable recommendation from the Committee."

Upon entering into confidentiality agreements with the Company, private equity firms Silver Lake Partners ("*Silver Lake*") and Kohlberg Kravis Roberts & Co. LLP ("*KKR*") gained access to evaluate Dell's proprietary data. To discourage other bidders from being deterred

by his potential alignment with Silver Lake or KKR, Mr. Dell agreed to consider partnering with such other sponsors and financing sources as the Committee might request. After JP Morgan noted a low probability of a strategic buyer having interest in the Company, the Committee limited the initial pre-signing market canvass to private equity firms. Based on "management forecasts that the Committee . . . considered 'overly optimistic,' " JP Morgan advised the Committee that a private equity sponsor could feasibly pay approximately $14.13 per share.

Both firms proposed all-cash transactions for all Company shares not owned by Mr. Dell: KKR at a range of $12 to $13 per share and Silver Lake at a range of $11.22 to $12.16 per share. After KKR withdrew following a decline in Dell's revenues and earnings, the Committee asked another private equity firm, Texas Pacific Group ("*TPG*"), to participate. Despite displaying initial interest, due to the volatility of the PC market, TPG ultimately chose not to bid. While other parties expressed interest in Dell, none made a formal proposal.

Ultimately only Silver Lake remained interested in an MBO, raising its offer six times to $13.65 per share. Though this was at the lower end of the price range sought by the Committee, it represented a significant premium to the Company's trading price. The Committee, after receiving fairness opinions from its financial advisors, recommended that the Board accept Silver Lake's offer, which it did unanimously (minus Mr. Dell, who was not present). For his part, Mr. Dell agreed join with Silver Lake and to "roll over his shares at $13.36 per share and invest up to $500 million in additional equity," giving him a "74.9% stake in the Company post-closing . . . ."

The parties proceeded to sign a merger agreement providing for the MBO (the "*Merger Agreement*"). Among other things, the Merger Agreement called for a post-signing "go-shop" period during which Evercore contacted 67 parties (both financial and strategic bidders, including the Company's closest competitor, Hewlett-Packard, who "never logged into the data room") to gauge their interest in a topping bid. Although only investor Carl Icahn and private equity firm Blackstone Group submitted competing bids, at the end of the go-shop the Committee and Board decided to recommend Silver Lake's enhanced $13.75 offer, sweetened by a $.21 per share special dividend payable to Dell stockholders. To facilitate Silver Lake's higher offer, Mr. Dell agreed that his retained 74.9% interest in the Company would be valued at $12.51 per share.

Holders of 57% of the Company's outstanding shares not owned by Mr. Dell (representing 70% of the shares present and voting) voted to approve the MBO. However, holders of over 38 million Dell shares (the "*Dissenting Stockholders*") dissented from the merger and demanded an appraisal under DGCL §262.

B. Vice Chancellor Laster's Analysis of "Fair Value"

In *Appraisal of Dell, Inc*., C.A. No. 9322–VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016) ("*Dell Appraisal*"), the Dissenting Stockholders claimed the MBO undervalued Dell's stock by billions of dollars based on their expert's DCF analysis establishing a fair value of $28.61 per share. By contrast, Dell's experts offered a DCF analysis establishing a fair value of $12.68 per share, while acknowledging that the MBO price could be a fair indicia of value.

In determining the fair value of Dell stock, Vice Chancellor J. Travis Laster ultimately gave the negotiated MBO price no weight. In the Vice Chancellor's opinion, several factors in the pre-signing and go-shop sales processes undermined the MBO price as a determinant of the fair value:

- *Leveraged Buyout ("LBO") Model*: The only bidders in the preliminary stages were "financial sponsors who used an LBO pricing model to determine their bid prices—meaning that the per-share deal price needed to be low enough to facilitate an IRR [internal rate of return] of approximately 20%." In this vein, the Vice Chancellor cautioned that "the highest price a bidder is willing to pay is not the same as fair value." Essentially, the Vice Chancellor concluded that, instead of fair value, "the Original Merger Consideration was dictated by what a financial sponsor could pay and still generate outsized returns."
- *Valuation Gap*: The Vice Chancellor found a "significant valuation gap" between Dell's stock market value and "fair value" for purposes of DGCL §262 due to the market's emphasis on short-term results and failure to give credit to management's long-term strategy. In this connection, he noted this gap "allegedly depressed the deal price by anchoring deal negotiations at an improperly low starting point."
- *Lack of Strategic Bidders*: The Vice Chancellor criticized the lack of meaningful competition during the pre-signing period. In particular, he was concerned by the Committee's decision not to reach out to potential strategic bidders. Because, in the Vice Chancellor's view, most price competition occurs during the pre-signing period, an artificially low valuation at the beginning of the process would in turn generate lower prices in the go-shop. The Vice Chancellor also observed that "large private equity buyers such as those engaged here are notoriously averse to topping each other . . . ."
- *Structural Issues*: The Vice Chancellor was concerned that the MBO structure "imposed several additional, supposedly

insurmountable impediments to Dell's ability to prove at trial that the deal's 'structure in fact generated a price that persuasively established the Company's fair value.' " The Vice Chancellor also considered that the size and complexity of the Company negatively impacted the bidding.

- *Winner's Curse*: The Vice Chancellor noted that the so-called "winner's curse"—a concern on the part of financial buyers that, by outbidding incumbent management who have "'an informational advantage" about the company, they will necessarily overpay—may have deterred financial bidders from outbidding an MBO group that included Mr. Dell.
- *Mr. Dell's Participation in the Buyout Group*: The Vice Chancellor also expressed concern that Mr. Dell's involvement with the Silver Lake buyout group presented a hurdle to other bidders who could not be assured of Mr. Dell's continued employment if they outbid Silver Lake.

On this basis, the Vice Chancellor concluded "the Company failed to establish that 'the sales process offers the most reliable evidence of the Company's value as a going concern.' " Further, "[b]ecause it is impossible to quantify the exact degree of the sale process mispricing," the Vice Chancellor decided to give "no weight" at all to the MBO price.

Having rejected both the MBO price and Dell's stock market price as reliable determinants of fair value, the Vice Chancellor examined the competing DCF analyses. Not satisfied with either, the Vice Chancellor performed his own DCF analysis, a blend of some assumptions made by the parties' experts and adjustments of his own. This analysis resulted in a determination by the Vice Chancellor of $17.62 as fair value, higher than the MBO price but significantly less than the DCF valuation urged by the Dissenting Stockholders. (For a more detailed discussion of Vice Chancellor Laster's analysis in *Dell Appraisal*, *see* Robert S. Reder & Loren D. Goodman, *Dell Appraisal Proceeding: Delaware Court of Chancery Finds Price Payable in Management Buyout Understates "Fair Value" by 28%*, 70 VAND. L. REV. EN BANC 11 (2017)).

C. The Supreme Court Decides DFC

A little over a year after *Dell Appraisal*, the Supreme Court issued an important opinion interpreting DGCL §262. In *DFC Global Corporation v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017) ("*DFC*"), the Supreme Court declined to establish a presumption in favor of deal price as the most reliable indicator of fair value.

Nonetheless, the *DFC* Court indicated that deal price may, in fact, be a more reliable indicator of fair value than a DCF analysis in a given appraisal proceeding. In this regard, the *DFC* Court noted that "a singular discounted cash flow model is often most helpful when there isn't an observable market price."

In so ruling, the *DFC* Court dismissed concerns raised by the Chancery Court that regulatory uncertainties and the buyer's focus on achieving an internal rate of return bounded by financing constraints rendered the negotiated deal price an ineffective measure of fair value. Rather, the *DFC* Court proclaimed that:

> Although there is no presumption in favor of the deal price, under the conditions found by the Court of Chancery, economic principles suggest that the best evidence of fair value was the deal price, as it resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid.

Further, the Supreme Court, in the *Dell Appraisal Appeal*, explained that:

> '[i]n some cases, it may be that a single valuation metric is the most reliable evidence of fair value and that giving weight to another factor will do nothing but distort the best estimate. In other cases, it may be necessary to consider two or more factors.' Or, in still others, the court might apportion weight among a variety of methodologies. But whatever route it chooses, the trial court must justify its methodology (or methodologies) according to the facts of the case and relevant, accepted financial principles.

(For a more detailed discussion of *DFC*, *see* Robert S. Reder & Blake C. Woodward, *Delaware Supreme Court Refuses to Establish a Presumption Favoring Deal Price in Statutory Appraisal Proceedings*, 71 VAND. L. REV. EN BANC 59 (2018)).

II. THE SUPREME COURT'S LEGAL ANALYSIS IN *DELL*

Against the backdrop of its decision in *DFC*, the Supreme Court considered the parties' appeal of Vice Chancellor Laster's decision in *Dell Appraisal*. Dell argued the Vice Chancellor had abused his discretion under DGCL §262 by failing to assign any weight to the MBO price. Specifically, Dell posited: (i) there is no requirement that deal price is "the 'most reliable' or 'best' evidence of fair value in order for it to be given any weight," (ii) there is no requirement that the trial court disregard deal price if it cannot discern the exact amount of mispricing through the sales process, and (iii) the trial court should not have "fashioned what seems akin to a bright-line rule that the deal prices in MBO transactions are distorted and should be disregarded." The Dissenting Stockholders countered that while the Vice Chancellor had in fact considered "all relevant factors," his DCF analysis was flawed.

The Supreme Court's 82-page opinion, building on *DFC*, reiterated there is no presumption that deal price equates to fair value under DGCL §262. Further, the Supreme Court explained, while "we are not saying that the market is always the best indicator of value, or that it should always be granted some weight," under the circumstances of the Dell MBO, "the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive, weight."

On this basis, the Supreme Court found that the Vice Chancellor's reasons for relying exclusively on his DCF analysis "do not follow from the court's key factual findings and from relevant, accepted financial principles." Accordingly, and for the reasons noted below, the Supreme Court ruled that Vice Chancellor Laster's decision was "an abuse of discretion meriting reversal."

A. The Relevant Legal Framework

At the outset, the Supreme Court laid out the framework for a judicial assessment of "fair value" under DGCL §262. Essentially, the dissenting stockholder " 'is entitled to be paid for that which has been taken from him.' " Thus, the "one issue" in appraisal is " 'the value of the dissenting stockholder's stock.' "

According to the Supreme Court, "the burden 'falls on the [trial] judge to determine fair value, using all relevant factors.' " In this connection, the "ultimate goal" is to "determine the 'fair or intrinsic value' of each share on the closing date of the merger." The Chancery Court must "first envisage the entire pre-merger company as a 'going concern,' as a standalone entity, and assess its value as such," reflecting the " 'operative reality' of the company as of the time of the merger.' "

Further, the Chancery Court is required "to give fair consideration to 'proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court.' " Because " '[e]very company is different; every merger is different, the appraisal endeavor is 'by design, a flexible process.' " The requirement in DGCL §262 that the Chancery Court consider "all relevant factors" has led the Supreme Court to "reject requests for the adoption of a presumption that the deal price reflects fair value if certain preconditions are met . . . ." Rather, the Chancery Court must "undertake an '*independent*' assessment of fair value," using its "significant discretion to consider 'all relevant factors[.]' "

Finally, the Supreme Court noted, "[t]here may be no perfect methodology for arriving at fair value for a given set of facts, and the Court of Chancery's conclusions will be upheld if they follow logically from those facts and are grounded in relevant, accepted financial principles. "To be sure, 'fair value' does not equal 'best value.' "

However, from the Supreme Court's vantage point, Vice Chancellor Laster's appraisal of Dell did not satisfy this standard.

B. The Vice Chancellor's reasons for disregarding MBO price did not follow from the record

The Supreme Court concluded that, based on the record developed at trial, Vice Chancellor Laster's failure to assign any weight whatsoever to the MBO price had "a dissonance between the key underpinnings of the decision to disregard the deal price and the facts as found, and this dissonance distorted the trial court's analysis of fair value." In this connection, the Supreme Court found that several of the Vice Chancellor's central premises were flawed:

- *Valuation Gap*: Contrary to the Vice Chancellor's belief that Dell's trading price was artificially low due to "myopia" on the part of the market, the evidence indicated that "the market for Dell's shares was actually efficient and, therefore, likely a possible proxy for fair value." Rather than failing to take Dell's long-term plans into account, analysts "just weren't buying Mr. Dell's story." In the Supreme Court's opinion, the market for Dell's shares indicated an efficient market at work.
- *Lack of Strategic Bidders*: The Supreme Court found " 'no rational connection' between a buyer's status as a financial sponsor and the question of whether the deal price is a fair price," noting that "all disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger. . . ." As in *DFC*, the Dell MBO process involved competition from a variety of bidders and potential bidders: there were opportunities for other bidders to come forward after the transaction was leaked, numerous potential bidders were specifically canvassed, the Committee convinced Silver Lake to raise its bid no less than six times, and the go-shop period gave potential bidders an additional opportunity to submit an indication of interest. Contrary to the Vice Chancellor's working assumption that the MBO price was depressed due to a lack of competition, the Supreme Court noted he may have "ignored an important reality: if a company is one that no strategic bidder is interested in buying, it does not suggest a higher value, but a lower one."
- *Leveraged Buyout ("LBO") Model; Structural Issues*: Features cited by the Vice Chancellor for the proposition that MBOs, by their very nature, produce deal prices that are "unreliable" measures of fair value "were largely absent" in the Dell sales

process. Moreover, the Supreme Court discounted the Vice Chancellor's concern that "the size and complexity" of Dell adversely impacted the probative value of the MBO price. If that was a legitimate concern, deal price could never be considered in an appraisal of any large and complex company, a bridge too far for the Supreme Court.

- *Winner's Curse*: To counteract the so-called winner's curse, Dell allowed "extensive due diligence" to reduce the "information asymmetry" that can lead bidders in an MBO to resist outbidding management. Further, the Supreme Court noted that "[t]he issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited." In fact, from the Supreme Court's point of view, a lack of higher bids triggered by a concern for overpaying suggested the deal price was fair.
- *Mr. Dell's Participation in the Buyout Group*: Unlike the Vice Chancellor, the Supreme Court was not troubled by Mr. Dell's teaming with the winning bidder. In addition to evidence that bidders did not find Mr. Dell's involvement important, Mr. Dell had in fact indicated his willingness to remain with the Company even if his buyout group did not prevail.

C. The probative value of market-based prices

The Supreme Court concluded that both the negotiated MBO price, as well as Dell's stock market valuation, had substantial probative value *under the circumstances*. The Supreme Court further explained that a negotiated deal price may still be granted *some level of weight* even when a company cannot prove it is *the most reliable* evidence. The Supreme Court was careful to indicate it was not establishing a broad rule that market-based evidence will always be the best indicator of value or that it should always be granted weight. Rather, in a case such as this:

> [W]hen 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 afford the Court of Chancery in these difficult cases.

D. The DCF Analyses

The Supreme Court also addressed issues posed by consideration of the various DCF analyses presented in *Dell Appraisal*.

The Supreme Court acknowledged that DCF models can provide "a helpful data point" when "there is no credible market information and no market check," or under circumstances in which there is reason to believe that market forces will not afford public stockholders fair treatment. However, from the Supreme Court's perspective, the Dell MBO process was so "robust" that the Vice Chancellor "should be chary about imposing the hazards that always come when a law-trained judge is forced to make a point of estimate of fair value based on widely divergent partisan expert testimony." Moreover, the Supreme Court found the Vice Chancellor's independently-performed DCF analysis "the antithesis of any economist's definition of fair market value." In this connection, the Supreme Court explained:

> When an asset has few, or *no*, buyers at the price selected, that is not a sign that the asset is stronger than believed—it is a sign that it is weaker. This fact should give pause to law-trained judges who might attempt to outguess all of these interested economic players with an actual stake in a company's future.

The Supreme Court also pointed to two policy reasons militating against reliance on a DCF analysis over credible market-based valuations. *First*, dealmakers might be disinclined to adopt best deal practices in connection with the sale of a company if they face a risk of the Chancery Court determining fair value based on an inflated DCF analysis rather than the price negotiated by the dealmakers. And, *second*, dealmakers, instead of "gambling on an appraisal's battle of the experts," might pursue alternative structures which could offer lower valuations than a merger but do not trigger DGCL §262 appraisal rights.

CONCLUSION

In the *Dell Appraisal Appeal* case, the Supreme Court reaffirmed its holding in *DFC* refusing to create a bright-line rule that deal price equates to fair value in the DGCL §262 context. Nevertheless, also as in *DFC*, the Supreme Court reaffirmed the important, if not dispositive, role that deal price can play in determining fair value, even in the context of leveraged MBOs. While the Chancery Court retains broad discretion under DGCL §262 to consider "all relevant factors" in conducting an appraisal of "fair value," and the Supreme Court will not lightly find that the Chancery Court abused its discretion, *Dell Appraisal Appeal* demonstrates that the factual record must be compelling before the Chancery Court can totally ignore deal price or other market-based data in favor of a DCF analysis—either one posited by an expert witness or independently developed by the Chancery Court. If a sales process is rigorous with no evidence of self-dealing or

other breach of loyalty, deal price will play a compelling role in the Chancery Court's determination of "fair value" under DGCL §262.