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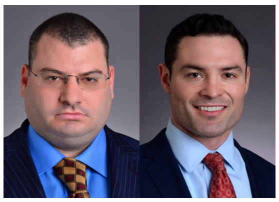

Delaware Court of Chancery Appraises Fair Value of Shares in Dell Management Buyout

By David Graff and Christopher Ayers*

A recent Delaware Court of Chancery's ruling in *In re: Appraisal of Dell Inc.*, Del. Ch., C.A. No. 9322-VCL, Laster, V.C. (May 31, 2016) could signal a change in tide for shareholder appraisal challenges, essentially encouraging outsider shareholders to bring them in hopes of ensuring that their shares are sold at fair value. On May 31, 2016, Vice Chancellor J. Travis Laster ruled that the fair value of Dell's stock at the time of its management-led buyout was $17.62 per share, a full 28 percent more than the transaction price of $13.75 per share. The court rejected the deal price because it found the evidence supporting that price to be unreliable; the court then engaged in its own analysis to determine the shares' true fair value.

What Is an Appraisal Action?

An appraisal action is a legislative remedy that allows shareholders to challenge a merger when they are dissatisfied with the selling price, and bring the matter to court for a judicial determination of the fair value of their shareholdings. To bring an appraisal action, the challenger must be a shareholder who is the record owner, and must continuously hold the shares through the consummation of the merger. Prior to commencing an action, the challenger must first send the corporation a written demand for the appraisal of the shares prior to the shareholder meeting held to vote on the merger. The demand is sufficient if it reasonably informs the corporation of the identity of the shareholder and that the shareholder demands the appraisal of their shares.

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Most importantly, the shareholder must have voted against the merger in order for a court to consider an appraisal of the shares.

In an appraisal action, the shareholder seeks the court's determination as to the fair value of the stock because they believe the negotiated merger price is lower than the company's true worth, and therefore they should be compensated. Both the petitioning shareholder and the surviving corporation in the merger are required to bear the burden of proof as to the company's fair value; thus both must present their own experts' calculations as evidence before the court. Fair value is determined by reference to the going concern value of the target company immediately prior to the merger.

Historic Deference to Arm's Length Transactions

Under Delaware's appraisal statute, the obligation to determine a company's fair value rests squarely on the court. The court is given broad discretion to "take into account all relevant factors" when determining proper fair value. In fact, the court may select one of the parties' valuation models as its general framework in evaluating fair value, or fashion its own.

Typically, the Delaware Court of Chancery has focused on stock market prices rather than the deal price when evaluating a company's fair value. Furthermore, when evaluating comparable companies, the court has relied on the market prices of other companies that were found to be similar to the company at issue.

The court, however, has frequently held that — when the merger resulted from an arm's length process between two independent parties and there is no claim or evidence of collusion — it should give "substantial evidentiary weight" to the merger price as an indicator of fair value. In fact, in a string of recent cases the court held that the deal price was indeed the fair value of a company. During an arm's length transaction, both parties are pursuing their own interests, and therefore there is no worry of collusion or illicit dealing. In that type of situation, the court feels comfortable giving deference to the deal price if there was an "arm's-length transaction negotiated over multiple rounds of bidding among interested buyers." In those deals, the court held "the sale process was sufficiently structured to develop fair value of the Company," and that each of those cases involved an active pre-signing market check or the process was kicked off by an unsolicited third-party bid.

Management-Led Buyouts Present Different Concerns

In light of the court's usual deference to merger price as fair value, it is a bit shocking that the court has found that, in this instance, the deal price of Dell's merger is not an accurate valuation of the company. There is a key difference, however, between this case and the string of cases the court broke with: this merger was a private transaction that was controlled through a management-led buyout, as opposed to a merger driven by market forces. In cases where the party selling a company is also on the side buying it, there is cause for concern that the shareholder's best interests are not being considered. Thus, the shareholder's interest in the company could be sacrificed and undervalued to better serve the management's interest in the sale. As the court asserted, "Because of management's additional and conflicting role as buyer, MBOs [management buyouts] present different concerns than true arms' length transactions."

In addition, the court determined there was a lack of meaningful price competition during the pre-signing phase, which signaled to the court that an undervaluation of the company could be occurring. The price established during such phase is critical, because go-shops "in MBO transactions rarely produce topping bids." Go-shops, the bidding periods after an initial bid has been placed and bidding for the company has been opened to more buyers, rarely generate topping bids because the sponsors in that phase face the same hurdles, such as IRR percentages (internal rate of return, the interest rate at which the net value of the cash flow from an investment will equal zero), that the buyout group (who placed the initial bid) faces. The court found it suspicious that during Dell's go-shop phase, two subsequent bidders placed higher bids than the initial bid (even though they eventually dropped out of the bidding), thereby suggesting that the original merger consideration was relatively low and did not equate to fair value. Thus, because the buyout was not arm's length and the activity during the go-shop period was suspect, the court decided to pursue a more thorough analysis of the factors of the sale and the methods that Dell's board employed to determine how to find the best deal price.

The court determined that the original merger consideration was below fair value due to: (1) the use of a leveraged buyout pricing model to determine the original merger consideration, (2) the evidence that there was a significant valuation gap driven by the market's short-term focus, and (3) the fact that there was a lack of meaningful pre-signing competition. Dell's financial sponsor came up with the original merger price by determining whether and how much a buyer would bid, using an LBO (leveraged buyout) model that solves for a range of prices that a buyer can pay while still achieving particular IRRs. However, a merger price needs to show that it represents the going concern value of the company, rather than just the value of the company to one specific buyer. Due to the numbers Dell's financial sponsor imputed in the equation, the court found that Dell's need to achieve IRRs of 20% or more to satisfy its own investors put a limit on how much capital the company and investors could actually use to finance the deal.

Appraisal Inquiry Does Not Imply Breach of Fiduciary Duty

Furthermore, the court found that because investors and analysts were focusing on short-term, quarterly results, they were excessively discounting the value of long-term investments. The court remarked that while management sometimes uses this informational asymmetry between itself and the public to time a buyout, nothing illicit occurred here. As long as a company's directors have acted in good faith and reasonably, the Delaware Court of Chancery will not find a breach of fiduciary duty. Appraisal analysis differs from a breach of fiduciary duty analysis because in an appraisal action the "court does not judge the directors' motives or the reasonableness of their actions, but rather the outcome they achieved." The court noted that the deal price could fall within a range of seemingly fair values and would not support fiduciary liability, but could still call for an appraisal action to determine the actual fair value of the company. Considering how upfront Dell CEO Michael Dell was in telling both his board of directors and the public that he had plans for the future to change the direction of his company, that he understood this decision would drive the stock price down for the short term, and that he tried to convince the market his company was worth more, the court found no breach of fiduciary duty. Even though outside analysts were discounting the value of Dell's long-term investments, the court found that Dell and its management did not intentionally capitalize on this undervaluation. Therefore, while the valuation gap did not reflect the fair value of the company, the court determined there was no breach of fiduciary duty.

How Did the Court Determine $17.62 to Be the Fair Value?

Because the court determined the sale process to be unreliable evidence of fair value, (namely, because it was a management-led buyout lacking arm's length) the court chose to rely on a DCF (discounted cash flow) methodology to determine the present value of the company, rather than give deference to Dell's LBO model, which only solves for the internal rate of return. According to the court, the "DCF analysis is a well-established method of determining the going concern value of a corporation." After reviewing the DCF analyses of both parties' valuation experts, the court decided to use two adjusted forecasts provided by the respondent's expert because it determined they were the most reliable forecasts for the company.

Prior to the merger, Dell's committee hired the Boston Consulting Group to prepare a detailed set of forecasts that valued the company as a going concern. Both parties' experts viewed the BCG 25% Case as reliable and the committee, BCG, and J.P. Morgan (who also advised Dell) regarded the BCG 25% Case as a "realistic and achievable set of projections for the Company." There were, however, some weaknesses in the projections that the respondent's expert accounted for and adjusted in the BCG 25% Case. While the court is generally "skeptical of litigation-driven adjustments to management projections," the court believed the respondent's expert had "persuasively justified his changes, and this court has used adjusted projections when the expert has provided sufficient support for the modifications." The court believed the BCG 25% Case to be a reliable set of forecasts, but because it was created by the respondent's expert the court labeled it a conservative forecast of the company's value. Additionally, both experts believed the Bank Case to be a reliable forecast (projections were prepared by the buyout group but Dell management provided key inputs), even though the court found it to be overly optimistic. Respondent's expert adjusted the Bank Case forecast to account for non-recurring restructuring expenses and for stock-based compensation, which the court believed to be a reliable DCF analysis, albeit a bit optimistic.

Using respondent's adjusted BCG 25% Case, a DCF analysis generated a fair value per share of $16.43 while the respondent's adjusted Bank Case resulted in a fair value per share of $18.81. Because the court found both forecasts to be realistic, it weighed them equally and thus held the fair value on the date of the merger to be $17.62 per share.

Proceed, Shareholders

In light of this recent decision by the Delaware Court of Chancery, outside shareholders should be encouraged, knowing that the court is willing to perform traditional valuation techniques to protect them and, when necessary, use its judgment to price a deal higher than the various corporate insiders.

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