Securities Regulation Daily Wrap Up, TOP STORY—Del. Ch.: Dell dissenters rejoice: appraisal values company at 25 percent above merger price, (May 31, 2016)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Anne Sherry, J.D.

Dell shareholders who dissented from the 2013 management buyout were vindicated by the Delaware Chancery Court's ruling in the appraisal case. Numerous factors in the pre- and post-signing phases of the merger negotiations meant that the merger consideration of $13.88 per share was not the best evidence of a fair price. Opting instead for a discounted cash flow analysis, the court arrived at $17.62 per share as the fair value of the company on the closing date (*In re Appraisal of Dell Inc.*, May 31, 2016, Laster, J.).

Judicial review. There are no presumptions in an appraisal proceeding; both sides bear the burden of proving their asserted value by the preponderance of the evidence. Dell contended that the merger consideration was the best evidence of the company's fair value on the closing date, but while Delaware courts will consider market price data, they are not beholden to "market fundamentalism." Even when the target is a public company, the deal price will not inevitably equate to fair value because of substantial delays between signing and closing, liquidity and fungibility considerations, and synergies priced into the offer. The chancery court said that while the final merger consideration was a relevant factor, it was not the best evidence of the company's fair value.

An inquiry into the sale process is also important, the court noted. This differs from an inquiry into whether directors breached their fiduciary duties—it is entirely possible that the directors satisfied their *Revlon* duties and yet the process still generated a price that was not persuasive evidence of fair value in an appraisal. The court wrote that the process "easily would sail through if reviewed under enhanced scrutiny," but that is not the same as proving that the deal price was the best evidence of the company's fair value.

Pre-signing factors. Here, three factors during the pre-signing phase of the sale process undercut the persuasiveness of the deal price as evidence of fair value. First, the original merger consideration was determined by use of an LBO pricing model, strongly indicating that the original merger consideration undervalued the company as a growing concern. The pre-signing negotiations did not focus on fair value, but rather on what a financial sponsor could pay and still generate outsized returns.

Second, there was compelling evidence of a significant valuation gap driven by analysts' focus on short-term results and the company's nearly $14 billion investment in its transformation, which had not yet begun to generate the anticipated results. An appraisal proceeding can, and should, address the issue of "opportunistic timing" where a company goes private before the market has priced in the benefits of such investments. Proposing an MBO when the stock price is low further anchors price negotiations to the depressed stock price, compounding the problem of "market myopia." The court observed that, rather than opportunistically creating the valuation gap to profit from it, Michael Dell and his management team tried to convince the market that the company was worth more. Nevertheless, the "anti-bubble" not only facilitated the MBO but undermined the reliability of the market price as a measure of value.

Finally, there was a lack of meaningful competition during the pre-signing phase. The committee engaged with only three financial sponsors, two of which dropped out. Without the threat of an alternate deal, the committee lacked the most powerful tool that a seller can use to extract a portion of the bidder's surplus. This undermined the reliability of the original merger consideration—and therefore of the final merger consideration, which keyed off that offer—as a measure of the company's value.

Post-signing "go-shop" phase. Two higher bids emerged during the go-shop: one from Carl Icahn and another from Blackstone. Blackstone withdrew its bid, but Icahn stayed in. The company's argument that another party would have topped the MBO bid if the company were worth more was sufficient, in the court's view, to discount the idea of a large valuation gap, such as the $28.61 per share value that the petitioners advanced. But in light of leverage constraints and other factors, the go-shop process was not sufficiently persuasive to rule out smaller gaps. Given that the pre-signing phase did not generate a price equivalent to fair value, the 2-percent bump achieved through the go-shop was not sufficient to prove that the final consideration was the best evidence of fair value.

The court credited an expert's testimony to the effect that MBO go-shops, although generally legitimate from the standpoint of fiduciary duty analysis, can be inadequate for price discovery. Before making a bid, a potential overbidder will evaluate its pathway to success. The go-shop structure was relatively flexible, and the size and complexity of the company meant that a successful topping bid would literally have been unprecedented. Blackstone, one of the world's most sophisticated private equity firms, "had to spend in excess of $25 million and assemble a due diligence team that filled a ballroom" just to achieve "excluded party" status, a prerequisite to continued negotiations. The magnitude of that hurdle no doubt had a chilling effect on other parties.

Two other factors in the go-shop phase were the "winner's curse" and the value that Michael Dell contributed to the company. The expert explained that as a winner, "you'd have to say to yourself 'I've almost certainly overpaid because the inside bidder, they looked at my offer and they decided not to match it. So either I'm very smart, smarter than the inside people,' which is unlikely to be the case, 'or I've just overpaid.'" This problem is endemic to MBO go-shops and creates a powerful disincentive for any competing bidder, but especially financial sponsors, to get involved. Furthermore, a competing bidder had to account for Michael Dell's value to the company. "A competing bidder that did not have Mr. Dell as part of its buyout group would be bidding for a company without that asset and would end up with a less valuable company," the court observed.

Petitioners' valuations. The petitioners' experts used a discounted cash flow analysis to arrive at a fair value of $28.61 per share on the closing date—more than double the valuation offered by the company's expert, who also used DCF. The difference was driven primarily by the projected cash flows they used. As noted above, the court did not find such a large gap between the proffered value and the merger price credible. If the company had really been worth that much, it would have attracted more interest, particularly from its largest competitor, Hewlett-Packard.

The court found two of the cash-flow cases used by the petitioners' experts to be realistic and weighted them equally, which fortuitously approximated the cost-savings number that management cited as attainable at the time of the merger. A DCF analysis using the average of the realistic cases generated a fair value of $17.62 per share. Assuming this figure was correct, a strategic acquirer could have gotten the company for approximately a 25 percent discount. Given the massive integration risk of such a large deal, this gap was small enough to explain why HP stayed out of the fray and no one else came forward.

The case is No. 9322-VCL.

Attorneys: Stuart M. Grant (Grant & Eisenhofer, P.A.) for petitioners. Gregory P. Williams (Richards, Layton & Finger, P.A.) and John L. Latham (Alston & Bird LLP) for respondent Dell Inc.

Companies: Dell Inc.; Southeastern Asset Management; Kohlberg Kravis Roberts & Co. L.P.; Silver Lake Partners; Texas Pacific Group; Icahn Enterprises L.P.; The Blackstone Group; The Hewlett-Packard Company

MainStory: TopStory DirectorsOfficers FiduciaryDuties InvestmentCompanies MergersAcquisitions PrivateEquityNews DelawareNews