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# *The Appraisal Landscape After the Delaware Supreme Court's* Dell *and* DFC Global *Decisions—Key Points, Open Issues and Practice Points*

In the second half of 2017, the Delaware Supreme Court issued two seminal decisions concerning appraisal—*DFC Global v. Muirfield* (Aug. 1, 2017) and *Dell v. Magnetar* (Dec. 15, 2017). These decisions are likely to accelerate the trends already developing in the recently changed landscape for appraisal actions. Below, we discuss (i) the key points arising from the decisions; (ii) the background of the cases; (iii) the likely practical effect of the decisions; (iv) open issues; and (v) related practice points.

**Key Points**

- **Very strong endorsement of reliance on the merger price to determine appraised "fair value" when the sale process was "robust."** Most importantly, the Supreme Court strongly endorsed the merger price as the most reliable "proxy" for fair value in arm's-length mergers involving a robust sale process. The Supreme Court held that the Court of Chancery should accord the merger price "heavy, if not dispositive weight" when the sale process was robust. In *Dell*, the Supreme Court expressly declined to adopt an express, formal judicial presumption that fair value equals the deal price when the sale process was robust (reasoning that an express presumption would be inconsistent with the requirement in the appraisal statute that, in determining fair value, the Court of Chancery must "take into account all relevant factors"). However, the substance and strong tone of these two opinions suggest that, as a practical matter, this presumption is now effectively operative. *DFC Global* and *Dell* will amplify and expand the trend already underway of increased reliance by the Court of Chancery on the deal price—with the result that appraisal claims (i) are less likely to be made (or at least to be litigated through trial) in the case of third-party arm's-length mergers where it appears that there was a robust sale process and (ii) will continue to be driven to cases involving a controller transaction, a management buyout, or another transaction where there is a basis to believe that there was not or may not have been a robust sale process.

- **Very strong resistance to viewing special factors as having distorted the market.** In both *DFC Global* and *Dell*, the Supreme Court flatly rejected the Court of Chancery's view that special factors had distorted the market for the target company by impeding competition and so had rendered the merger price unreliable for determining fair value. In *DFC Global*, throughout the sale process, the target company faced extreme regulatory uncertainty due to a pending complete overhaul of the regulatory scheme applicable to the payday loan industry—to the point that the company was rapidly, continually and significantly revising its projections downward and ultimately ceased to provide any forecasts. Chancellor Bouchard's decision to give only one-third weight to the merger price when determining fair value (and one-third each to DCF and comparables analyses), notwithstanding that the company had been fully shopped, appeared to be rooted in a view that, with projections that seemingly had no substance or reliability and a buyer apparently opportunistically seeking to acquire the company at a low price, the buyer's price was not fully reliable as an indicator of the intrinsic going concern value of the company. In *Dell*, which involved a management buyout, Vice Chancellor Laster regarded the sale process as well-crafted for fiduciary duty purposes—but, for appraisal purposes, as insufficient to outweigh factors that the court viewed as inherent in MBO transactions and as undermining the reliability of an MBO merger price as an indicator of fair value. In both cases, the Supreme Court emphasized the efficiency of the market prior to the sale process, the robustness of the sale process, and the absence of any specific evidence indicating that the special factors identified by the Court of Chancery could not have been, or had not been, assessed by the market and reflected in the merger price.

- **Skepticism as to the reliability of DCF analyses in determining fair value—and direction to the Court of Chancery to take the merger price into account to some extent even in those cases in which it is not the "best" evidence of fair value.** In *Dell,* the Supreme Court emphasized the "less-than-surefire" nature of DCF analyses given that myriad subjective inputs are required and small changes in inputs can lead to significantly different results; the inherently uncertain nature of projections, which are the key input to a DCF analysis; the "hazards that always come when a law-trained judge is forced to make a point estimate of fair value based on widely divergent partisan expert testimony"; and the "lack of credibility" of DCF results of the parties' respective experts that "land galaxies apart." In both *Dell* and *DFC Global*, the Supreme Court strongly suggested that, based on the Court of Chancery's findings that the sale process had been robust, on remand, the Court of Chancery should determine fair value to be equal to the deal price. Moreover, the Supreme Court directed that the Court of Chancery take the merger price into account in other cases at least to *some* extent even when the merger price is not the "best" or the "most reliable" evidence of fair value. Apparently then, even in the case of a *less*-than-fully-robust sale process in a non-controller transaction, the merger price should be accorded *some* weight, based on the extent to which the less than perfect sale process had elements of robust-ness. As a DCF result typically exceeds the deal price, this direction to the Court of Chancery may have a depressing effect on appraisal award amounts in non-controller cases in which the court previously would have relied solely on a DCF analysis.

- **Detailed analysis of the specific facts and circumstances of an MBO to assess the reliability of the merger price.** In *Dell,* the Supreme Court acknowledged that certain features of MBOs inherently undermine the robustness of a sale process (and therefore the reliability of the merger price). Based on a detailed analysis of the Court of Chancery's findings in *Dell*, however—relating to the sale process, the nature of the company, and the transaction terms—the Supreme Court concluded that those potentially problematic features were "largely absent" in the Dell MBO (and therefore the merger price was highly reliable). We note that MBOs can be viewed as falling on a continuum between controller transactions and third party arm's-length transactions—and the Supreme Court appeared to view the Dell MBO as closer to the latter. That view appears to have been based primarily on (i) the transparency of information about the company in the market and in the sale process and (ii) the apparent willingness of management to cooperate with potential rival bidders and to sell their shares to a topping bidder if one emerged.

- **Confirmation that a sale process may be robust even if the only bids received are from a small number of financial buyers.** The Supreme Court specifically and definitively rejected in both cases the concept that had been expressed in two Court of Chancery decisions (*Dell* and the 2016 *Lender Processing* decision) that a merger price derived from a financial buyer's "LBO pricing model" is inherently less reliable for appraisal purposes than a strategic buyer's merger price because the LBO model is driven by the buyer's required internal rate of return rather than the intrinsic value of the company. The Supreme Court reasoned that strategic buyers also base their pricing on a required rate of return. Further, the Supreme Court expressly confirmed in both cases that a sale process that included widespread solicitation of financial and strategic buyers was robust even if only a small number of financial bidders ultimately made offers—at least where the record indicated that the reason was that other parties were not interested in bidding.

- **Likely Practical Impact**

  - **Reduction in appraisal litigation overall, with claims driven to those cases where a remedy is most appropriate.** In our view, appraisal claims are likely to be litigated through trial only in the case of controller transactions, MBOs and transactions in which the sale process was seriously flawed in terms of meaningful competition. The prevalence of appraisal cases has grown steadily from 2010 (when appraisal rights were asserted in less than 5% of the transactions for which they were available). By 2017, appraisal actions were being asserted in about 25-30% of the eligible transactions. We expect that appraisal will now be viewed more as an extraordinary remedy available only in specific types of cases.

    *DFC Global* and *Dell* represent a potent reinforcement and expansion of recent developments that already were likely to reduce appraisal litigation overall and to drive it away from cases involving third party arm's-length mergers where there was a reasonable sale process. These other recent developments include (i) the Court of Chancery's evolution over the past two years to increased reliance on the merger price (and increased skepticism of the DCF methodology) to determine fair value; (ii) the enactment in 2016 of statutory amendments designed to discourage appraisal overall (by not permitting claims involving a de minimis number of shares to proceed and by allowing companies to "prepay" any amount of a potential ultimate appraisal award and eliminate the tolling of the high statutory interest on the prepaid amount), and (iii) the Court of Chancery's issuance in 2017 of *below*-the-merger-price results in two cases. We note the similar development in the area of fiduciary duty litigation, where the Delaware courts in recent years (in decisions such as *Corwin, Cornerstone, MFW, C&I Energy,* and *Trulia*) have sought to reduce litigation overall and drive claims to those cases involving the most problematic factual context.

  - **Possibly, a depressing effect on appraisal results generally.** First, given that the Supreme Court characterized the *Dell* petitioners' DCF result as "lack[ing] credibility on its face" due to the $23 billion "chasm" between it and the market-based data, experts in appraisal cases may as a strategic matter decide to present DCF results that do not diverge so extremely from the merger price as typically has been the case. Second, given the Supreme Court's direction to the Court of Chancery to take the merger price into account at least to some extent even when it is not the *"most reliable"* evidence of fair value, there may be a depressing effect on the appraisal award amount in cases involving a non-controller transaction with a flawed sale process as, in the past, the Court of Chancery typically relied solely on a DCF analysis (without having to attribute any weight to the merger price to the extent that the sale process was reasonable although less than fully robust).

**Background—*DFC Global***

DFC Global, a "payday" loan company, engaged an independent financial advisor to investigate a sale of the company to a financial sponsor. At the time, and throughout the sale process, the company faced significant business uncertainty relating to a pending complete overhaul of the regulatory scheme applicable to the industry (which was expected to affect certain companies favorably and drive others out of business, without any way to predict the result for any specific company). The company was fully shopped over a period of about two years, with 43 financial sponsors and 3 potential strategic buyers contacted. While there were multiple interested potential buyers, ultimately only Lone Star (a financial buyer) and one other financial buyer submitted indications of interest, after which Lone Star was granted a period of exclusivity. Prior to and during the sale process (including after receiving the indications of interest), DFC Global continuously and significantly lowered its projections based on the regulatory uncertainty (and eventually announced it could no longer provide any earnings forecasts). At the same time, Lone Star continually lowered its offer price from $12.16 per share initially down to, ultimately, the merger price of $9.50.

The Court of Chancery concluded that the extreme regulatory uncertainty rendered all methodologies for determining fair value unreliable. The court utilized an "imperfect blend" of (i) the merger price, (ii) a DCF analysis, and (iii) a comparables analysis. The Supreme Court unanimously reversed. Chief Justice Strine, writing for the court, emphasized that the market was capable of assessing, and had assessed, the regulatory uncertainty and that it was reflected in the merger price. While rejecting an express, formal judicial presumption favoring reliance on the deal price under specified circumstances (citing the difficulty in defining those circumstances and potential inconsistency with the mandate in the Delaware statute to take "all relevant factors" into account), the Supreme Court strongly endorsed primary or sole reliance on the deal price when the sale process was robust. The case was remanded to the Chancery Court, with a direction to reconsider the only one-third weight accorded to the merger price—given that, based on the robust sale process, the merger price was strongly reliable (and, given that the DCF analysis was particularly unreliable because the company's projections were unreliable).

**Background—*Dell***

Michael Dell (the founder, CEO and 16% stockholder of Dell, Inc.) and private equity firm Silver Lake Partners took Dell private in a $25 billion MBO—with a deal price of $13.75 per share, which represented a 37% premium over the unaffected stock price. In the merger, Michael Dell, having rolled over his equity and invested $750 million of cash, obtained 75% ownership of the buying company. In the pre-signing phase, Michael Dell had discussed a potential going private transaction with Silver Lake and another financial buyer, and the special committee had contacted one additional financial buyer, but Silver Lake was ultimately the only bidder. No strategic buyers were solicited because the committee believed that they would not be interested (primarily because of Dell's very large size and complexity). In the post-signing go-shop phase, 67 parties (including potential strategic buyers and financial sponsors) were solicited. Carl Icahn made a topping bid during the go-shop, which caused Michael Dell/Silver Lake to raise their price by 2% (which was still somewhat below Icahn's price).

While the merger price represented a substantial premium over the unaffected Dell stock trading price, the company's proxy statement reflected that Michael Dell and the company's financial advisors viewed the company's value as being significantly higher. Nearly half of the stockholders dissented from the merger and sought appraisal rights. Vice Chancellor Laster conducted, and relied exclusively on, a DCF analysis, the result of which was 30% higher than the merger price. The Delaware Supreme Court, in a unanimous opinion written by Justice Valihura, reversed the appraisal award and remanded the case for reconsideration given the Supreme Court's view that "the deal price deserved heavy, if not dispositive, weight." The Supreme Court declined to "give in to the temptation to dictate" that, on remand, fair value should be determined to be the deal price. Instead, the Supreme Court stated that the Court of Chancery has discretion on remand to enter judgment at the deal price with no further proceedings or, if the Court of Chancery chooses to accord weight to additional factors, it must do so with adherence to the Supreme Court's rulings in *Dell* and must "explain that weighting based on reasoning that is consistent with the record and with relevant, accepted financial principles."

**Open Issues**

***What is a "robust" sale process?*** Notably, the courts have not defined what a "robust" sale process entails. The Court of Chancery has emphasized the need for the sale process to have involved, or been structured to create, "meaningful competition."

In every case in which the Court of Chancery has relied primarily or exclusively on the merger price, the sale process involved substantial solicitation of potentially interested parties, as well as other standard indicia of a strong sale process. Notably, however, the Court of Chancery has found that the sale process was "robust" in appraisal cases when (a) no actual competition emerged but the process was structured to provide for competition in that an auction was publicly announced, the interest of numerous parties was solicited, and the "threat" of competition was maintained by not letting the sole financial bidder know whether it was competing against other bidders (*Lender Processing*); (b) only a small number of financial sponsors (and no strategic buyers) submitted bids after a widespread solicitation (*PetSmart* and *Dell*); and (c) although there was a public auction, the most likely buyer, which was the target's main competitor, was not specifically contacted (as the target board had decided that it did not want to have to provide confidential information to the competitor before knowing if it had serious interest in bidding) (*PetSmart*).

The Supreme Court mentioned in *Dell* (without further discussion) 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." It remains unclear, however, whether the "robust" sale process standard is less demanding, equivalent to, or more demanding that the *Revlon* standard. Notably, the Delaware Supreme Court, in the 2016 *C&J Energy* decision, interpreted *Revlon* as having been satisfied for fiduciary duty purposes when there was only a single bidder sale process with no active shopping of the company before the merger agreement was signed, and only "passive shopping" (*i.e.*, a merger agreement provision permitting responses to unsolicited bids) after the signing of the merger agreement, with no competing bid being made. *Would the Supreme Court view such a process—which satisfied* Revlon*—as a "robust" sale process for appraisal purposes?* Arguably, yes, for the same reason that the court viewed it as satisfying *Revlon*—that is, without a high termination fee or other unreasonable deal protections, any party that wanted to submit a topping bid could do so post-closing, with the result that the merger price could reasonably be viewed as market-based. On the other hand, arguably, no—because there was no "meaningful competition." Resolution of this issue awaits further judicial development.

***In the context of a non-controller transaction with a robust sale process, are there <u>any</u> special factors that the court conceivably might view as distorting the market and rendering the merger price unreliable?*** In *DFC Global,* the Supreme Court rejected the concept that extreme regulatory uncertainty—to the point that the company was unable to produce projections with any meaning—distorted the market for the company; and, in *Dell,* the Supreme Court rejected the Court of Chancery's theory that, based on a "valuation gap" between the market's and the management's respective views of the company's value (with the market purportedly taking a more short-term view of the company's turnaround prospects), the bidding in the sale process was therefore "anchored" to an artificially low stock price. In both cases, the Supreme Court focused on the "apparent efficiency" of the market and the transparency of information available to the market generally and to the potentially interested parties—indicating a high bar to its accepting that, in the context of a non-controller transaction with a robust sale process, there could be factors that would distort the market. The opinions suggest, however, that the following factors (which, we note, may particularly be relevant in the private company or MBO context) *could* be viewed by the court as distorting the market:

- A limited base of stockholders or a non-active trading market for the company's shares;
- Sparse information about the company in the marketplace (such as public filings not being up to date; analysts not following the company; the company not providing information to analysts; the company not explaining its long-term plan for the company; a company track record of not holding stockholder meetings or of not responding to questions from stockholders); or
- In the case of an MBO, indications that the due diligence that management provided to interested parties was not broad enough to overcome management's inherent "informational advantage"; management purposefully tempering investors' expectations for the company to artificially depress the stock, or other evidence of management trying to position itself to opportunistically take over the company at a reduced price; or depending on the circumstances, management not being willing to sell their shares and/or remain with company in the event a topping bidder emerges.

***In the context of a non-controller <u>MBO</u> with a robust sale process, when would the court view the merger price as <u>not</u> reliable?*** In Dell, the Supreme Court concluded that the features of MBOs "which could theoretically undermine the probative value of the deal price" were "largely absent" in this case. If the following features were present, the court might view the merger price as not reliable:

- *Narrow go-shop.* The Court of Chancery, in the opinion below, had expressed skepticism that a post-signing go-shop would be effective in MBO situations because potentially interested parties would see "no realistic pathway to success." The Supreme Court stated that (i) the Court of Chancery itself found that the *Dell* go-shop was "broad" and "raised fewer structural barriers than the norm"; (ii) rival bidders (such as Blackstone, TPG, Hewlett Packard, and Icahn) "did have a realistic pathway to succeeding if they desired" (particularly as not all of them viewed Michael Dell as being critical to the company and could proceed without his being involved post-merger); and (iii) go-shops in MBOs have sometimes resulted in topping bids (at least where the management's ongoing participation was not viewed as critical).
- *Informational advantage due to limited due diligence.* The Supreme Court reasoned that the "winner's curse" phenomenon *(i.e.,* the theory that a potential buyer believes it will be overpaying for the company if it tops management's bid given the informational advantage that management

has) was mitigated in this case by the extensive cooperation of management in providing "extensive due diligence" to potentially interested parties. (The informational advantage also was mitigated due to some of the parties' doubting the value of Michael Dell's insight and one party's due diligence team being led by a person who had recently been an executive at Dell.)

- *Non-cooperation by, or critical role of, management.* Competition can be impeded when potentially interested parties view the management group's sale or rollover of its equity interest, or its continued participation in the post-merger company, as critical. As noted, the Supreme Court found in *Dell* that the Court of Chancery's findings supported a conclusion that at least some of the possible bidders did not view it as critical that Michael Dell either sell his interest or continue with the company. In any event, according to the Supreme Court, the record indicated that Michael Dell actually was willing to consider selling his shares and working with other bidders.

***Could a <u>controller</u> transaction conceivably be structured so that the court would rely on the merger price?*** Even in the context of expanded reliance on the merger price in recent years, the Court of Chancery has not relied on the merger price in the case of controller transactions. It is uncertain whether the court might rely on the merger price in a controller transaction if, for example, the minority stockholder protections prescribed in *MFW* (for the application of business judgment review of fiduciary challenges to controller transactions) were satisfied. With *MFW* compliance, arguably, the minority stockholders would not have been exploited and the requisite independent board and minority stockholder approvals would indicate that the merger price likely reflected something close to fair value—notwithstanding the controller having stated that it would not consider selling its shares and, therefore, there could be no competition. However, in a controller transaction, the choice the board and the minority stockholders have is between the controller's deal and no deal—thus the concept of "meaningful competition" (actual or "threatened") would seem to be inapposite. We note that, if the controller commits to sell its shares if a topping bid emerges, then the controller would have, in effect, reduced its control and made potential competition possible—in our view, making it more likely that the court would rely on the merger price.

***How do these decisions affect the likelihood that the court, when it relies on the merger price, will adjust the merger price downward to exclude the value of merger synergies?*** The appraisal statute mandates that the court exclude from fair value any value that arises from the merger itself. Notwithstanding the statutory mandate, however, the Court of Chancery, when it has relied on the merger price, has almost invariably declined to make any downward adjustment to exclude value arising from the merger (such as merger-specific synergies or, possibly, a control premium). The court has cited conceptual and practical difficulties in determining which synergies should be excluded, how they would be valued, and how to determine whether that value was reflected in the merger price. Neither *DFC Global* nor *Dell* involved significant expected synergies and the issue of a downward adjustment to exclude any such value was not raised. As discussed, in our view, appraisal claims are now unlikely to be pursued aggressively through trial or settled for amounts significantly above the deal price in cases in which the court is likely to rely on the merger price—therefore, it may be more unlikely that the issue of downward adjustment of the merger price will arise or receive judicial attention.

***Will comparables analyses be viewed as another tool of some reliability in determining fair value?*** The Court of Chancery typically has declined to accord any weight to comparable analyses in determining fair value. (A comparables analysis uses operating metrics and valuation multiples in a peer group of public companies to determine an appropriate valuation multiple for a target company.) In almost every appraisal case in which the petitioners have presented a comparables analysis, the Court of Chancery has viewed the peer group as not "sufficiently comparable" for the analysis to be reliable. We note that *Dell* makes clear that the Supreme Court's view is that: (i) there is *no* "perfect" method for determining fair value; (ii) the DCF methodology is inherently problematic; and (iii) the merger price, as a market-based data point, should be accorded at least some weight even when it is not the "best" or "most reliable" evidence of fair value. In this context, in cases in which the merger price is viewed as less than entirely reliable, is it possible that a comparables analysis, which is a market-based methodology, will be viewed as another tool providing a reliable data point that could (should?) be accorded some weight? Put differently, with the Supreme Court's expressed antipathy in *Dell* to the DCF methodology, might the court now prefer a comparables analysis to a DCF analysis as a secondary consideration when the merger price is not fully reliable?

**Practice Points**

- **Reliance on the merger price.** The extent to which the court is likely to rely on the merger price to determine fair value will depend on the facts and circumstances—including how robust the sale process was, how efficient the market was before the sale process, and whether there were other impediments to obtaining fair value. *DFC Global* and *Dell* indicate that the court will be skeptical of arguments that the market was inefficient or that there were impediments to obtaining fair value in the context of a robust sale process. As discussed above, the court may be open to viewing factors relating to a lack of transparency of information about the company in the marketplace (due to, say, limited trading of shares or a limited following by analysts) as creating market inefficiency.

- **MBOs.** MBOs can be viewed as being on a continuum between controller transactions and third party arm's-length transactions, based on the specific facts and circumstances relating to: (i) the size of the management group's equity holdings, the extent of its dominance or influence on the board, the importance of its role at the company, and the size and importance of its role in the transaction; (ii) the extent to which there is an alignment of the management's interests with the stockholders *(i.e.,* is the management group a "net" seller or buyer of shares?); (iii) the extent to which it may be the wrong time to sell *(i.e.,* an opportunistic time for the management to buy) the company; (iv) the extent to which the management group is prepared to, and does, provide information to potential rival bidders and will consider or commit to selling their shares and/or remaining with the company in the event of a topping bid; and (v) the extent of the competition in the sale process. *DFC Global* and *Dell* indicate that the availability of information about the company and, depending on the circumstances, the management's willingness to sell their shares and/or remain with the company may be critical factors.

- **DCF analyses.** Given the Supreme Court's emphasis on the "lack of credibility on its face" of a DCF analysis that varies widely from the merger price derived in a robust sale process, appraisal experts may want to consider whether, as a strategic matter, to present a DCF analysis with a result that (although higher) is not *vastly* higher than the merger price (at least when the sale process, although not fully robust, was not *seriously* flawed). In addition, we note that the Supreme Court's strong critique in *Dell* of the DCF methodology, although made (and most pertinent) in the appraisal context, has the potential, depending on the circumstances, to increase skepticism about DCF results in other contexts as well (including, for example, with respect to fairness opinions, particularly to the extent that the range of values provided is narrow)—which would then emphasize the benefits of utilization of a variety of valuation metrics rather than DCF alone.

- **Comparables analyses.** In the past, the Court of Chancery has almost invariably not viewed comparables analyses as reliable, finding that the peer companies selected were not "sufficiently comparable." In *DFC Global* and *Dell*, the Supreme Court seems to have acknowledged that there is no perfect tool for determining fair value—and, as discussed, was particularly skeptical of the DCF methodology. In this context, it may be that, when the merger price is not entirely reliable (say, because the sale process was less than fully robust), the Court of Chancery might become more receptive to according some weight to a comparable transactions analysis—which is, in a sense, a market-based analysis—in determining fair value.

- **Synergies.** Notwithstanding the courts' continued reluctance, when it relies on the merger price to determine fair value, to make a downward adjustment to deduct the value of synergies or other elements of value (such as a control premium) arising from the merger itself (consistent with the statutory requirement that value arising from the merger be excluded), a buyer should argue for such an adjustment. Given that the Court of Chancery stated in the 2016 *Lender Processing* decision that it would make such an adjustment if a buyer presented a sufficient record to justify it, a buyer should analyze and contemporaneously document the extent to which its deal price reflects value that the buyer or the transaction itself will potentially create.

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