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Why Post-Dell Appraisal Fears Are Unfounded

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In Appraisal of Dell Inc. (May 31, 2016), the Delaware Court of Chancery awarded an appraisal amount ($17.62) that was 30 percent higher than the price that was paid in the $25 billion merger ($13.75) in which Michael Dell (the founder, CEO and 16 percent stockholder of Dell) and private equity firm Silver Lake Partners took Dell private. In the merger, Mr. Dell, having rolled over his equity and invested $750 million of cash, obtained 75 percent ownership of the company. The court utilized a discounted cash flow (DCF) analysis to appraise Dell's "fair value" for appraisal purposes (i.e., the going concern value of Dell at the time of the merger, excluding the value of any expected synergies), having concluded that, in this case, the merger price was not a reliable indicator of fair value.

Background


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In the presigning phase, Mr. Dell discussed a potential going-private transaction with Silver Lake and another financial buyer, and the special committee contacted one financial buyer, but Silver Lake was the only bidder. In the post-signing go-shop phase, numerous financial buyers were contacted. No strategic buyers were solicited, as the committee believed that they would not be interested (primarily because of Dell's very large size and complexity). Carl Icahn made a topping bid, which caused Michael Dell/Silver Lake to raise their price by 2 percent — but the ultimate merger price was still slightly below Icahn's bid. While the merger price represented a substantial premium over the unaffected Dell stock trading price, the company's proxy statement reflected that Mr. Dell and the company's financial advisers viewed the company's value as being significantly higher. Nearly half of the stockholders dissented from the merger and sought appraisal rights (although, in a separate litigation, the court ruled that, for most of the dissenting shares, appraisal rights had not been perfected properly and thus had been forfeited).


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Definitions: For clarity, we define here our usage of the following terms in this article:

LBO ("leveraged buyout") — A transaction with a financial buyer that includes no management buyout component or a nonsignificant management buyout component.

MBO ("management buyout") — A transaction with a financial buyer that includes a significant management buyout component.

Whether the court will regard a transaction with a management buyout component as an LBO or an MBO will depend on the facts and circumstances, particularly the extent to which the target company and/or the transaction is viewed as dominated by the target company managers who are participating in it.

Key Points

In our view, the decision is consistent with the court's recent approach in appraisal cases — and underscores that the court will base appraised "fair value" on the merger price only when the court believes that the merger price is the best indicator of fair value.

Some broad language in the decision has given rise to concern among some commentators that the decision reflects a new direction by the court with respect to use of the merger price to determine "fair value" in appraisal cases involving financial buyers. In our view, the decision is consistent with the court's appraisal jurisprudence. Historically, the court has relied primarily on the discounted cash flow (DCF) methodology to determine appraised "fair value." In a few recent cases, the court has relied instead on the merger price when the court has determined that it was the best indicator of fair value. All of these cases involved a presigning public auction sale process; in most of them, the court, in addition, regarded the inputs available for a DCF analysis to be unreliable, and none of them involved an MBO.

The court regarded the Dell sale process as well-crafted for fiduciary duty purposes — but, for appraisal purposes, as insufficient to outweigh the factors that undermined the reliability of the merger price as an indicator of "fair value."

The court found that the Dell sale process, as a process matter, "easily" passed muster for fiduciary duty purposes — but that, because the process "lacked meaningful competition," it was not sufficient for the court to determine that the price derived through it reflected "fair value" for appraisal purposes. The decision serves as a reminder that the extent to which the court will view a sale process as having been sufficiently competitive to establish that the merger price is the best indicator of appraised fair value will depend on the facts and circumstances — and that the court will take into account its view of the underlying reality of the sale process based on real-world factors.

The decision highlights the appraisal risk in MBOs.

The opinion reflects that the courts generally are skeptical that the merger price in an MBO is a reliable indicator of "fair value" for appraisal purposes. Due to a number of features present in Dell (not all of which are always present in MBOs), that skepticism was heightened.

Contrary to recent commentary on the decision, in our view the court's discussion of the "LBO pricing model" does <u>not</u> mean that the court will not rely on the merger price to determine fair value in any merger with a financial buyer.

In our view, the court's discussion indicates that a buyer's use of an "LBO pricing model" will be one factor taken into account in evaluating whether the merger price is the best indicator of appraised fair value — and we expect that it would be unlikely to ever be a significant factor where a truly competitive market check has taken place. We note that most of the recent cases in which the court did view the merger price as the most reliable evidence of fair value involved LBOs.

Discussion

When determining what weight, if any, to give to the merger price in making fair-value determinations in appraisal cases, the Court of Chancery has evaluated the cases on a continuum based on the type of transaction and the nature of the sale process.

At one end of the continuum are transactions by controllers that involve no competitive process, and, at the other end, are arm's-length transactions with strategic buyers that involve a presigning public auction. LBOs and MBOs would fall somewhere in between, depending on the facts and circumstances, including the extent to which there was meaningful competition in the sale process. MBOs would tend to fall toward the controller end of the spectrum, requiring more competition than an LBO to move along the continuum in the other direction. As there is no bright-line test to determine whether the management buyout component of a financial buyer transaction is or is not significant enough for the transaction to be considered an MBO as opposed to an LBO, and as there is no bright-line test to determine whether a sale process involved "meaningful" competition, the appraisal risk depends on a nuanced analysis of the facts and circumstances of the specific transaction.

Factors inherent in MBOs tend to militate against the merger price being deemed a reliable indicator of fair value for appraisal purposes.

As noted by the court in Dell, these factors include that the managers participating in these transactions generally:

- Have an information advantage over potential competing bidders, which will tend to reduce competition and to enable the buyers to choose an opportunistic time to buy the company; and

- Have interests in the transaction that at least to some extent (and in some cases significantly) diverge from the interests of the stockholders generally — for example, in addition to their being sellers of shares in the transaction, the participating managers also typically will have employment positions at the post-merger company and/or may be "net buyers" of shares in the transaction, potentially giving rise to motivations that conflict with the objective of obtaining the best price for the shares).

We note that these factors are not inherent in (although they may also appear in) LBOs or strategic transactions.

In the Dell MBO, there were also a number of important factors (not all of which are always present in MBOs) that appeared to have further undermined the reliability of the merger price as the best indicator of appraised fair value.

These additional factors included that:

- *Michael Dell was uniquely important to the company.* Given Michael Dell's large existing equity interest, large equity interest being acquired in the transaction, role as CEO, status as founder, and role as the creator of the business plan for transformation of the company, he was even more important to the transaction than management typically is in MBOs.

- *Michael Dell's interests were, in important respects, adverse to the other stockholders' interests.* Due to the very high equity interest that he was obtaining in the transaction, Michael Dell was a "net buyer" of shares — which caused his interests not only to be not aligned with the other stockholders, but to be adverse to their interests — in that his interests were in the merger price being as low as possible.

- *The only presigning discussions involved Michael Dell contacting two financial buyers to discuss his desired transaction.* These discussions, presumably, involved Mr. Dell's determining whether the two buyers would be interested in doing a transaction that met his objective of his obtaining a 75 percent interest in the company. (The special committee contacted one other financial buyer in the presigning period, but that buyer was not interested in discussing a transaction.)

- *The universe of potential buyers was particularly limited.* Given Dell's large size and complexity, there was a very limited universe of potential buyers — meaning that, even with the best sale process, it would be difficult to achieve meaningful competition.

- *There was very limited variability among the potential buyers.* Among the interested financial buyers, each of them evaluated the company based on executing the company's existing business plan (which had been created by Michael Dell), without bringing to the table buyer-specific plans to create value (which would have led to different pricing among the bidders and some pressure to bid higher).

- *It appeared to be a particularly opportune time to buy the company, given the very large valuation gap between the stock trading price and management's view of the company's value.* The very large valuation gap underscored that, at the time, there was an unusually high degree of uncertainty relating to the company, which would tend to discourage potential competition. The court viewed the large gap as "anchoring" any bid prices to the very low stock price and as indicating (even more than would be typical in other MBOs) that it was an extremely opportunistic time for an MBO.

- *The special committee rejected a topping bid.* The court did not view the fact that Carl Icahn, during the post-signing go-shop period, made a slightly higher bid as evidence of competition in the process. To the contrary, the court viewed it as further evidence that the Michael Dell/Silver Lake merger price was low.

- *The only potentially interested strategic buyer was not solicited during the presigning period.* Dell and its financial advisers identified HP as the only strategic buyer large enough to potentially have an interest in the company — but they did not contact HP in the presigning phase of the sale process. (HP was contacted during the go-shop and signed a confidentiality agreement but did not then proceed further.)

- *The special committee:*
    - did not consider a transaction other than a financial buyer whole-company acquisition, even though the business plan that Michael Dell had developed and that all of the financial buyers intended to follow without modification could have been executed in a public or private company context;
    - did not explore stand-alone alternative transactions to close the valuation gap (such as a recapitalization, restructuring or asset sales);
    - did not consider (or even calculate) going-concern value of the company; and
    - relied exclusively on the premium over the stock trading price when recommending the transaction (notwithstanding the very large valuation gap).

The court's view was that the sale process — albeit well-crafted and satisfying the directors' fiduciary duties — was insufficient, for appraisal purposes, to outweigh the factors that undermined the reliability of the merger price as an indicator of appraised fair value.

The court explained that the sale process is viewed through different lenses for fiduciary duty cases and appraisal cases. In fiduciary duty cases, the inquiry is into the directors' decision-making process and protections against conflicts of interest. In appraisal cases, the inquiry is into the result of that process — that is, irrespective of the directors' motivations and process, did the merger price reflect "fair value"? The court found that Dell's sale process, as a process matter, "easily" passed muster for fiduciary duty purposes — but that it was not sufficient, as a substantive matter regarding appraised fair value, to determine that the price derived through the process reflected fair value, particularly in the context of an MBO.

In the Dell process, Michael Dell purported to be willing to cooperate and participate with any buyer selected by the special committee; the go-shop was "relatively open and flexible," according to the court; and a slightly higher competing bid emerged during the go-shop. The court concluded, however, that, despite the positive optics of the process, numerous real-world factors limited the universe of potential buyers, resulting in a process that "lacked meaningful competition." The court's view was also influenced by the infirmities of the sale process (for appraisal purposes) noted above. We note that it is not entirely clear in the court's discussion of the sale process which points are intended to apply to all transactions, which to LBOs, and which only to MBOs. In our view, the factual context of the Dell MBO was an important overlay on the full discussion, and the absence of some combination of the negative Dell-specific factors noted above could well result in a different analysis.

Whether a go-shop will be regarded by the court as having provided for meaningful competition in a sale process will depend of the facts and circumstances.

In Dell, the court found that the go-shop terms were relatively "open and flexible," and two competing bids were made during the go-shop (although one was quickly withdrawn). The court emphasized that, nonetheless, real-world factors inhibit competition in the post-signing phase of an MBO (including the fact that financial buyers may be reluctant to compete with one another because of their ongoing relationships). While the court was not entirely clear about the extent to which its skepticism about go-shops was intended to apply only to MBOs or to apply also to LBOs, it is clear that go-shops will be evaluated by the court on a continuum, depending on the facts and circumstances of the specific situation. Relevant factors would be the type of transaction, the number and type of possible competing bidders, the extent of any presigning competition, the terms of the go-shop, and the results of the go-shop (i.e., whether any competing bids in fact emerged).

In Dell, the court stated that a go-shop has limited utility in promoting competition in the context of an MBO, and that the most persuasive evidence of meaningful competition in an MBO will be the competition that is present in the presigning period. The court reasoned that only a large gap between the deal price and fair value would possibly incentivize a competing bidder to emerge during a go-shop to take advantage of that gap, but that a less than large gap would not provide sufficient incentive, given the practical disincentives to post-closing bidding, particularly in an MBO. (It should be noted that, in any event, a go-shop may be important in fiduciary duty litigation challenging the "price" or "process" in a company sale.)

Even when the court deems a sale process to have been insufficient to support use of the merger price to determine fair value, the merger price may affect the court's determination under a DCF analysis.

The court has substantial discretion in determining fair value in a DCF analysis. To the extent that a sale process was reliable (albeit not reliable enough to support using the merger price to determine fair value), the merger price may "anchor" a DCF valuation, may influence the DCF inputs selected, and may influence the court's choice of the fair-value point within the range. In Dell, the court rejected the plaintiff's DCF valuation result, which was about double the merger price, stating that, if the gap between the merger price and fair value had been that large, a competing bid would have emerged to take advantage of the gap. Further, the court could have selected the high or low end of the range of DCF values that it determined, but selected the midpoint — presumably, at least in part, based on its view that the sale process (which it characterized as "praiseworthy in many ways") gave the merger price at least some level of reliability.

The court viewed the "LBO pricing model" as a negative factor when considering whether there was evidence that the merger price reflected fair value.

Commentators have expressed concern that the court's discussion of the "LBO pricing model" indicates that, in all LBOs (as well as MBOs), the court will not rely on the merger price to determine fair value. The court reasoned in Dell that an LBO pricing model solves for what a buyer is willing to pay (determined by the requirements that financial buyers have for a certain rate of return and for sufficient leverage capacity to support financing of the transaction). By contrast, the court explained, a DCF model solves for what the going-concern value of the target company is (which is the relevant issue for determining "fair value"). In our view, the court's discussion indicates that a buyer's using an LBO pricing model will be just one factor in determining whether the merger price is a reliable indicator of fair value — and that it is not likely to be a significant factor in cases in which there is otherwise persuasive evidence that the merger price is a reliable indicator of fair value. There is no reason to expect that in LBOs, there could not be persuasive evidence that the merger price is reliable, notwithstanding use of the LBO pricing model. Indeed, in the recent cases in which the court has relied primarily or exclusively on the merger price, most of them were LBOs (although, as noted above, none were MBOs, and all involved meaningful competition in the sale process).

Even when the court considers use of an LBO pricing model as a negative factor, the issue is likely to be of far less importance than it was in Dell. First, as discussed, in Dell, there was no countervailing evidence of the merger price being reliable, in the court's view. Moreover, the gap between the LBO model-derived price and the going-concern value was unusually large. It is important to note that, although the court characterized financial buyers as essentially monolithic in their pricing given that they all target the same internal rate of return (IRR), their pricing determinations nonetheless can vary substantially. Variation occurs based on differences in the degree of leverage a firm is willing to use (with more leverage creating more risk), the exit multiples it projects, and, most importantly, what improvements it can make to the business to improve the cash flow (by growing revenue, reducing expenses, recapitalizations, and so on).

In Dell, there was almost no variation because all of the financial buyers that considered a potential transaction intended simply to execute the company's existing plan and not to add value. Further, the very large gap in Dell between the stock market price and management's view of going-concern value (which provided the opportunity for a deal at a price so far below the DCF-based price) is rare — and, as the court noted, it "anchored" the deal price to a low number. In most cases, so long as there is any actual or perceived competition, a buyer whose LBO model-driven price is far below going-concern value simply would not submit a bid, as it would be unlikely to be successful.

The court continues to face an impossible task in appraisal cases.

Almost half of the 115-page Dell opinion is devoted to discussion of economic and financial theories and studies, reflecting the court's ongoing efforts to grapple with developing an appropriate macroeconomic and corporate finance framework for appraisal cases. It is apparent that even the most senior and independent investment bankers could not make the determinations required to satisfy the existing mandate of the Delaware appraisal statute. Indeed, the very notion of having to define a precise "fair-value" number is unworkable when the available tools for valuing companies merely establish a range of values. In our view, Dell underscores the advisability of legislative change and/or further Delaware Supreme Court guidance in the appraisal area.

Practice Points for Financial Buyers

Appraisal risk uncertainties that pose planning challenges for a potential buyer:

A buyer will face uncertainty as to the likelihood that an appraisal case will be brought, and, if it is brought, whether the court will view the transaction as an MBO as opposed to an LBO. A buyer and its counsel should conduct a risk assessment with respect to these uncertainties, based on the facts and circumstances of the specific situation. Once the probabilities are determined, the buyer can:

- factor the risk into its modeling for the transaction — and increase the general contingency reserve for the transaction to the extent deemed appropriate;
- make decisions relating to the balance between minimizing deal risk and merger price on the one hand and appraisal risk on the other hand (in other words, the most effective way to mitigate appraisal risk is for there to be "meaningful competition" in the sale process, but presigning competition can reduce deal certainty and increase deal cost); and
- consider what steps, if any, should be taken to mitigate the appraisal risk if it is deemed to be significant — such as an seeking an appraisal condition to the merger (which is likely to be resisted by the target company), or structuring the transaction to avoid appraisal rights (for example, a recapitalization with a tender offer).

Again, in our view, the appraisal risk post-Dell is not higher than it was pre-Dell. To the extent that increases in the general contingency reserve, appraisal conditions and so forth were not considered necessary before, they should not be considered necessary now. Dell simply serves as a reminder that there has been and continues to be an appraisal risk. While there is an inherent element of uncertainty relating to appraisal, in most cases the degree of risk is not wholly unpredictable — although assessing the risk does require a careful, nuanced analysis by the buyer and its counsel.

Key considerations in determining the appraisal risk in an MBO:

- The importance of the management's role at the company, and the size and importance of its role in the transaction;
- The extent to which there is an alignment of the management's interests with the stockholders;
- The extent to which it may be the wrong time to sell the company; and
- The extent of the competition in the sale process — particularly in the pre-signing phase. The advantages and disadvantages of presigning competition, including the potential impact on any appraisal case, should be considered in the planning stages.

We note also that, as a practical matter, appraisal cases are determined in retrospect and that the court may well be influenced by (as occurred with Dell) a substantial increase in the value of the post-merger company during the period of the appraisal proceeding.

Go-shops

In negotiating a go-shop, a buyer should take into account the court's view, stated in Dell, that MBO go-shops rarely lead to topping bids. In addition, it should be noted that the court was especially disapproving of unlimited or numerous matching rights.

"Synergies"

A buyer should analyze and contemporaneously document the extent to which its deal price reflects value that the buyer and the transaction itself will potentially create — through cost-savings associated with taking the company private, as well as recapitalizations, acquisitions, divestitures, restructuring, and so on. In the event that an appraisal case is brought, and that the court does rely on the merger price to determine fair value, a buyer should be prepared to establish that these expected synergies were included in the merger price and, under the appraisal statute, should be excluded from the determination of fair value. The court continues to grapple with the legal and practical complexities of how to exclude synergies from the merger price when the merger price is used to determine fair value. However, in recent cases (including Dell), the court has acknowledged that synergies must be excluded, and, in Dell, the court stated that even financial buyer go-private transactions have the implicit buyer-generated synergy of "reducing agency costs" by taking the company private. (We note that the court's brief discussion on this point would seem to indicate that the merger price would, by definition, virtually always be higher than "fair value" because, even in financial buyer transactions, there are synergies that must be excluded.)

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