Delaware Supreme Court's Rulings Re-Establish Importance of Deal Price and Sale Process in Appraisal Proceedings

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In two important recent decisions, *DFC Global Corp. v. Muirfield Value Partners, L.P.* and *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, the Delaware Supreme Court provided clarity about the role of the deal price and the sale process in appraisal proceedings, reassuring buyers and sellers in M&A transactions that market-based indicators of value, including the target's stock price and the deal price, should receive heavy, if not dispositive, deference where there is an absence of evidence demonstrating an inefficient market and where the deal price is the result of a robust sale process. We believe these decisions can be read fairly to create a new approach to the fair value analysis required in appraisal proceedings. While not establishing a presumption or bright-line rule in favor of the deal price, the Delaware Supreme Court's opinions emphasized that market-based evidence, including the unaffected stock price in an efficient market and price discovery through an open and fair sale process, often provides the most reliable evidence of fair value. Thus, for practical purposes, the opinions in *DFC Global* and *Dell* effectively suggest that the Chancery Court should first evaluate whether the market and deal prices are reliable indicators of fair value, and should depart from those market-based indicators of value and substitute its own (or expert) valuation only where the appraisal petitioner demonstrates through accepted economic or valuation principles that those indicators do not reliably reflect fair value. These opinions also reiterated the important point that the focus of appraisal proceedings is ultimately to determine the *fair* value of a company's shares, not necessarily the *best* value.

These decisions also help to remove the uncertainty that private equity-led or MBO transactions will automatically be treated differently than strategic transactions in appraisal proceedings. While the Chancery Court had asserted that the deal price in private equity-backed transactions is less reliable than in strategic buyer transactions due to a financial sponsor's focus on its internal rate of return in negotiating the deal price, the Supreme Court rejected this notion of a "private equity carve out," stating that both strategic and financial buyers expect certain internal rates of return when they undertake transactions. This rejection of the "private equity carve out" puts financial sponsors on equal footing with strategic buyers when assessing post-closing economic exposure.

The importance of these decisions is highlighted by the magnitude of the monetary judgments they reversed or remanded, after the Chancery Court had determined appraisal values meaningfully in excess of the deal price ($7 billion in the case of *Dell*). While the Supreme Court's opinions may not prevent appraisal cases from being filed, these decisions should mitigate the risk of unrealistic fair values resulting from appraisal proceedings involving publicly traded companies.

Delaware Chancery Court Decisions in 2016 and 2017 Left Parties to M&A Deals Vulnerable to Post-Closing Economic Exposure from Appraisal Litigation

Delaware courts historically did not consistently place significant weight on deal price, relying more often on a discounted cash flow ("DCF") analysis to determine fair value in appraisal proceedings. Beginning in 2015, a handful of decisions from the Delaware Chancery Court began focusing on deal price. This trend was upended with the Chancery Court's decisions in *In re Appraisal of Dell* and *In re Appraisal of DFC Global*. Delaware appraisal litigation during 2016 and 2017 created further uncertainty for M&A buyers and sellers, with the Chancery Court issuing decisions with varying weight given to the deal price in determining fair value.

In *In re Appraisal of Dell*, for example, the Chancery Court afforded no weight to the deal price, utilizing instead its own DCF analysis to establish a putative fair value for Dell's stock that was $7 billion in excess of the deal value. In determining that the deal price was an unreliable indicator of fair value, the Chancery Court cited a perceived "valuation gap" between the market price of Dell's stock and Dell's intrinsic value, a lack of strategic buyer competition, and certain issues with the sale process "endemic" to private equity-led or MBO transactions.[1] The Chancery Court made this fair value determination notwithstanding a sale process that "easily would sail through if reviewed under enhanced scrutiny."

In *In re Appraisal of DFC Global*, the Chancery Court declined to defer exclusively to the deal price as the best evidence of fair value, notwithstanding a robust sale process. This was due, in part, to flaws that the Chancery Court determined to exist in the ability of the market to establish a fair price in uncertain regulatory conditions. Weighing equally a discounted cash flow analysis, a multiples-based valuation, and the deal price, the Chancery Court determined that the fair value of DFC Global's stock was approximately 7% higher than the per-share deal price.

Subsequent Chancery Court decisions in 2016 and 2017 varied in the level of deference accorded the deal price as the most reliable evidence of fair value, in some cases giving the deal price exclusive weight, and in other cases using a DCF analysis to arrive at a fair value determination below the deal price. Therefore, these opinions did not resolve the uncertainty or continued risk of appraisal arbitrage to M&A buyers and sellers raised by *In re Appraisal of Dell* and *In re Appraisal of DFC Global*, and demonstrated variability within the Chancery Court regarding its approach to appraisal proceedings.

Delaware Supreme Court Clarifies Approach to Appraisal Actions

DFC Global v. Muirfield Value Partners and *Dell v. Magnetar Global* are the Delaware Supreme Court's first opinions on appraisal rights in seven years and provide significant clarity about the role of market-based indicators in determining fair value and the preferred approach to appraisal proceedings by the courts.[2] The key elements of the Delaware Supreme Court's decisions in these cases are analyzed below.

- ***Deference to the Deal Price***. Although in both cases the Supreme Court declined to create a presumption or bright-line rule in favor of the deal price as the best estimate of fair value, the decisions indicate that significant or dispositive weight should be placed on market-based indicators of value, such as the target's unaffected stock price or the deal price, where petitioners fail to demonstrate that the market for the target's stock is inefficient and the evidence establishes that the deal price resulted from a robust sale process. In *DFC Global*, the Supreme Court remanded to the Chancery Court to reconsider the weight given the deal price in its valuation analysis, noting that economic principles suggest that the best evidence of fair value was the deal price, "as it resulted from an open process, informed 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." In *Dell*, the Supreme Court noted that "market-based indicators of value," including Dell's stock price that resulted from a semi-strong efficient market and the deal price resulting from a robust sale process, "deserved heavy, if not dispositive, weight." It held that the Chancery Court had erred in affording no weight to the deal price given the evidence of market efficiency, fair play, low barriers to entry in the sale process, and outreach to all logical buyers.

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[1] *In re: Appraisal of Dell Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016).

[2] *DFC Global Corp. v. Muirfield Value Partners, L.P.*, No. 518, 2016 (Del. Aug. 1, 2017); *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd.*, No. 565, 2016 (Del. Dec. 14, 2017).

- ***Importance of Sale Process in Sustaining Deference to Deal Price***. In reversing and/or remanding the Chancery Court's decisions, the Supreme Court focused on the robustness of the sale process in both *DFC Global* and *Dell* in establishing the reliability of the deal price as a marker of fair value, providing a potential road map for bidders to design sale processes that facilitate deference to the deal price:
  - *Bidder Outreach*. *DFC Global* involved approaching "every logical buyer" (dozens of financial buyers and several strategic buyers) during a two-year search. *Dell* involved a pre-signing phase that canvassed multiple "major-league" financial buyers, followed by a meaningful post-signing go shop during which Dell's financial advisors surveyed the interest of over 60 potential bidders, including Dell's closest strategic competitor. Moreover, the *Dell* Supreme Court rejected the notion that the absence of strategic bidders diminished the relevance of the deal price. It explained that "[f]air value entails at a minimum a price some buyer is willing to pay—not a price at which no class of buyers in the market would pay," and noted that "if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one."
  - *Fair Play; Barriers to Entry*. In *DFC Global,* there was both an open opportunity for potential buyers to engage with DFC Global during the sale process without meaningful inhibition of deal protections and no hint of self-interest. In *Dell*, the Supreme Court noted that (i) Dell's financial advisors "choreographed the sale process to involve competition . . . at every stage," (ii) Michael Dell was willing to work with any viable party and pledged his voting power to any bidder (voting in proportion to other shares), and (iii) Dell was cooperative and responsive to all of the bidders' due diligence requests. The *Dell* opinion further noted that Dell's go-shop was designed to raise "fewer structural barriers than the norm." Moreover, in *Dell*, the Supreme Court highlighted that there was no evidence that management purposefully tempered investors' expectations to drive down the company's stock price so that a takeover could be executed at a lower price, and that the open and cooperative due diligence process mitigated any information asymmetries between management and rival bidders.
- ***The Role of Market Price When Considering Deference to the Deal Price***. A driving factor of the Chancery Court's analysis in not deferring to the deal price in both *DFC Global* and *Dell* was that the market price of the target company's stock did not accurately reflect intrinsic value, which, in turn, served to anchor the deal price at an unreliably low value relative to fair value. In *DFC Global*, the Chancery Court perceived DFC Global's stock price to be in a "trough" due to regulatory uncertainty in its industry (payday loans). In *Dell*, the Chancery Court reasoned that Dell's investment in $14 billion of acquisitions to turn around the company had not been properly priced into the company's stock price, creating a "valuation gap" between stock price and intrinsic value. The Chancery Court concluded in both cases that these market inefficiencies rendered the deal price unreliable.

  The Supreme Court's decisions in both cases noted no evidence in the record to justify ignoring the efficient market hypothesis. Similarly, they noted no evidence to justify discounting or ignoring market prices based on a perceived inability of the market to price DFC Global's or Dell's common stock. Specifically, the Supreme Court in *DFC Global* noted evidence that the market was capable of pricing regulatory uncertainty, while in *Dell* it highlighted the size of Dell's public float, extensive analyst coverage, trading volume, lack of a controlling stockholder, and a history of the stock price reacting quickly to the public release of information. While Dell's stock price may not have reflected management's expectations regarding the future success of Dell's recent acquisitions, the Supreme Court expressed the view that this did not mean that the market for Dell's stock was inefficient, but rather that investors simply "weren't buying Mr. Dell's story."

Moreover, the Supreme Court's decisions endorsed the efficient market hypothesis as a relevant inquiry in appraisal proceedings, saying in *Dell* that the hypothesis had been "long endorsed by this Court," and in *DFC Global* that the court was cognizant of "the economic reality that the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."

- ***Rejection of a "Private Equity Carve-Out."*** The Supreme Court in *DFC Global* and *Dell* rejected the "private equity carve-out" in which the Chancery Court deemed the deal price less reliable, notwithstanding a robust sale process, because private equity buyers are focused on meeting a required internal rate of return. The Supreme Court in *DFC Global* did "not understand the logic of this finding" given 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, or for that matter, any sizeable investment of its capital." In rejecting the application of the private-equity carve-out in *Dell*, the Supreme Court noted that the "sale process bore many of the same objective indicia of reliability that it had found persuasive in DFC."
- ***Management Led Buyouts***. The Supreme Court in *Dell* rejected the Chancery Court's view that MBOs *per se* preclude deference to the deal price. Perhaps most importantly, the Supreme Court rejected the view that go-shops are ineffective in MBOs, pointing to evidence where go-shops in MBOs had resulted in topping bids. In addressing the Chancery Court's argument for a "winner's curse" (*i.e.*, that topping a management bid in an MBO results in overpayment due to management's superior information), the Delaware Supreme Court explained that Dell provided substantial due diligence to potential bidders to reduce any information asymmetry, and made Michael Dell himself available to meet with potential bidders. The court explained that "[i]f a deal price is at a level where the next upward move by a topping bidder has a material risk of being a self-destructive curse, that suggests that the price is already at a level that is fair."
- ***Use of DCF Analysis***. The Supreme Court's decisions indicate that a DCF analysis may become less of a focus in appraisal proceedings. The Supreme Court in *Dell* noted that the DCF analysis is considered the best tool for valuing companies in the absence of credible market information and no market check, but acknowledged that the analysis is only as good as the inputs and assumptions used. Notably, the Supreme Court described the DCF analysis as providing "a helpful data point," a conspicuous shift away from past characterizations of the DCF analysis as the "gold standard" in valuation.

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