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Delaware Court of Chancery Appraises Fully-Shopped Company at Nearly 30% Over Merger Price

In an appraisal decision issued this week, the Delaware Court of Chancery held that the fair value of Dell Inc. was $17.62 per share—almost four dollars over and nearly 30% more than the price paid in the 2013 go-private merger. *In re Appraisal of Dell Inc., C.A. No. 9322-VCL (Del. Ch. May 31, 2016)*. The result reflects the remarkable view that “fair value” in Delaware represents a price far higher than any buyer would have been willing to pay and that the merger price derived from an admirable sales process should be accorded no weight.

In 2012 Michael Dell informed the company’s board that he wished to pursue a management-led buyout. In response, the board formed a special committee, which embarked on a year-long process culminating in the approval of a merger agreement under which Mr. Dell and a private equity firm paid $13.75 per share—a 25% premium over the pre-announcement unaffected share price of $10.88 and a 37% premium over the trailing 90-day average. Over the course of its pre-signing auction and very public post-signing go-shop, the committee contacted over 60 potential merger partners. In view of this robust sales process, the Court of Chancery previously refused to entertain the customary avalanche of fiduciary duty litigation challenging the deal. As this week’s opinion reiterated, the company’s careful process “would easily sail through [a fiduciary duty challenge] if reviewed under enhanced scrutiny.”

The court nevertheless accorded that process no deference in deciding that the company’s appraised “fair value” was billions more than the market price. Finding that the company’s investors were “focused on the short term,” the decision concluded that there was “a significant valuation gap between the market price of the Company’s common stock and the intrinsic value of the Company.” The merger market was likewise irrelevant in appraising the transaction, the court reasoned, because financial sponsors like private equity firms “determine[] whether and how much to bid by using an LBO [leveraged buyout] model, which solves for the range of prices that a financial sponsor can pay while still achieving particular IRRs,” or internal rates of return. While some aspects of the decision focused on the fact that the transaction was a management buyout, much of its reasoning appears to apply to financial buyers generally. The court thus concluded that “what the sponsor is willing to pay diverges from fair value because of (i) the financial sponsor’s need to achieve IRRs of 20% or more to satisfy its own investors and (ii) limits on the amount of leverage that the company can support and the sponsor can use to finance the deal.”

The decision may turn out to be an outlier, as other Chancery decisions have held that the merger price—including in private equity deals—is the most reliable indicator of fair value. In the meanwhile, however, proponents of appraisal arbitrage will tout the *Dell* result to encourage the flow of even greater funds into the practice.

For their part, private equity firms should be expected to ask whether they face routine appraisal exposure in Delaware, no matter how robust the auction, and therefore seek out alternative transaction structures to cap and price their risk (or exit the market entirely). Consider, for example, the acquisition of a Delaware company with 1 billion shares trading at $12 per share, for a total valuation of $12 billion, where a private equity buyer is willing to pay $16 billion in total to acquire the target. Assume further that the buyer’s reserve price easily
topped the competitors and the seller succeeds in extracting the full amount the buyer is willing to pay through a robust auction. A private equity buyer in this situation, concerned that a court will rely on the logic of Dell and award a 30% increase over the merger price to dissenting shares, is likely to consider transactional alternatives to mitigate the risk. To cap its appraisal exposure, the private equity buyer might insist on a provision in the merger agreement allowing it to walk away if a small fraction of the shares—1 or 2 percent—perfect appraisal rights. This approach is likely to be unpalatable to selling boards, however, and creates substantial risk that the buyer will exit the transaction when the appraisal cap is exceeded. Alternatively, a buyer might choose a higher appraisal cap of 10% of the shares, but augment that approach by reducing its offer to create a reserve for the eventual appraisal award for the 100 million dissenting shares. In this scenario, if the reserve is based on the Dell result, the buyer’s top offer price would be only $15.53 per share (instead of $16), with the excess reserved for a payoff to the appraisal arbitrageurs of $20.19 per share. This outcome would result in a wealth transfer of $423 million from the public stockholders to the arbitrage firms.

Either way, however, there is a substantial risk that public stockholders lose out—whether by losing a value maximizing deal altogether or through value leakage to appraisal arbitrageurs. Accordingly, it is very much open to question whether the Dell dynamic will incentivize transactions that maximize value to stockholders and a market for corporate control that promotes managerial accountability.

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