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Dell, DFC Global and the changing landscape of appraisal actions

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In a pair of recent important decisions, the Delaware Supreme Court underscored that, for public companies whose stock trades in an efficient market, deal price should be accorded significant weight in determining fair value in appraisal actions. These two decisions – *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.* and *DFC Global Corp. v. Muirfield Value Partners, L.P.* – should provide an added degree of price certainty to buyers of public companies by tempering the escalation of appraisal litigation from arbitrageurs that acquire shares after the announcement of an M&A transaction with the goal of seeking outsized returns in an appraisal action.

An appraisal action is a statutory right under Delaware law that allows the stockholders of the target to receive the 'fair value' of their shares as of the closing date of the merger transaction, rather than just their pro rata portion of the merger consideration. The statute requires the trial court to "take into account all relevant factors" and to reach its own conclusion regarding the calculation of fair value, which is defined as "the value to the stockholder of the firm as a going concern". Delaware courts have taken different approaches to making this assessment,

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ranging from deferring entirely to the deal price, to disregarding the deal price and instead performing its own discounted cash flow or other valuation analysis, which can reflect the input of the parties' respective expert witnesses, as well as the court's own independent judgment.

The potential determination by a trial court that the fair value exceeds the deal price gives rise to the risk that the buyer will be required to pay dissenting stockholders a per-share amount that exceeds the deal price. Academic research indicates that this outcome transpires frequently. One study found that in over 80 percent of the appraisal actions that went to trial from 1993 to 2013, including for both private and publicly-traded targets, the trial court determined that the fair value of the target's shares exceeded the deal price. Not surprisingly, activist and event-driven hedge funds have increasingly pursued a strategy of 'appraisal arbitrage' that entails acquiring the shares of a target following the announcement of an M&A transaction, with the goal of contesting the fair value of the target's stock in an appraisal action after closing. This activity has been further encouraged by the relatively high statutory interest rate in Delaware for appraisal actions – the Federal Reserve discount rate, plus 5 percent – in the present-day low-interest environment. The rise of appraisal arbitrage is reflected in the increase in both the number of appraisal actions in Delaware, from 20 in 2012 to 48 in 2016, and the aggregate value of the dissenting shares at stake, from approximately $150m in 2004 to $1.5bn in 2013, according to research conducted by professors at Case Western University School of Law and Brooklyn Law School.

In both *Dell* and *DFC Global*, the Delaware Supreme Court reversed decisions of the Court of Chancery that had disregarded the deal price and determined that a discounted cash flow analysis would be a more appropriate mechanism to determine fair value. If applied more consistently, this approach could diminish the incentive to pursue an appraisal arbitrage strategy and provide greater price predictability to buyers. Many of the arguments advanced by arbitrageurs in prior cases and accepted by the Court of Chancery in these cases were rebutted by the Delaware Supreme Court.

No "valuation gap". In Dell, the Court of Chancery had concluded that "investor myopia" and a hangover from Dell's recent internal restructuring efforts, which had not yet begun to increase profitability, had produced a "valuation gap" between Dell's fundamental and market prices. This gap, in turn, purportedly set a low floor for the sale process. However, the Delaware Supreme Court rejected this premise on the basis of the efficient markets hypothesis, which teaches that the "price produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst". In this case, the Delaware Supreme Court explained that the trial court record showed no evidence that Dell's shares, which were widely and heavily traded and highly responsive to material news pertaining to the company's performance, bore the hallmarks of an inefficient market. As a result, the Delaware Supreme Court determined that the markets could, and, in this case, did, properly assess and value the company's long-term outlook.

No "private equity carve out" for market evidence. In both Dell and DFC Global, the Court of Chancery had focused on the fact that most of the bidders for the target were financial sponsors and posited that their bids reflected a focus on obtaining a desirable internal rate of return, than on the fair value of the target's stock. On appeal, the Delaware Supreme Court held in DFC Global and reiterated in Dell that there is "no rational connection" between a buyer's status as a financial sponsor and the question of whether the deal price is indicative of fair value for appraisal purposes,

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because, among other things, "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". The Delaware Supreme Court further explained in *Dell* that the "Court of Chancery ignored an important reality: if a company is one that no strategic buyer is interested in buying, it does not suggest a higher value, but a lower one".

Theoretical characteristics of management buyouts do not, per se, undermine the probative value of deal price. In *Dell*, the Court of Chancery impliedly endorsed the view that management buyouts have intrinsic characteristics that would, per se, undermine the probative value of the deal price. For example, the Court of Chancery explained that management buyouts could not eliminate the threat of a 'winner's curse' – the idea that, in outbidding incumbent management to 'win' a deal, a buyer would likely overpay for the company because management would presumably have paid more if justified by the true valuation of the company. The Delaware Supreme Court rejected this view, concluding that any such 'winner's curse' could be mitigated through a due diligence process where bidders have access to all the necessary information.

Regulatory uncertainty not a basis for discounting the deal price. DFC Global entailed the acquisition by a private equity fund of a publicly-traded payday lending firm. The shareholders argued that the share price of the target did not reflect its fair value, in part because of "regulatory uncertainty" arising from reforms of the payday lending industry being considered by various governmental entities. The Delaware Supreme Court rejected this view, noting that the markets take into account the effect of potential regulatory action on companies' performance in a variety of industries. In addition, the record at trial established that equity and debt analysts, equity buyers and debt providers were attuned to the particular regulatory risks facing the payday industry in general and the target in particular. This was reflected in fluctuations in the target's stock price in response to announcements by governmental entities with authority over the target and in previous efforts by the target to refinance its debt that ultimately failed on account of insufficient interest in the public bond markets.

It remains to be seen whether and to what extent Delaware courts will continue to extend deal price as an indicator of fair value and, as a result, potentially reduce the growth of appraisal arbitrage. In *DFC Global*, the Delaware Supreme Court expressly declined to establish a rebuttable presumption that deal price is the best evidence of fair value. However, *Dell* and *DFC Global* should impact the manner in which appraisal proceedings are presented and tried in Delaware courts. Companies in appraisal cases should appropriately rely on market indicators, such as pre-transaction share price and deal price, which were unencumbered by abnormalities as the strongest indicia of fair value. In addition, companies may want to argue more aggressively that, in determining fair value, the deal price should be discounted to reflect the fact that it incorporates the expectation that certain synergies will be realised. Finally, in light of the complexities of applying the methods of valuation science, judges may rely on court-appointed experts to assist the court in determining fair value where they do not otherwise defer to market indicators. Prospective buyers and their advisers would be well-served to continue monitoring developments in this area of the law. ■

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