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M&A REPORT: DELAWARE SUPREME COURT REAFFIRMS THE IMPORTANCE OF DEAL PRICE AS AN INDICATOR OF FAIR VALUE IN APPRAISAL ACTIONS

To Our Clients and Friends:

The Delaware Supreme Court's recent decision in *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.* represents the latest significant opinion from Delaware courts that has contributed to the reduction in M&A litigation by underscoring that, in an efficient market, the deal price should be accorded significant—if not complete—deference in determining fair value in appraisal actions.

Background and Decision

The *Dell* case stems from the 2013 buyout of Dell by a private equity firm with the support of Dell's eponymous founder, who owned approximately 15% of the outstanding shares. After a full appraisal trial, the Court of Chancery concluded that the deal price should not be afforded any weight because it was "not the best evidence of [Dell's] fair value." Instead, the Court of Chancery applied its own discounted cash flow analysis, which valued Dell's shares at approximately 30% higher than the merger consideration. The Delaware Supreme Court took issue with each of the three factors that caused the Court of Chancery to choose not to take the deal price into account:

- ***No "Valuation Gap":*** The Court of Chancery had concluded that "investor myopia" and hangover from Dell's recent transformational efforts, which had not yet begun to generate anticipated results, had produced a "valuation gap" between Dell's fundamental and market prices. This "valuation gap," in turn, purportedly set a low floor for the sale process. However, the Delaware Supreme Court, consistent with the efficient market hypothesis long endorsed by Delaware courts, concluded that the price produced by an efficient market is generally a more reliable indicator of fair value than a *post hoc* analysis presented by a partisan expert witness in an appraisal proceeding. In addition, the Delaware Supreme Court explained that the trial court record showed no evidence that Dell's shares, which were widely and heavily traded, bore the hallmarks of an inefficient market. On this basis, 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:*** The Delaware Supreme Court also concluded that the Court of Chancery erred in completely discounting the deal price due to the financial sponsors' focus on obtaining a desirable internal rate of return, rather than on "fair value." Consistent with its recent decision in *DFC Global Corp. v. Muirfield Value Partners, L.P.*, the Delaware Supreme Court held 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, 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 went on to note 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 MBOs Do Not* Per Se *Undermine the Probative Value of Deal Price:*** One of the main concerns that the Court of Chancery's *Dell* opinion raised among practitioners was the view that management buyouts (MBOs) have intrinsic characteristics that would, *per se*, undermine the probative value of the deal price. For example, the Court of Chancery endorsed the idea that MBOs 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 the company were really worth it. 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.

In light of the foregoing, the Delaware Supreme Court concluded that the Court of Chancery had erred in not assigning any mathematical weight to the deal price and found that the record suggested that the deal price deserved heavy, if not dispositive, weight.

Key Takeaways

The Delaware Supreme Court's decision in the *Dell* case, combined with its consistent pronouncement in the recent *DFC* opinion, do not represent the death knell of M&A appraisal litigation. However, we expect these cases will further temper the escalation of appraisal litigation from arbitrageurs that acquire shares after the announcement of an M&A transaction with no interest other than the speculative value of an appraisal proceeding.

The *Dell* and *DFC* decisions should also impact the manner in which appraisal proceedings are presented and tried in Delaware courts. Companies in appraisal cases should appropriately rely on market indicators (pre-transaction share price and deal price) that 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 the deal price incorporates the expectation that certain synergies will be realized—a deal-specific consideration that Delaware law excludes from the process of determining fair value. 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.

Most importantly, *Dell* and *DFC* send an unequivocal message that, in appraisal cases, Delaware courts must act consistently with the tenets of the efficient market hypothesis, and that, absent clear departures from fair play and process, the deal price should be the absolute cap in the determination of fair value.

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