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"Fair value" in M&A – Dell and Delaware

A Delaware court has rejected a market-led approach to the question of assessing a company's "fair value", holding that a deal price arrived at through an arms-length sale process materially undervalued the target company at issue.

We examine the decision and consider whether similar arguments could be mounted in New Zealand. The reasoning in the decision could be particularly relevant to transactions conducted by way of scheme of arrangement.

The facts

In 2013, NASDAQ listed company Dell Inc. was taken private in a US$24.9 billion (US$13.65 per share) deal, with existing shareholders receiving cash for their shares. The acquiring consortium was led by Dell CEO Michael Dell, together with private equity firm Silver Lake. An independent special committee of the Dell board negotiated the transaction, which was ultimately approved by shareholders holding 57% of Dell's shares.

A small group of shareholders who voted against the transaction exercised appraisal rights under Delaware law, seeking a higher price for their shares. These shareholders were largely hedge funds pursuing an appraisal arbitrage strategy - buying into a company about to conduct a transaction, with the intention of voting against the deal and then pursuing a higher price for their shares through the judicial appraisal process.

Under section 262(h) of the Delaware General Corporation Law, the Delaware Court of Chancery can "determine the fair value of shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value." In determining fair value, the Court must take into account all relevant factors.

The Court held that Dell's fair value at the time of the transaction was US$17.62 per share, materially in excess of the $13.65 deal price. In reaching this decision the Court acknowledged that the sale process was properly conducted (a potential concern given the role of Dell's CEO in the acquiring consortium) and that no other bidder had emerged prepared to offer a superior price.

Why then was the transaction's $13.65 per share not "fair value"?

The Delaware Court's analysis

The concept of "fair value" under Delaware law is not equivalent to the economic concept of fair market value. Neither market price (in the case of listed companies), nor the price arrived at following a properly-run sale process, are regarded as necessarily representative of fair value. This approach rejects the efficient market hypothesis and is explicitly open to arguments that markets may not in fact fairly reflect a company's underlying value.

Pre-announcement market price

In reaching his decision on fair value, the Judge considered and disregarded the market price for Dell's shares, which was US$9.35 when the deal was first proposed, US$13.42 when it was officially signed, and never closed above US$14.51 afterward. In reaching this conclusion the Judge relied on:

> *"the widespread and compelling evidence of a valuation gap between the market's perception and the Company's operative reality. The gap was driven by (i) analysts' focus on short-term, quarter-by-quarter results and (ii) the Company's nearly $14 billion investment in its transformation, which had not yet begun to generate the anticipated results. A transaction which eliminates stockholders may take advantage of a trough in a company's performance or excessive investor pessimism about the Company's prospects (a so-called anti-bubble). Indeed, the optimal time to take a company private is after it has made significant long-term investments, but before those investments have started to pay off and market participants have begun to incorporate those benefits into the price of the Company's stock."*

This reasoning draws on common criticisms of stock markets as reliable mechanisms for price discovery, in particular their focus on short term performance. Dell had invested US$14 billion in a business transformation project, the future results of which the Judge considered were not properly reflected in the share price.

The Court's approach is best illustrated by exploring its reasoning for why certain pricing benchmarks (such as Dell's share price prior to the announcement of the transaction, or the deal price) were not proxies for fair value.

Deal price

The US$13.65 deal price was the result of a competitive sale process run by Dell's independent directors. At least three private equity firms considered acquiring Dell, with KKR and Blackstone also putting in bids. No trade bidders participated, a fact the Judge partially attributed to the presence of the Michael Dell-led consortium.

Ultimately no bidder was prepared to offer more than US$13.65 per share, the final deal price (and well above the US$9.35 pre-deal market price). In rejecting arguments that the deal price should serve as a proxy for fair value, the Judge based his decision on an analysis of the leveraged buyout model often used by private equity firms, in which returns on capital are amplified through the use of debt to fund a significant proportion of a company's purchase price. Here, the Dell/Silver Lake consortium pursued a leveraged buyout, with much of the purchase price funded by debt.

In the Judge's view, bidders pursuing an LBO strategy targeting high returns (20% or more IRR) could not afford to pay full value for Dell, as the high returns required by their business model constrained the price they would be able to pay. In short, if the acquisition model requires higher returns than "normal", it compels you to purchase the asset for a lower price than you could offer if you were only seeking "normal" returns.

The fact that only private equity bidders participated in the sale process compounded the issue for the Judge:

> *"Financial sponsors using an LBO model **could not have bid close to $18 per share** [the Judge's ultimate valuation, based on a modified DCF analysis] **because of their IRR requirements and the Company's inability to support the necessary levels of leverage.** Assuming the $17.62 figure is right, then a strategic acquirer that perceived the Company's value could have gotten the Company for what was approximately a 25% discount. Given the massive integration risk inherent in such a deal, it is not entirely surprising that [strategic bidders] did not engage and that no one else came forward."*

With respect to parties pursuing LBO models, such as private equity, the Judge's view perhaps focuses too much on the "financial engineering" aspects of such transactions, while discounting the broader operational improvements that can result from leveraged buyouts.

The Judge considered that a traditional DCF valuation, assuming a "reasonable" cost of capital, was a better proxy for fair value, and arrived at a valuation of US$17.62 per share by adopting competing experts' DCF models and adjusting relevant inputs to what the Judge considered reasonable – unusual reading in a legal judgment.

Assessment of the decision

The suggestion that the price arrived at through a properly-run sale process can be successfully attacked has caused considerable disquiet in U.S. M&A circles. One journalist summed up the reasoning as follows:

> *"The proof that $17.62 was the fair price is that no one was willing to pay it:*
>
> 1. *Public shareholders won't pay fair value for Dell, because they are obsessed with the short term and can't understand the long-term strategic vision.*
> 2. *No strategic buyer would pay fair value to buy Dell, because that would be risky.*
> 3. *No private-equity buyer would pay fair value to buy Dell, because private-equity firms only buy companies at a discount."*

Some commentators have sought to limit the case's findings on the basis that it involved an MBO so should not be extended to more ordinary contexts.

Beyond these practical concerns, reactions to the decision probably turn on one's attitude towards markets, and their utility as a mechanism for price discovery. For many, the price of an asset arrived at through a reasonable market process is "the price" – any other suggested price is theoretical. For others, the flaws of market processes (such as those highlighted by the Judge in Dell) would justify departing from a strictly market-led approach to valuation.

Application to New Zealand

Appraisal-style rights are included in the New Zealand Companies Act. If a New Zealand company resolves to, among other things, approve a major transaction or amalgamate with another company, and a shareholder votes against that decision, then that shareholder is entitled to require the company to purchase his or her shares either at an agreed or arbitrated price, which in either case must be "fair and reasonable".

The logic applied in the Dell case could equally be applied here. However, Companies Act appraisal rights are typically easy to structure around, for example through the use of wholly-owned special purpose vehicles. The logic of the Dell decision, and the concept of challenging values arrived at through market processes, could have greater practical relevance to schemes of arrangement.

What about schemes?

Schemes of arrangement are back in vogue for New Zealand M&A transactions, with recent legislative reforms having put to rest a period of tension between schemes and the Takeovers Code.

The Companies Act grants the High Court wide latitude in approving schemes, with the Act giving little guidance on the relevant factors that should be considered by the Court. In most cases, schemes progress through court with little controversy, with the need for shareholder approval typically being the substantive hurdle.

However, there is nothing preventing shareholders who oppose a scheme from seeking to challenge it on the basis that it undervalues their shares. Although the New Zealand market lacks aggressive hedge funds willing to pursue tactics like appraisal arbitrage, a sufficiently motivated and resourced shareholder could bring a challenge. Given that an independent valuation report would almost certainly have been prepared, any action would need to demonstrate why the report's (presumably) positive finding was incorrect.

In New Zealand this kind of challenge could be brought as part of the scheme approval process, unlike in Delaware where appraisal actions can only be taken after the transaction has been consummated.

Although it's unlikely that a New Zealand court would participate in the kind of judicial valuation exercise seen in Dell, the possibility of a challenge on these grounds delaying implementation of a scheme is a real one and is a factor for parties to consider when contemplating a scheme.

The full judgment, In re Appraisal of Dell Inc., can be accessed online.[1]

Footnote

1. http://law.justia.com/cases/delaware/court-of-chancery/2015/ca-9322-vcl.html

Our thanks to Joshua Pringle for writing this Brief Counsel.

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