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The Delaware Court of Chancery Selected Business Valuation Case Summaries

SELECTED SUMMARIES OF 2017 DECISIONS

INTRODUCTION

Duff & Phelps' experts testify on commercial and shareholder disputes across the country, as well as in the Delaware Court of Chancery, which is widely recognized as one of the nation's leading business courts in terms of volume of complex business-related cases. As a result, the Delaware Court of Chancery has developed significant case law in this area.

This high volume of business cases results in the Court issuing numerous opinions, many of which address business and security valuation and economic damages. In this Court Case Update, we focus on four opinions from 2017 to highlight how certain valuation and damages analysis topics are viewed by the Court. In addition, we focus on two Chancery Court decisions that were overturned by the Delaware Supreme Court in 2017. We chose these six opinions based on the valuation themes they represent and the depth of analysis contained in the Court's opinions. We also note that the 2016 decision *In re ISN Software Corp. Appraisal Litigation*, C.A. No. 8388-VCG (Del. Ch. August 11, 2016) was affirmed by the Delaware Supreme Court in October 2017.

In our review of the cases herein, we have attempted to summarize the salient points related to valuation and damages only. We recommend that interested readers obtain the full Court opinions to gain a complete understanding of all the issues addressed and each judge's position. We have included a hyperlink to each decision below its case caption.

We have summarized the following cases:

Delaware Court of Chancery

In re Appraisal of PetSmart, Inc.,
Consolidated C.A. No. 10782-VCS (Del. Ch. May 26, 2017)
Vice Chancellor Slights
Issues: merger price, discounted cash flow ("DCF"), projections
Click here to view the opinion

In re Appraisal of SWS Group, Inc.,
C.A. No. 10554-VCG (Del. Ch. May 30, 2017)
Vice Chancellor Glasscock
Issues: merger price, DCF, projections, cost of capital, warrants, terminal growth rate
Click here to view the opinion.

ACP Master, Ltd., et al. v. Sprint Corporation, et al.,
C.A. No. 8508-VCL; *ACP Master, Ltd., et al. v. Clearwire Corporation, C.A.* No. 9042-VCL
(Del. Ch. July 21, 2017, corrected August 8, 2017)
Vice Chancellor Laster
Issues: merger price, synergies, DCF, projections, terminal growth rate
Click here to view the July 21, 2017 opinion.
Click here to view the August 8, 2017 opinion

Kristen C. Wright v. Clinton A. Phillips, C.A. No. 11536-VCG
(De. Ch. December 21, 2017)
Vice Chancellor Slights
Issues: S Corporation, synergies, discount for lack of marketability
Click here to view the opinion

Delaware Supreme Court

DFC Global Corporation v. Muirfield Value Partners, L.P., et al.,
No. 518, 2016 (Del. Aug. 1, 2017)
Chief Justice Strine
Justices Valihura, Vaughn and Seitz
Judge LeGrow
Issues: merger price, DCF, weighting of approaches, long-term growth rate
Click here to view the opinion.

Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., et al.,
No. 565, 2016 (Del. Dec. 14, 2017)
Chief Justice Strine
Justices Valihura, Vaughn and Traynor
Judge LeGrow
Issues: merger price, DCF
Click here to view the opinion.

CASE SUMMARY

In re Appraisal of PetSmart, Inc., Consolidated C.A. No. 10782-VCS (Del. Ch. May 26, 2017)

Click here to view the opinion.

In this appraisal action resulting from the acquisition of PetSmart, Inc. ("PetSmart" or the "Company"), a publicly traded company, by BC Partners, Inc. ("BC Partners"), the Delaware Court of Chancery gave full weight to the transaction price of $83.00 per share to determine the fair value of PetSmart's stock. In rejecting the Petitioners' discounted cash flow (DCF) analysis, the Court found that, while DCF analyses at times are considered the most reliable indicator of fair value, in this case, PetSmart's "robust pre-signing auction" and the "absence of any evidence that market conditions impeded the auction" allowed the merger price to be the best measure of value.

In 2014, PetSmart's board engaged a financial advisor to pursue strategic alternatives following a series of disappointing financial results and at the encouragement of an activist investor. This led to an auction process in which 27 potential bidders, including three strategic parties, were contacted. Fifteen parties executed nondisclosure agreements, and five private equity funds eventually placed bids, with BC Partners outbidding the next highest bidder by $1.50 per share. Following board and stockholder approval, the Petitioners sought statutory appraisal. Petitioners argued that the transaction price of $83.00 was unreliable and provided a DCF analysis that valued PetSmart at $128.78 per share, $4.5 billion more than the price paid by BC Partners.

The Court reduced the parties' competing positions to three questions: "(1) was the transactional process leading to the [acquisition] fair, well-functioning and free of structural impediments to achieving fair value for the Company; (2) are the requisite foundations for the proper performance of a DCF analysis sufficiently reliable to produce a trustworthy indicator of fair value; and (3) is there an evidentiary basis in the trial record for the Court to depart from the two proffered methodologies for determining fair value by constructing its own valuation structure?"

First, the Court determined that "the process employed to facilitate the sale of PetSmart, while not perfect, came close enough to perfection to produce a reliable indicator of PetSmart's fair value." When the Company's Board of Directors (the "Board") decided to pursue a sale, it engaged a reputable investment bank and created an "Ad Hoc Advisory Committee" to oversee the process. The Board viewed a sale as one of several strategic outcomes, in addition to pursuing new revenue and cost-saving initiatives and seeking a leveraged recapitalization. Additionally, the Board was reportedly prepared to walk away from a sale if the final offer was not deemed satisfactory. In December 2014, the Board accepted the highest bid of $83.00 per share from BC Partners, which was higher than PetSmart's stock had ever traded and which represented a 39 percent premium over its unaffected stock price the day before the activist investor disclosed its stake in the Company. Between the filing of the proxy statement and the stockholder vote, no topping bid was presented, and the stockholders approved the merger.

The Court rejected the Petitioners' arguments. The Petitioners had argued against reliance on the transaction price as the appropriate measure of fair value, arguing that a financial bidder's leveraged buyout ("LBO") model will rarely produce a fair value. The Court found that there was effort to "entice potential strategic bidders" and that "the private equity bidders did not know who they were bidding against and whether they were competing with strategic bidders." The Court concluded that "while it is true that private equity firms construct their bids with desired returns in mind, it does not follow that a private equity firm's final offer at the end of a robust and competitive auction cannot ultimately be the best indicator of fair value for the company." The Court also found that (i) there was an adequate credit market, (ii) the Board had begun the process of reviewing strategic alternatives before being requested to do so by a shareholder, (iii) the Board was well informed as to the sale process, (iv) the Board's financial advisor was not conflicted and (v) the merger price was not stale despite the Company's improved performance between the signing and closing. In concluding that the transaction price resulted from "proper transactional process," the Court said it was "satisfied that the deal price [was] a reliable indicator of fair value" of the Company.

Second, in reaching its conclusion, the Court considered the "reliability of the other valuations of PetSmart in the trial record" in order to discharge its statutory obligation to consider all relevant factors. The Court noted that although DCF analyses are often pegged as the "'gold standard' of valuation tools," the Court determined that "if the 'data inputs used in the [DCF] model are not reliable,' then the results of the analysis likewise will lack reliability." In this vein, the Court focused on the projections used in the Petitioners' DCF analysis (the "Management Projections"). The Management Projections were prepared by PetSmart's management at the direction of the Board after the decision had been made to pursue a strategic alternative. The Management Projections included increased sales growth due to new business initiatives, the Company's recent acquisition of online retailer Pet360 and various proposed cost-saving plans. The Court cited the following factors in concluding that these projections were "at best, fanciful" and therefore could not lead to a reliable DCF analysis:

- PetSmart management did not usually create projections for more than one year in the future and therefore had "virtually no experience" with longer-term projections;
- The shorter-term projections historically prepared by management frequently were not representative of PetSmart's actual performance;
- The Management Projections were not created in the ordinary course of business, rather they were created for exclusive use in the sale process; and
- PetSmart's management was under "intense pressure" from the Board to be aggressive in its forecasts, with the expectation that any potential bidder would discount the projections.

The Court noted that "[w]hen faced with unreliable contemporaneous management projections [the Court] has adopted other contemporaneous projections as a basis for a DCF analysis where it is satisfied that those projections provide a reliable estimate of the Company's future cash flows." These projections must be "contemporaneous, meaning they must reflect the 'operative reality' of the Company" at the time of the transaction. The Court addressed multiple versions of projections presented by the parties' "Projections Experts," and found that none produced a reliable DCF result as implemented by the parties' "Valuation Experts." Instead, the Court concluded that each set of projections represented expectations of how PetSmart would be run under BC Partners' management, and were therefore not reflective of the Company's "operative reality."

Finally, the Court addressed the possibility of conducting a DCF analysis by making appropriate adjustments to the Management Projections. In doing so, the Court considered various "sensitivities" presented by the Company's financial advisor. However, the Court concluded that, given its "lack of confidence" in the Management Projections underlying the [financial advisor's] sensitivities, it would not adjust its opinion that the fair value of PetSmart at the time of the merger was best reflected by the $83.00 per share transaction price

CASE SUMMARY

In re Appraisal of SWS Group, Inc., C.A. No. 10554-VCG (Del. Ch., May 30, 2017)

Click here to view the opinion.

On May 30, 2017, Vice Chancellor Glasscock issued an opinion in an appraisal action, determining that shares of SWS Group, Inc. ("SWS" or the "Company"), had a fair value of $6.38 at the time of the Company's merger with Hilltop Holdings, Inc. ("Hilltop"), below the merger price of $6.92 per share.

On January 1, 2015, Hilltop purchased SWS with a mix of cash and stock valued at $6.92 per share. The Court ruled the transaction price to be an unreliable indication of fair value because it was based on a "problematic process." The Court cited in particular a standing "Credit Agreement" between SWS and Hilltop that granted the acquirer partial veto power over competing offers. Both experts agreed that the sales process rendered the deal price an unfit valuation method. Both experts presented DCF analyses, and the Petitioners' expert also presented a comparable companies analysis.

Vice Chancellor Glasscock determined that SWS had a "unique structure, size and business model," which made it difficult to find reliable comparable companies. Therefore, the Court decided to rely exclusively on the DCF methodology to determine fair value. Within the experts' DCF analyses, there were several contested inputs the Court ruled upon.

First, the Petitioners' expert argued that by the end of the discrete period covered by management's projections, the Company had yet to reach a "steady state," and therefore it was reasonable to extend the projections an additional two years to provide more stable financials to calculate a terminal value. The Court found there to be inadequate evidence to support the extension and therefore ruled in favor of the projection period included in management's projections.

Next, the Court, while adhering to previous rulings that advise to "exclude speculative elements of value that arise from the 'accomplishment or expectation' of a merger," ruled that the warrant exercise of two creditors was part of SWS's operative reality. The Court supported this decision by stating that the creditors, who themselves were "third parties acting in their own self-interest," had exercised the warrants three months prior to the transaction date.

Due to the Court recognizing the warrant exercise as a portion of SWS's operative reality, $87.5 million in debt owed was cancelled in exchange for over 15 million shares of SWS. "[This] change increased regulatory capital. It did not, necessarily, create excess capital in the sense of 'excess cash' … beyond what was needed to run the business to meet management projections," as was contended by the Petitioners' expert. The Court noted that SWS's management projections had assumed a warrant exercise in 2016, and distributable excess cash was not assumed in those projections. Ultimately, the Court decided there was no persuasive reason to differ from management's judgment and thus ruled that the excess regulatory capital linked to the warrant exercise would not be immediately distributable.

As a final result of the warrant exercise, the Court found that "because the warrant exercise occurred earlier than management [had] expected in its projections … it [was] appropriate to reduce the interest expense accordingly to reflect the Company's operative reality." Vice Chancellor Glasscock used the assumed tax rate of 35 percent and added back a portion of the interest expense to effectively increase SWS's net income.

Next, the Court ruled the terminal value growth rate to be 3.35%, which was derived by the Respondents' expert by taking the midpoint of the long-term expected economic growth rate and the long-term expected inflation rate. While the Petitioners' expert initially used a terminal growth rate of 3.00%, he accepted the Respondents' expert's rate of 3.35% as reasonable in his rebuttal report.

Finally, both experts used the Capital Asset Pricing Model to calculate the cost of equity, but they disagreed as to the proper equity risk premium ("ERP"), equity beta and size premium. The Court ruled the following:

- **ERP:** The Court agreed with the Petitioners' expert in the use of the supply-side ERP as opposed to the historical ERP used by the Respondents' expert. The Court noted the "vigorous debate on the issue" and stated that "[w]hile it is true that a case-by-case determination of ERP remains appropriate, here there is no basis in the factual record to deviate from what this Court has recently recognized as essentially the default method [i.e., the supply-side ERP] in these actions."

- **Equity Beta:** The Court disagreed with the Respondents' expert's use of SWS's weekly stock return data from the two years leading up to the announcement of Hilltop's initial offer. Vice Chancellor Glasscock explained that this time period contained "merger froth" that could have led to corresponding volatility reflected in SWS's stock price. The Court also noted that the five-year monthly and weekly betas were lower than the two-year weekly beta, reflecting this. Instead, the Court favored the Petitioners' expert's method of surveying numerous possible betas and concluding on a blended median, despite the inclusion of companies that may have not been closely comparable.

- **Size Premium:** Both experts used Duff & Phelps' size premium deciles to arrive at their respective size premiums; however, each expert used a different approach to calculate the overall valuation of the Company, and as such used different deciles. The Respondents' expert incorporated the market capitalization of SWS prior to Hilltop's offer, while the Petitioners' expert used their own DCF analysis to determine size. The Court noted that because SWS was a public company, the market capitalization approach could generally be used. However, because the Company "had a substantial amount of in-the-money warrants and [a] significant influence by certain major creditors," in some ways SWS was more similar to a private company, thus suggesting the Petitioners' expert's method of calculating the size premium. Ultimately, the Court decided it was appropriate to take the midpoint of these approaches, which resulted in a size premium of 3.46%.

On February 23, 2018, this decision was affirmed by the Delaware Supreme Court.

CASE SUMMARY

ACP Master, Ltd., et al. v. Sprint Corporation, et al., C.A. No. 8508-VCL; *ACP Master, Ltd., et al. v. Clearwire Corporation,* C.A. No. 9042-VCL (Del. Ch. July 21, 2017, corrected August 8, 2017)

Click here to view the July 21, 2017 opinion.
Click here to view the August 8, 2017 opinion

On July 21, 2017, Vice Chancellor Laster issued an opinion in the appraisal of Clearwire Corporation, finding the fair value of Clearwire to be $2.13 per share, less than half the $5.00 merger price paid by Sprint Nextel Corporation. Because neither side argued in favor of the merger price, the Court did not consider it in this case, and instead relied on the DCF method to determine the fair value of the Clearwire shares. Consolidated with the appraisal proceeding and decision, Aurelius Capital Management, LP (ACP) — a shareholder of Clearwire — had filed a claim for breach of fiduciary duty. In the same decision addressing appraisal, the Court found that the merger was fair under the entire fairness standard of review.

Sprint completed the merger in July 2013, paying $5.00 per share to acquire the 49.8 percent of Clearwire's equity that it did not already own. After a series of negotiations, Sprint and Clearwire initially signed a merger agreement in December 2012 at $2.97 per share, which drew significant shareholder opposition. A subsequent bidding war between Sprint and DISH Network pushed the merger price up to $5.00, and the merger was approved with approximately 82 percent of the unaffiliated shares voting in favor.

Unlike in some appraisal cases, the Respondent in this matter — Sprint — did not argue that the deal price should be given any weight. The Court identified several factors limiting the reliability of the merger price, including the presence of a controlling shareholder, a process that was "far from perfect" and considerable transaction synergies. The Court also noted that if it had relied on the merger price, it would have needed to back out the value of the synergies, which were estimated by Sprint to be in the range of $1.95 to $2.60 per share.

Consistent with the approach taken by both experts in this case, the Court relied on the discounted cash flow method in determining fair value. The Petitioners' expert concluded on a value of $16.08 per share, and the Respondent's expert estimated a value of $2.13. According to the decision, approximately 90 percent of the difference in the fair value estimates was driven by the experts' choice of projections. The Court accepted the projections relied on by the Respondent's expert, which were prepared by Clearwire's management in the ordinary course of business, and "reflected Clearwire's operative reality on the date of the merger."

The Court also noted that Clearwire management was experienced in preparing long-term financial forecasts and regularly updated the projections.

The Court rejected the projections used by the Petitioner's expert, which were not created by Clearwire management. Rather, they were created by Sprint management for the purposes of supporting an increased bid to top DISH's offer. The Court found that the model was based on unrealistic assumptions, was "not a plausible business plan" and did not reflect Sprint's plan for Clearwire in the event the merger did not close.

After determining the most reliable set of projections, the Court applied a perpetuity growth rate of 3.35 percent, representing the midpoint of inflation and GDP growth. While the experts reached different conclusions on components of the discount rate, the overall impact of the discount rate was immaterial, and the issues were not addressed in the Court's decision.

On the fiduciary duty claim, the Court did identify multiple instances of unfair dealing during the initial phase of the deal process. However, stockholders' refusal to accept the initial offer, the subsequent bidding war between Sprint and DISH Network, the resulting $5.00 per share merger price and "compelling evidence that the price was fair" all resulted in a determination that the merger was entirely fair.

CASE SUMMARY

Kristen C. Wright v. Clinton A. Phillips, C.A. No. 11536-VCG (De. Ch. December 21, 2017)

Click here to view the opinion.

On December 21, 2017, Vice Chancellor Glasscock III issued a letter opinion regarding the valuation of three entities owned by a former husband and wife in the context of a fiduciary duty claim matter.

The former husband and wife each owned 50 percent of a recycling and shredding business, operated via three entities. Two of the entities, DataGuard, Inc. and DataGuard Recycling, Inc. (collectively, the "DG Companies") primarily shred waste materials and recycle certain discarded materials. The sole function of the third entity, CK Aurora Business Ventures, LLC ("Aurora"), is to own the real estate and lease it to the DG Companies.

The Petitioner filed a complaint alleging breaches of fiduciary duty by the Respondent and seeking his exclusion from the business, and the parties each filed Motions for Order of Sale. The parties ultimately decided to settle the matter by the Respondent purchasing the Petitioner's 50 percent interest in each of the three entities, with the purchase price to be determined by the Court. The Court preliminarily concluded on a combined pre-adjustment value of the entities of $1,767,465, noting that the value still needed to be adjusted in accordance with the opinion for certain items, as noted below. As part of the decision, the Court deemed the Valuation Date to be the date of the Letter Opinion.

Both parties engaged experts to value the entities. While the parties' experts disagreed on the values of the entities, the experts employed the same basic approach to value, which the Court agreed with. Both experts determined the value of the real estate owned by Aurora, and then added this value to a valuation of the DG Companies based on the income approach. The Respondent's expert used income figures and certain assumptions based on the Petitioner's expert, but made certain adjustments to the analysis.

The primary areas in which the parties' experts disagreed were: (i) impact of S corporation status; (ii) marketability and brokerage commission discounts; (iii) synergies; and (iv) value of the real estate.

First, the Petitioner's expert argued that S Corporation status added value above that of a C corporation, and applied an individual tax rate of 14.5 percent instead of a C corporation rate of 31 percent. The Court found that the DG Companies' "status as S corporations has a discrete value applicable here" and added the "amount attributable to the DG Companies' status as S corporations," as identified by the Petitioner's expert. While the Court discussed the approach to addressing S Corporation status as reflected in *Del. Open MRI Radiology Assocs., P.A. v. Kessler* (Del. Ch. 2006), it is not clear from the decision here whether that approach was specifically adopted.

Second, the Respondent's expert applied a 20 percent marketability discount, inclusive of a 10 percent "brokerage commission" (i.e., the cost that would be incurred to engage an investment banker or business broker to sell the business). The Respondent's expert argued that costs to sell the business will be incurred someday when the Respondent sells the three entities to a third party, "and that the costs should be shared equally between the parties at the current time." The Petitioner argued that "because this transaction is between a known buyer and seller, [the Court] should not consider the transaction costs of an uncertain future transaction." The Court applied the 10 percent marketability discount, finding a lack of marketability to be "part of the operative reality of the entity," but rejected the Respondent's expert's additional 10 percent discount for brokerage commissions, noting the costs are "too speculative to be justified."

Third, the Petitioner's expert argued that synergies would arise from consolidation in ownership, and these synergies should be included in the value. The Respondent argued that certain synergies arising from the sale were "inappropriate because the DG Companies already share a single facility and other costs, and thus will not recognize any true increase in value from the consolidation of ownership." The Court noted a "certain irony" in the Petitioner's argument that "her removal from the business she helped to build should increase their value, in an amount of which she is entitled to half." The Court concluded that adding any value from savings from the Petitioner's discharge were "too speculative." The Court left the calculation of the removal of these savings from the Petitioner's expert's valuation to the parties.

Lastly, in determining the value of Aurora, the Petitioner's expert relied on a real estate appraisal performed in 2015 by an independent appraiser hired by a bank. The Respondent retained a commercial real estate agent for purposes of the litigation to provide an estimate of the value of Aurora based on listing prices of comparable properties. In addition, the Respondent retained, for purposes of the litigation, a general contractor who previously performed work on Aurora, to provide estimates of additional costs to repair or replace certain items identified by the Respondent. The additional costs served to reduce the value of Aurora. The Court found the real estate appraiser's 2015 valuation report, which was commissioned by a non-party, to be indicative of fair value at the relevant time. The Court found that the addition of the income generation valuation method in the real estate appraiser's report "makes it more likely an accurate indicator of the value of the" property than the Respondent's broker's estimate. The Court found the maintenance cost estimate in the real estate appraiser's report to be reasonable, and therefore, did not discount the value for the repair costs estimated by the Respondent's general contractor.

CASE SUMMARY

DFC Global Corporation v. Muirfield Value Partners, L.P., et al., No. 518, 2016 (Del. Aug. 1, 2017)

Click here to view the opinion.

On August 1, 2017, the Delaware Supreme Court reversed and remanded the ruling by the Court of Chancery in the DFC appraisal matter.

The Supreme Court began its opinion by declining the Respondent's request to "establish, by judicial gloss, a presumption that in certain cases involving arm's-length mergers, the price of the transaction giving rise to appraisal rights is the best estimate of fair value." The Supreme Court noted that this "has no basis in the statutory text" and highlighted the Court of Chancery's need to take into account "all relevant factors."

In the appraisal of DFC, issued on July 8, 2016, the Court of Chancery deemed it appropriate to use three equally weighted valuation techniques to arrive at a fair value conclusion: a DCF model, a multiples-based comparable company analysis and the transaction price.

While the Supreme Court refused to create a presumption in favor of the deal price when certain conditions are present, it noted that this "does not in any way signal our ignorance to 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."

The Supreme Court noted that despite the factors cited by the Court of Chancery supporting the deal price as reliable evidence of fair value, the Court of Chancery incorrectly assigned no more than one-third weight to the deal price. The Court of Chancery's reasons for assigning one-third weight to the deal price included: (i) regulatory developments causing the market's assessment of the value of the Company to not be "as reliable as under ordinary conditions" and (ii) the fact that the prevailing buyer was a financial buyer.

In its analysis, the Supreme Court agreed with the Respondent that the Court of Chancery's finding regarding regulatory developments was "not rationally supported by the record." Chief Justice Strine noted that the record demonstrated that the market factored in this regulatory risk when determining the deal price.

Furthermore, the Supreme Court did not "understand the logic" of the Court of Chancery's finding that the deal price did not merit a larger weighting because the prevailing buyer was a financial buyer focused on achieving an internal rate of return. Chief Justice Strine noted that this is the case for both financial and strategic buyers, stating "the fact that a financial buyer may demand a certain rate of return on its investment in exchange for undertaking the risk of an acquisition does not mean that the price it is willing to pay is not a meaningful indication of fair value." Chief Justice Strine highlighted the competitive bidding process, the Company's inability to refinance its public debt leading up to the transaction and that the Company's existing debt was placed on negative credit watch within one week of the announcement of the transaction.

The Supreme Court ruled that it "cannot sustain the Chancellor's decision to give only one-third weight to the deal price because the factors he cited in giving it only that weight were not supported by the record."

Chief Justice Strine also addressed the Court of Chancery's equal weighting of the three approaches and criticized the lack of explanation for such weighting. The Supreme Court concluded that "the Court of Chancery must exercise its considerable discretion while also explaining, with reference to the economic facts before it and corporate finance principles, why it is according a certain weight to a certain indicator of value."

Next, the Supreme Court addressed the Court of Chancery's revised application of the DCF method. In the original opinion, the Court of Chancery mistakenly utilized the working capital projections based on the Respondent's expert's methodology, despite determining that the Petitioners' expert's method was more appropriate. After both sides filed motions for reargument requesting reconsideration of certain aspects of the Court of Chancery's application of the DCF method, the Court of Chancery issued an order on September 14, 2016, to correct the working capital projections. However, as the Respondent noted in its appeal, in addition to adjusting working capital projections, the Court of Chancery also increased the perpetuity growth rate from 3.1 percent to 4.0 percent.

The Supreme Court agreed with the Respondent that the "record evidence does not rationally support" the increase in the perpetuity growth rate. Chief Justice Strine noted that a perpetuity growth rate of 4% "not only assumed that DFC would keep pace with inflation, but in fact would markedly exceed it." The Supreme Court determined that there was no basis to support a change in long-term growth rate when making the working capital adjustments for DFC.

Finally, the Supreme Court addressed the Petitioners' cross-appeal, which claimed that the DCF model should have been given predominant weight, the deal price should have been given little, if any, weight and the Court of Chancery "abused its discretion by giving weight to its comparable companies analysis." The Supreme Court disagreed with this, noting that the comparable companies analysis was supported by the record and that both experts agreed on most of the comparable companies used by the Court of the Chancery. Chief Justice Strine also noted that there were "ample reasons for the Chancellor to doubt the reliability of the [DCF] model" and it "was therefore not an abuse of discretion for him to consider other factors in reaching a decision about DFC's fair value."

As a result of the issues noted above, the Supreme Court reversed and remanded the case to the Chancellor, leaving the Chancellor with the "discretion to address the open issues using procedures he finds the most helpful."

See 2016 Delaware Summaries for a summary of the Chancery Court's 2016 opinion.

CASE SUMMARY

Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., et al., No. 565, 2016 (Del. Dec. 14, 2017)

Click here to view the opinion.

On December 14, 2017, the Delaware Supreme Court reversed and remanded the ruling by the Court of Chancery in the Dell appraisal matter, stating that while the Chancery Court did consider all relevant factors, including the stock price and deal price, it erred in deciding to give the market data (i.e., stock price and deal price) no weight in its conclusion of fair value.

In the initial May 31, 2016, opinion, the Chancery Court concluded that the fair value of Dell's common stock on the closing date of its going-private transaction was $17.62 per share, over 28 percent higher than the merger price of $13.75 per share. The Chancery Court's decision relied exclusively on the DCF method and gave no weight to the merger price. Vice Chancellor Laster opined that in this case a combination of factors undercut the relationship between the merger price and fair value, including the buyer's use of an LBO pricing model and the valuation gap between the market price of Dell's common stock and the intrinsic value of the company.

On appeal, the Delaware Supreme Court stated that the reasons the Chancery Court provided for giving the merger price no weight did not follow from the Chancery Court's key factual findings and from relevant, accepted financial principles. The Supreme Court stated that "the record as distilled by the trial court suggests that the deal price deserved heavy, if not dispositive, weight."

The Supreme Court concluded that the three central premises on which the Chancery Court relied in placing no weight on the merger price were flawed, and that without these premises, "the trial court's support for disregarding the deal price collapses." On these three issues, the Supreme Court concluded that:

(1) There was no valid basis for finding a "valuation gap" between Dell's market and fundamental values;

(2) The lack of strategic bidders is not a credible reason for disregarding the deal price; and

(3) The features of management buyouts which could theoretically undermine the probative value of the deal price were not present in this transaction.

First, the Chancery Court concluded that the market for Dell's stock was inefficient and that a "valuation gap" existed between the market price and Dell's fundamental value, resulting at least in part from the "inadequate — and lowball — assessment" of the publicly available information by "short-sighted analysts and traders." However, the Supreme Court found that analysts did consider and understood Dell's long-term plans in their evaluation of the company. The Supreme Court cited substantial evidence in the record that undermined the Chancery Court's conclusion that the market was inefficient, including: (i) a deep public float; (ii) coverage by more than 30 equity analysts; (iii) active trading, with more than 5% of shares traded every week; (iv) no controlling shareholder; and (v) a track record of the stock price responding rapidly to new information. The Supreme Court further stated that the record "simply does not support the Court of Chancery's favoring of management's optimism over the public analysts' and investors' skepticism — especially in the face of management's track record of missing its own projections."

Second, the Supreme Court found that the lack of strategic bidders is not a credible reason to disregard the merger price. As was the case in the DFC Global matter, the Supreme Court saw "no rational connection" between a buyer's status as a financial buyer and the fairness of the merger price, noting that "all disciplined buyers, both strategic and financial, have internal rates of return that they expect" in a merger, or any large capital investment. In addition, the Court found that there were a number of factors in the sale process that increased its reliability. These included: (i) the involvement of private equity firm Silver Lake Partners, a potential buyer, at every stage of the process, both pre-signing and during the go-shop period; (ii) the fact that the Special Committee persuaded Silver Lake to increase its bid six times; and (iii) a 45-day go-shop period with "fewer structural barriers than the norm" and incentives for the financial advisor to make the go-shop as effective as possible. The Supreme Court cited the Chancery Court's own statements that the sale process "easily would sail through if reviewed under enhanced scrutiny." Ultimately, the Supreme Court concluded that to the extent that the Chancery Court disregarded the deal price based on the presence of only private equity bidders, its reasoning was "not grounded in accepted financial principles."

Third, the Supreme Court found that certain problems supposedly present in all management buyouts did not detract from the reliability of the deal price in this case. Specifically, the Supreme Court found that there were no structural issues that limited the effectiveness of the go-shop, with rival bidders having a realistic path to success and the capability of overcoming the size and complexity of Dell. The Supreme Court determined that the threat of a "winner's curse" was reduced by the extensive due diligence undertaken by prospective bidders, noting 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 the price is already at a level that is fair. The issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited." Finally, the Court determined that Mr. Dell's value to the company was not an impediment to the success of prospective bidders, noting that some bidders did not consider Mr. Dell to be essential to their bids and noting evidence that Mr. Dell was willing to work with other buyout groups.

While the Supreme Court's opinion focuses on the weight of the stock price and deal price in determining the fair value of Dell, the Supreme Court addresses the DCF analyses presented in the Court of Chancery appraisal trial, stating that "despite [the Supreme Court's] sentiments [of reliance on the merger price], to aid the Court of Chancery if it justifies granting any weight to the DCF on remand, we address the specific issues raised by the parties in their appeals and cross-appeals." In doing so, the Supreme Court addresses various valuation topics challenged by the parties, including:

- **Tax Issues:**
  - **Terminal Period Tax Rate:** "[T]he Court of Chancery did not abuse its discretion" in applying the Company's effective tax rate rather than the top marginal tax rate under U.S. law.
  - **Deferred Taxes:** The Supreme Court found that if the Court of Chancery chooses to include foreign earnings in its analysis, it should adjust its model to include some rational tax consequence upon repatriation.
  - **FIN 48:** The Supreme Court deferred to the Court of Chancery's finding regarding the treatment of FIN 48 reserves (tax-related reserves). The Supreme Court stated that it is "reluctant to speak broadly about this issue" due to a lack of reliable guidance in the record regarding the treatment of FIN 48 reserves in a DCF.
- **Projection Adjustments:** The Supreme Court found that the Court of Chancery had logic for its adjustments to the projections related to cost savings and new data, and the adjustment did not amount to an abuse of discretion, as alleged by the Petitioners.
- **Adjustments to Excess Cash:** The Supreme Court found that the Court of Chancery's reduction of excess cash by $3 billion for working capital and $1.2 billion for restricted cash did not amount to an abuse of discretion, as alleged by the Petitioners.

See 2016 Delaware Summaries for a summary of the Chancery Court's 2016 opinion.

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For further information regarding our services or issues discussed in this publication, please contact

Jaime d'Almeida
Managing Director
+1 617 378 9445
jaime.dalmeida@duffandphelps.com

Rebecca Levy
Director
+1 617 378 9461
rebecca.levy@duffandphelps.com

Duff & Phelps Contributing Authors

Emma Baumgartner
David Furman
Daniel Patiño
Rachel Perdigao
Matthew Root