The M&A LAWYER

January 2018 ▪ Volume 22 ▪ Issue 1

JUST GETTING STARTED: M&A IN 2017 AND WHAT TO EXPECT IN 2018

By Frank Aquila and Melissa Sawyer

Frank Aquila and Melissa Sawyer are partners in the Mergers & Acquisitions Group of Sullivan & Cromwell LLP. The views and opinions expressed in this article are those of the authors and do not necessarily represent those of Sullivan & Cromwell or its clients. Contact: aquilaf@sullcrom.com and sawyerm@sullcrom.com. *The authors are grateful for the assistance of Nick Williams, an associate at Sullivan & Cromwell, for his helpful research for this article.*

2017 had many of the hallmarks of a blockbuster year for U.S. M&A. The U.S. economy was strong. In addition, economic growth in other key markets like Europe, Japan, China, and India was also positive. For much of the year, investor and CEO confidence was high and acquisition financing was both readily available and inexpensive. However, although the volume of U.S. deals rose slightly, the total value of U.S. M&A deals fell by almost 10%, and the median P/E multiple and premium on deals declined relative to 2016. Many companies seemed to put their transformative M&A activity on pause in a deal slowdown that may have been attributable to uncertainty regarding health care and tax reform while waiting for a direction on other regulatory policy. Even historically super-acquisitive companies saw a decline in the overall number of deals completed, with the numbers tapering off noticeably in the third quarter.

Given the strength of the global economy and U.S. tax reform, the knockout year that we had expected in 2017 will most likely be upon us in 2018 as the uncertainty over health care reform, tax reform, and Brexit fades into the economic background.

Regardless of whether M&A activity weakens or strengthens, it is possible to make a few conceptual observations about recent trends and issues in M&A.

American Made: M&A and the Regulatory State

During the 2016 presidential campaign, the Trump administration was widely expected to adopt a Reagan-like antitrust outlook. In other words, merger enforcement activity was expected to decline,

IN THIS ISSUE:

THOMSON REUTERS®

42078076

value. In the wake of numerous high-profile scandals, and with so much at stake, what can boards do to protect employees, preserve the corporation, and safeguard the shareholders' investment? A recent article from the *Washington Post* revealed that many companies are increasingly investing in employment practices liability insurance ("EPLI") plans, which cover sexual harassment, racial discrimination, and wrongful firing claims. In addition to the palpable moral hazard created by these plans, sexual harassment insurance is in no way an effective method of preventing offenses or mitigating risk.

Nevertheless, it is clear that there is certainly no easy or quick fix. Yet there is a lot that boards can and should do in terms of implementing preventative and responsive policy. At the same time, in diligencing a potential acquisition target, buyers should take a close look at the target's culture and policies for addressing sexual harassment allegations. Since it is unlikely at most targets that even the most serious sexual harassment litigation or settlement will breach a threshold of materiality sufficient to excuse a buyer from closing a signed deal, buyers may want to perform some sensitivity analysis around the potential reputational and economic impacts of a credible allegation.

Leap!: What to Expect in 2018

Although 2017 never developed into the blockbuster M&A year that the deal community had anticipated, the economic factors that we had all expected to lead to many deals are still in place and should give rise to a significant uptick in activity in 2018.

FOR WHOM *DELL* TOLLS: WHAT THE DELAWARE SUPREME COURT'S LATEST APPRAISAL DECISION PORTENDS FOR THE FUTURE OF PUBLIC COMPANY M&A LITIGATION

By S. Michael Sirkin

S. Michael Sirkin is a partner at Ross Aronstam & Moritz LLP in Wilmington, Delaware, where he practices corporate and business litigation. The views expressed herein are those of the author alone and do not necessarily represent the views of the firm or its clients. Contact msirkin@ramllp.com.

On December 14, 2017, the Delaware Supreme Court issued its highly anticipated decision in the *Dell* appraisal action.[1] In its 82-page decision, the Supreme Court reversed the Court of Chancery and held that the merger price paid in the management-led buyout "deserved heavy, if not dispositive, weight"[2] in the fair value analysis required by the appraisal statute.[3]

As highlighted below, *Dell* changes the law in at least three potentially significant ways, some more subtle than others. First, it represents the Delaware courts' strongest endorsement yet of the efficient markets hypothesis. This has direct implications for public company appraisal actions, but it also might impinge on the managerial freedom that has long been afforded to corporate fiduciaries seeking to act on the belief that the market has mis-valued their companies. Second, *Dell* makes market value—the value that a bidder would be willing to pay to acquire the target firm—an upper bound on the jurisprudential concept of fair value in the appraisal context. This too has direct implications for appraisal litigation practice. But it also reconceptualizes the fundamental purpose of the appraisal remedy. Finally, and especially on the heels of *DFC*,[4] *Dell* establishes a steep uphill climb for a public company appraisal petitioner, who must now overcome the powerful forces of evidence from the stock market, debt markets, and M&A market to even get the court to give meaningful consideration to their fundamental valuation positions.

These three issues are discussed more fully below, following a brief summary of the transactional facts and the Supreme Court decision in the case.

Transactional Background

The appraisal action arose from the 2013 acquisition of Dell Inc. by a buying group led by the company's eponymous founder and CEO, Michael Dell, together with private equity firm Silver Lake Partners. Mr. Dell expressed interest in taking the company private one year earlier, in August 2012, and the company's board appointed a special committee of independent directors to explore and evaluate strategic alternatives.[5]

With help from its advisors, the special committee determined that strategic buyers would not likely be interested in acquiring the company. As a result, it limited its initial marketing effort to private equity firms KKR and Silver Lake. Following diligence, both KKR and Silver Lake made offers, each of which contemplated some degree of buy-side participation from Mr. Dell. But as time wore on, the company's financial performance suffered, causing KKR to drop out. The committee attempted to replace KKR with another private equity firm, TPG, but TPG never made an offer despite doing diligence.[6]

On February 5, 2013, the special committee and Silver Lake agreed that Silver Lake would buy the company for $13.65 per share. Mr. Dell agreed to rollover all of his shares at a discount, and that he and his affiliates would contribute $750 million in additional equity into the deal. The agreed-upon deal would give Mr. Dell approximately 75% of the private company, with Silver Lake owning the remainder. Importantly, the committee secured from Mr. Dell the contractual commitments to work with other potential bidders, and to vote his shares with the unaffiliated stockholders in the event of a viable topping bid.[7]

The signing of the merger agreement kicked off a 45-day go-shop period in which the special committee contacted 67 potential topping bidders. Two financial buyers expressed interest during the go-shop period, and the special committee committed to reimburse them (and Silver Lake) for due diligence expenses up to $25 million. No one ultimately made a topping bid for the whole company, though a competing group launched a proxy contest in support of a leveraged recapitalization proposal.[8]

As a result, Silver Lake ultimately raised its offer to $13.75 per share, and the deal closed on October 29, 2013.[9]

The Supreme Court Decision

As with most public company appraisal actions, *Dell* required the court to consider and address three main sources of valuation evidence.

- ***The Stock Market Evidence:*** The Court of

Chancery had found that the stock market had significantly undervalued the company for a substantial period of time. The Supreme Court rejected that view, holding that the market for the company's stock bore all of the hallmarks of an efficient market. "In these circumstances," the Supreme Court held that "a mass of investors quickly digests all publicly available information about a company, and in trading the company's stock, recalibrates its price to reflect the market's adjusted, consensus valuation of the company."[10] At bottom, the Court held that the collective wisdom of the stock market provided more powerful evidence than the trial court's factual findings that the company's insiders believed a significant "valuation gap" existed for an extended period of time.[11]

- ***The M&A Market Evidence:*** The Court of Chancery gave no explicit weight to the merger price in its fair value determination because the sale process did not include strategic buyers, and because of structural impediments inherent in the nature of a management buyout. The Supreme Court rejected both of those premises, deeming them "untenable in view of the Court of Chancery's own findings of fact as considered in light of established principles of corporate finance."[12] Echoing its *DFC* decision, the Supreme Court held that the lack of strategic bidders is not a credible reason for disregarding the deal price.[13] And with respect to the MBO structure and its potential impact on the merger price, the Supreme Court simply disagreed with the Court of Chancery's judgment that potential topping bidders would not have perceived there to be a realistic pathway to success in bidding against the incumbent Silver Lake/Michael Dell buying group.[14] Importantly, the two courts took different views of the kind of proof necessary to deviate from the deal price. The Court of Chancery relied on expert testimony to hold that the structure of the process was such that it may have deterred potential bidders from getting involved or putting top dollar into a bid, while the Supreme Court found persuasive the lack of any factual evidence that a potential bidder was actually so deterred.[15]

- ***The DCF Analyses:*** As a result of its holdings with respect to the market evidence, the Court of Chancery used the discounted cash flow ("DCF") methodology to arrive at its fair value estimate. The Supreme Court rejected that view on policy grounds,[16] holding that "the Court of Chancery should be chary about imposing the hazards that always come when a law-trained judge is forced to make a point estimate of fair value based on widely divergent partisan expert testimony."[17] By so doing, the Supreme Court invites the Court of Chancery in future cases to avoid the costly and difficult process of resolving esoteric disputes between similarly qualified experts with opposing incentives, disputes that often reside on the bleeding edge of applied corporate finance. Courts still need to consider all relevant factors, to be sure, but may retreat to the safety and wisdom of the collective judgment of markets without resolving every DCF dispute in many cases.

Three Potentially Significant Ways *Dell* Changes the Law

The Delaware Supreme Court explicitly endorsed the semi-strong form of the efficient capital markets hypothesis for use in appraisal cases. The Court of Chancery concluded after trial that there was "extensive and compelling" evidence of a "significant" valuation gap between Dell's stock price and its "operative reality" that persisted "over a prolonged period."[18] In reaching this conclusion, the Vice Chancellor relied heavily on contemporaneous valuation analyses and trial testimony by company insiders and advisors.

The Supreme Court criticized the Court of Chancery's analysis on the ground that it "ignored the efficient market hypothesis long endorsed" by the Delaware Supreme Court.[19] Citing *DFC*, the Supreme Court explained that the efficient market hypothesis "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, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client."[20] The Supreme Court then applied the teachings of the "semi-strong" form of the efficient market hypothesis, concluding that the indisputable evidence that Dell traded on an efficient market overwhelmed the evidence relied on by the trial court that company insiders believed the stock to be significantly undervalued.[21]

This marks at least a subtle shift in the law. Following *Dell*, at least in the appraisal context, contemporaneous evidence generated by company insiders that they believed the company to be undervalued by the market is insufficient to overcome the collective wisdom expressed by a thick and liquid trading market.

But in fiduciary duty cases, Delaware law has long afforded corporate directors the freedom "to function on a theory that they understood better than the public market for the firm's shares what the value of their firm was."[22] To be sure, the power questions that animate fiduciary duty cases differ from the valuation questions at issue in appraisal, but Delaware courts may soon confront arguments in fiduciary duty cases that directors can no longer act on the belief they know better than the market.

The Delaware Supreme Court adopted a market value standard for appraisal. The Supreme Court held that "[f]air value entails at minimum a price some buyer is willing to pay—not a price at which no class of buyers in the market would pay."[23] This statement seems sensible and intuitive, but it is also a sweeping change to the core fair value determination in appraisal cases, and reflects a changed view of the fundamental purpose of appraisal.

Before *Dell*, "[t]he concept of fair value under Delaware law [was] not equivalent to the economic concept of fair market value."[24] "[T]the court's task [was] not to find the actual real world economic value of the petitioners' shares, but instead to determine the value of the petitioners' shares on the assumption that they are entitled to a pro rata interest in the value of the firm when considered as a going concern, specifically recognizing its market position and future prospects."[25] The appraisal remedy was therefore understood as protecting a stockholder against an ill-advised decision to sell the company, as opposed to operating independently.

But now, a successful appraisal case requires proof that some buyer or class of buyers exists that would pay more for the target company.[26] By establishing market value as an upper bound of fair value, *Dell* suggests a changed view of the purpose served by the appraisal remedy. Instead of protecting a selling stockholder against an ill-advised decision to sell the company, *Dell* reflects an appraisal remedy designed to protect against a conflicted sale or broken sale process.

The Delaware Supreme Court raised the bar for future public company appraisal petitioners. In the wake of the Supreme Court decisions in *Dell* and *DFC*, an appraisal petitioner contemplating a public company appraisal action should perceive it difficult to find a realistic pathway to success.

To take an example, assume that a public company is acquired by a third party in a publicized sale process. Assume further that the stock traded in market that bore the hallmarks of market efficiency, and that the sale occurs at a modest premium to the prevailing stock market price. Following *Dell* and *DFC*, a would-be appraisal petitioner would have to anticipate litigating and winning ***all*** the following issues:

- ***Stock Market Mis-Pricing:*** An appraisal petitioner must overcome *Dell*'s explicit endorsement of the efficient markets hypothesis, and must do so in a way that is different from what the petitioners did in *Dell* itself. As a result, an appraisal petitioner must develop a convincing argument that specific, material information was withheld from the market. As a 10b-5 plaintiffs' lawyer could attest, this is a tall order.

- ***Exclusion of a Buyer Willing to Pay More:*** An appraisal petitioner must prove that the company's sale process excluded a buyer or group of buyers who was willing to pay more for the target. Following *Dell*, it is not enough for a petitioner to establish merely that a possible buyer was excluded. Nor is it sufficient to show that a group of buyers was excluded. *Dell* requires specific evidence that the excluded buyer would have paid more. As an evidentiary matter, third-party discovery proving that a jilted buyer would have paid more is rare.

- ***Valuation:*** An appraisal petitioner also must prove its own valuation case, which typically requires proof by way of expert testimony and a DCF analysis that the company was worth more than the merger price.

Conclusion

As discussed above, *Dell* will have a significant impact in all appraisal cases going forward. And it might also have spillover effects into other kinds of litigation, including fiduciary duty cases and other contexts in which valuation issues arise.

ENDNOTES:

[1] *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, 2017 WL 6375829 (Del. Dec. 14, 2017) ("*Dell Appra*isal").

[2] *Dell Appraisal*, at *16.

[3] *See* 8 *Del. C.* § 262.

[4] *DFC Glob. Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

[5] *Dell Appraisal*, at *3.

[6] *Id.* at *4-5.

[7] *Id.* at *6.

[8] *Id.* at *6-8.

[9]*Dell Appraisal*, at *9.

[10]*Id.* at *17.

[11]*Id.* at *16-19.

[12]*Id.* at *16.

[13]*Id.* at *19-20.

[14]*Dell Appraisal*, at *23-25.

[15]*Id.* at *23.

[16]The Supreme Court also made specific rulings on contested DCF issues. *See Dell Appraisal*, at *28-34.

[17]*Id.* at *26.

[18]In re Appraisal of Dell Inc., 2016 WL 3186538, at *32 (Del. Ch. May 31, 2016).

[19]*Dell Appraisal*, at *17.

[20]*Id.* at *17.

[21]*Id.* at *17-19.

[22]*Paramount Commc'ns Inc. v. Time Inc.*, 1989 WL 79880, at *19 (Del. Ch. July 14, 1989) ("But just as the Constitution does not enshrine Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text. Directors may operate on the theory that the stock market valuation is 'wrong' in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation's present and future condition."); *see also Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1376 (Del. 1995) ("[T]he directors of a Delaware corporation have the prerogative to determine that the market undervalues its stock and to protect its stockholders from offers that do not reflect the long-term value of the corporation under its present management plan."); *cf. Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 301 (Del. 1996) ("[T]he market price of shares may not be representative of true value.").

[23]*Dell Appraisal*, at *21.

[24]*Finkelstein v. Liberty Digital, Inc.*, 2005 WL 1074364, at *12 (Del. Ch. Apr. 25, 2005).

[25]Id.

[26]*Dell Appraisal*, at *27 ("What this statement means is that the Court of Chancery's DCF value was the antithesis of any economist's definition of fair market value. . . . When an asset has few, or *no*, buyers at the price selected, that is not a sign that the asset is stronger than believed—it is a sign that it is weaker. This fact should give pause to law-trained judges who might attempt to outguess all of these interested economic players with an actual stake in a company's future.").

DELAWARE DECISION SUGGESTS PRO RATA RECAP THAT ENABLES PROLONGING OF EXISTING CONTROL STRUCTURE MAY BE SUBJECT TO ENTIRE FAIRNESS ABSENT INDEPENDENT DIRECTOR AND MINORITY STOCKHOLDER APPROVAL: *NRG YIELD*

By Gail Weinstein, Steven J. Steinman, Christopher Ewan, Matthew V. Soran and Andrew J. Colosimo

Gail Weinstein is senior counsel in the New York office of Fried, Frank, Harris, Shriver & Jacobson LLP. Christopher Ewan, Steven Steinman, Matthew Soran, and Andrew Colosimo are partners in Fried Frank's New York office. Contact: gail.weinstein@friedfrank.com or christopher.ewan@friedfrank.com or steven.steinman@friedfrank.com or matthew.soran@friedfrank.com or andrew.colosimo@friedfrank.com.

In *NRG Yield v. Crane*,[1] the Court of Chancery dismissed fiduciary duty claims against directors who approved a corporate recapitalization that