Perspectives from a Business Governance Attorney regarding Delaware Fair Value Litigation

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Introduction

The perspective of a practicing attorney is primarily influenced by both historical securities litigation decisions and personal experience. In order to provide a practitioner perspective, this discussion includes thought leadership on the current state of corporate security transactions from a practicing business governance attorney.

Michael J. Zdeb is a partner in the Chicago office of Holland & Knight. Michael represents equity participants and businesses in shareholder disputes and in corporate governance matters. His experience includes matters involving shareholders and members in limited liability companies, as well as partnership disputes.

Michael utilizes his own business and tax experience and works with a team of experienced valuation analysts and litigators to ensure the best possible outcome for his clients. More often than not, this approach has resulted in creative settlements and resolutions that take into account the specific needs of the client, the financial aspects of the business, and other dynamics of the business.

Michael has a background in valuation matters, and, in particular, in the valuation concepts involved in the "fair value" standard of value employed by courts in shareholder appraisal rights and breach of fiduciary duty claims. Michael also serves as counsel to international and domestic businesses in the manufacturing, distribution and logistics, consulting, and telecommunications industries.

The *Insights* editorial team brainstormed to develop questions in the securities litigation discipline that should be of interest to our readers. We then presented our questions to Michael. We hope you find Michael's thought leadership as informative as we did.

Questions and Answers

Zanni: *In re Appraisal of Dell Inc.* (2016. Del. Ch.), the court recognized that certain financial buyers use leveraged buyout ("LBO")-based models to calculate a business purchase price. LBO-based financial models are typically based on the purchase price that a private equity investor will pay in order to achieve a certain internal rate of return.

The court further noted that an LBO-based purchase price does not necessarily equal the fair value of the subject business enterprise.

How do you interpret the court's ruling in *Dell* (i.e., to ignore the actual merger price in favor of a purchase price based on the discounted cash flow valuation method)?

Zdeb: The *In re Appraisal of Dell, Inc.*, judicial decision is 114 pages of a comprehensive explanation of why the Vice Chancellor rejected the merger consideration as being indicative of the company's fair value.

The decision in *Dell* and other recent cases have resulted from a number of developments: the Delaware requirement that the Chancellor determine "fair value" with consideration of:

1. the deal price not being presumptively equal to the fair value,
2. the delays that can occur between the announcement of a deal and the actual

closing and the market developments during that time gap,

3. the differences in the liquidity of the public market versus the private merger and acquisition market, and
4. the requirement that synergies be disregarded.

The *Dell* decision is a pointed reminder that "operative reality" is the context in which the fair value valuation takes place. The operative reality in this case included a marketplace that the court found did not reflect the significant investments and new business model of the company.

I view the *Dell* decision as one that is likely limited to some specific facts and circumstances. That is, *Dell* is a case involving a management leveraged buyout with limited financial bidders and a "market valuation gap."

The court noted the context of a management-led buyout of a large and complex company where limited competition in the bidding process occurred. The court saw the public market as not reflective of the operative reality of the company at a time when a significant long-term investment and reshaping of the company was in its nascent stage.

Since the determination of fair value is to take into account all relevant facts and considerations, these considerations undermined the position that the merger price was indicative of "fair value."

Specifically, the court noted that, in considering all relevant factors, fair value would include consideration of those elements that might throw light on the future prospects of the company. In that context, the transaction advisers and the bidders used current market data with a leverage buyout model— while Mr. Dell had been publicly stressing the long-term view of the recent reshaping of the company.

I believe the court was heavily influenced by both (1) the leverage buyout approach of the financial advisers to the board as well as (2) the limited bidder activity. As the court noted in its judicial decision, the LBO model solves for a value that produces a return relative to the risk level that the financial bidder is willing to take. The LBO model does not solve for the intrinsic value that the court is required to determine as "fair value."

Once the court determined that the deal price was not indicative of that intrinsic value, it conducted its own fair value determination—not limited to an LBO model that produced "outsized returns."

Zanni: In your view, how important are value indications from third-party financial buyers—as compared to third-party strategic buyers—in dissenting shareholder appraisal rights litigation?

Zdeb: It is an interesting topic. On one hand, financial buyers are using current market data and solving for a risk-reward value. The current market pricing may not be indicative of:

1. the relative information available to the public and
2. the differences in market liquidity for the shares versus the company.

In addition, as the court noted in the *Dell* decision, the financial model might be designed for "outsized returns." The financial buyer has investments in winners and losers and seeks returns for its investors with that backdrop of requiring greater returns for greater relative risk.

The strategic buyer presents other concerns, mainly the prospect of the deal price being reflective of a synergistic value (and not a fair value). Under Delaware appraisal law, synergistic value should be disregarded.

Both types of transaction participants present issues and require thoughtful analysis. Neither may be indicative of "fair value." *Dell* and other recent cases demonstrate that this issue can occur when:

1. there is a lack of robust bidding process,
2. there are indications that the market pricing may be missing some element of value in the operative reality, or
3. the price was driven by synergies that the buyer hoped to realize.

Zanni: In your own words, describe the legal concept of shareholder appraisal rights in Illinois. Are the legal protections offered to dissenting, noncontrolling shareholders adequate, biased, or relatively fair? Has the level of this shareholder legal protection evolved over time?

Zdeb: The concept of the oppression of a noncontrolling shareholder has been in the Business Corporation Act of Illinois since about 1933. However, it is only more recently that the courts have addressed this concept.

Rather than focus on a statutory approach to oppression, Illinois long ago recognized that, in a closely held business, fiduciary duties existed that the traditional corporate model did not

address. The approach in Illinois has been similar to the *Donahue* approach in Massachusetts. Duties exist among shareholders that are more similar to those that exist in partnerships—the duty of loyalty, the duty of good faith, and fair dealing.

As for the legal concept of "oppression," the definition is frequently equated with the "reasonable expectations" standards. That is, if the parties in control of the company defeat by their actions the reasonable expectations of the other shareholders, a statutory action for dissolution may exist. The focus of this approach is on the expectations.

An alternative approach exists with more of a focus on the conduct of those in control and of the company—whether it is unduly prejudicial, harsh, and unfair. In most cases, the result will be the same.

What may be somewhat unique in Illinois is the approach to the remedies that will be triggered. By statute, a finding of oppression allows the court to order a wide variety of remedies that are specifically listed. In addition, the Illinois statute allows for any other remedy that the court would find equitable under the circumstances.

In most other jurisdictions, the remedies, other than disputes, are not specifically set out by state statute and are a matter of judicial interpretation.

In my experience, the most frequent remedy is an order to have the oppressed shareholder bought out at a "fair value" price. I believe this is a result of the recognition that any other remedy is not likely to resolve the differences among the parties and would continually involve the court in disputes between the parties.

Illinois has a specific statutory definition of "fair value." It is the value of the business enterprise without a discount for lack of control nor—except in extraordinary circumstances—a discount for lack of marketability. In effect, fair value is the proportional total business enterprise value, discounted for a lack of marketability only in extraordinary circumstances.

This same fair value definition exists by judicial interpretation in several other jurisdictions. However, in Illinois, this definition is explicitly set out in the statute.

Zanni: In *Corwin v. KKR Financial Holdings LLC*, the Delaware Supreme Court held that the business judgment rule is the appropriate standard of review for a post-closing damages action when a merger not subject to entire fairness has been approved by a fully informed and uncoerced controlling interest of disinterested stockholders.

How do you view the *Corwin* decision? Because of the *Corwin* decision, do you anticipate any changes in the number of dissenting shareholder appraisal rights case filings?

Zdeb: The *Corwin v. KKR Financial Holdings LLC* decision is indicative of a trend in Delaware to apply the business judgment standard of review to post-closing claims—rather than entire fairness or enhanced scrutiny—where a fully informed, uncoerced vote of disinterested stockholders approved the transaction. *Corwin* has been considered in two more recent decisions:

1. *City of Miami Gen. Employees v. Comstock* (August 24, 2016) by Chancellor Bouchard
2. *Larkin v. Shah* (August 25, 2016) by Vice-Chancellor Slights

The two more recent judicial applications have left some observers to wonder if the "cleansing" effect applies if there was a controlling stockholder or a conflicted board. The "cleansing" effect of such a vote is likely to reduce the number of post-closing claims—absent a conflicted board or a controlling stockholder.

Zanni: Based on your experience, do you see any current trends developing in shareholder appraisal rights litigation matters or in shareholder oppression

matters (e.g., more filings now than in prior years, different types of filings, or other issues)?

Zdeb: I have noticed a couple of trends, the most recent being the weight to be given to deal consideration in the shareholder appraisal rights proceedings regarding fair value. Recent cases have found both the consideration indicative of fair value and, in others, the consideration was disregarded.

The acceptance or rejection of a deal price in a transaction has been a hot topic in Delaware for a couple of years now. *Dell* is one of a number of cases in which the deal price was not considered to be indicative of the fair value, thereby leading the court to conduct its own discounted cash flow method valuation analysis.

The recent judicial decisions point out that a robust process with independent boards is likely to produce a value to which the court will give weight. This view was again stated in *In re Appraisal of Petsmart, Inc.,* on May 26, 2017, by Delaware Vice-Chancellor Glasscock. In that case, the court found that a pubic sales process that develops market value is often the best evidence of "fair value."

In many respects, the exception is the leveraged management buyout in *Dell* (1) where there was a demonstrable "market gap" in value with an LBO model solving for "outsized returns" or (2) where the process of the board was lacking independence. In *Dell*, a control group existed and the company sale process was not "robust" or conducted in a way to gain the best price.

Zanni: Are there any relatively current legal decisions that you find interesting, and why?

Zdeb: I am following the developments regarding two topics.

The first topic that has interested me is the application of the size premium in establishing a present value discount rate. A large number of studies and professional publications are debating the effect of the size premium, in particular the "10th decile," in the valuation of private companies under the "fair value" standard of value.

To date, the Delaware Chancery has not rejected the application of a size premium due to the arguments that it contains an impermissible element of lack of marketability or lack of liquidity. The effect of the size premium—and the implications of a lack of liquidity in the 10th decile—are hotly debated matters.

In my view, the cases in which the attempt to exclude or modify the application of the 10th decile premium have not convinced the court of the ability to identify the extent of the impermissible element or the manner in which an adjustment would be made. It is possible, in time, that the valuation profession will be able to demonstrate to the Chancery the effect of illiquidity in the 10th decile premium.

At least one study has advanced a methodology, which, as of this date, has not been presented to the court. The implications of any decision by the Chancery to reject or allow for such adjustments are significant. While the Court in unusual circumstances has made adjustments in the past, an approach with a method to be applied generally has not been accepted.

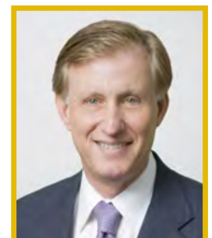
The second topic that has interested me is the impact of synergies in the determination of "fair value" in shareholder appraisal rights proceedings. In a case decided in May 2017, without going into the level of details present, the petitioners in the appraisal rights proceeding were able to convince the court that the sales process was structurally defective as a means of indicating market value.

In addition, the respondent company was able to demonstrate that the price included a significant effect of synergistic value that the buyer could create following the acquisition.

Delaware appraisal law requires synergistic value to be disregarded. The "fair value" standard is the value of the company as a going concern—and not its value to a specific third party as an acquisition.

As a result, the court was guided by the adversarial presentations of the parties and was convinced by both sides that the transaction value was not indicative of "fair value." In addition, the respondent was able to convince the court that the holding company faced significant challenges in its ability to raise capital and meet regulatory approvals.

The court then conducted its own discounted cash flow method valuation analysis, and the court found the share fair value to be less than the actual deal price.



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