Goodmans LLP Update

Corporate Securities

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Comparing and Contrasting Appraisal Rights in Canada and the U.S. in Light of *Dell*

Introduction

On May 31, 2016, the Delaware Court of Chancery ruled in *In re: Appraisal of Dell Inc.* that the "fair value" of Dell's common stock at the time of its 2013 management-led buyout (MBO) was US$17.62 per share, over 28% higher than the US$13.75 per share the company's stockholders received under the merger. In addition to being a high profile transaction, the decision is notable for a number of reasons, including the Court's conclusions that factual circumstances undermined the reliability of the merger consideration as an appropriate indication of fair value, notwithstanding that the Court found that Dell's board had fulfilled its duties to the company's stockholders in agreeing to the sale.

The merits of the decision have been the subject of considerable debate in the U.S., with some commentators criticizing the Court for departing from the merger consideration in a fully shopped deal, and others focusing on the somewhat unique facts of the case. While the ultimate impact of *Dell* remains to be seen, given increasing focus on the potential use of "appraisal arbitrage" strategies in Canada, the decision provides an opportunity to consider how Canadian courts would likely approach facts similar to those in *Dell*, as well as structural differences between Canadian and U.S. dissent and appraisal regimes that may affect the implementation of these strategies north of the border.

The *Dell* Decision

In *Dell*, a relatively small group of Dell's shareholders exercised their appraisal rights under Delaware corporate law in connection with the MBO, arguing that the fair value of Dell's common stock on the closing date of the MBO was significantly in excess of the consideration Dell's stockholders received. The principal issue in the case was the appropriate methodology for determining the fair value of Dell's common stock.

The Court rejected the company's argument that the merger consideration represented the best measure of fair value. While the Court accepted that the deal price was a relevant factor, it held that it was not determinative in this case given a number of factors that undermined the reliability of the merger consideration as an indication of fair value. In particular, the Court focused on:

- evidence that Dell's management believed the market significantly undervalued Dell's stock, offsetting the weight that would otherwise be attributed to the substantial premium represented by the merger consideration,
- the use of a leveraged buyout pricing model premised on a targeted internal rate of return, which the Court held could reflect a significant discount to the fair value that a strategic bidder might be willing to pay,
- its determination that the price of Dell's common stock did not account for the substantial shift in Dell's long-term business strategy that was underway at the time, resulting in a gap between market value and fair value, and
- concerns regarding the process through which the transaction was pursued, including limited pre-signing competition (in particular, the failure to engage with a major competitor) and a perception (based in part on empirical evidence) that the post-signing "go-shop" was ineffective.

Having determined that the transaction price was not an appropriate measure of fair value for appraisal purposes, the Court adopted a discounted cash flow analysis as its valuation methodology. The Court

refused to accept the expert testimony of either the petitioners or the company (which led to drastically different valuations) and engaged in a detailed review of the evidence (including prior valuation information) before concluding that the fair value of Dell's common stock was $17.62 per share. As a result, the petitioners were awarded approximately $25 million in additional consideration plus approximately $12 million in statutory interest.

The Canadian Approach to Fair Value

Similar to Delaware corporations, shareholders of Canadian corporations are afforded statutory rights of dissent in respect of certain fundamental changes involving the corporation (such as going-private transactions) and the right to receive "fair value" for their shares. Most Canadian corporate statutes provide that fair value is determined as of the date of the shareholders' resolution adopting the applicable corporate action. As in the U.S., there is no statutory definition of "fair value." There are many potential traps for the unwary when exercising dissent rights, and failing to strictly comply with the required procedures can result in a loss of dissent rights entirely.

Historically, dissent rights have been exercised less frequently in Canada than in the U.S. and, correspondingly, judicial consideration of dissent rights has been more limited in Canada. The Canadian jurisprudence that exists demonstrates that there are three principal valuation methodologies that Canadian courts may adopt in a particular case, either alone or in some combination:

- the market value approach (with no minority discount),
- the discounted cash flow approach, and
- the net asset value approach (also known as the liquidation approach).

No one methodology is generally considered to be superior to the others. Rather, the "one true rule" is that the court will consider all of the relevant evidence that may assist in a particular case and exercise its best judgment based on that evidence. At the same time, recent cases demonstrate that, in going private transactions, Canadian courts will generally use the transaction price as the starting point for an assessment of fair value, and then consider whether the facts or circumstances tend to undermine or reinforce that measure of fair value (and in any event, often use one or more other valuation methods as a "check").

Accordingly, the analytical framework for dissent rights in Canada is similar to that in Delaware. While it is impossible to predict whether a Canadian court would have reached the same conclusion in *Dell*, the decision can be contrasted in some respects with the relatively recent decision of the Alberta Court of Queen's Bench (affirmed by the Alberta Court of Appeal) in *Paulson & Co. Ltd. v. Deer Creek Energy Limited*, a leading Canadian case in this area. In that case, Deer Creek agreed to be taken private by Total E&P Canada Limited, an arm's length party. Despite a limited confidential marketing process and strong deal protections in favour of Total, the Court was persuaded that the deal price represented fair value. In arriving at that conclusion, the Court cited Deer Creek's strong board and management, reliance on the advice of experienced financial advisors, and a robust negotiation process that led to a superior proposal that was ultimately matched by Total. The differing results in *Dell* and *Deer Creek* underscore the fact-specific nature of appraisal cases.

Structural Differences in the Canadian Regime

There are a number of structural differences between the Canadian and U.S. regimes that need to be carefully considered in appraisal scenarios, including:

- *Interest:* Currently under Delaware law, dissenting shareholders receive statutory interest at a rate equal to five percent above the Federal Reserve discount rate (though pending amendments to the Delaware Code would allow the surviving company to pre-pay the undisputed portion of a pending appraisal claim, thereby ceasing the accrual of interest on that amount). Most Canadian corporate statutes, on the other hand, provide judges with discretion to award a "reasonable rate of interest," which has typically been interpreted as the prime rate. This lower rate of interest – which may be the only return the dissenter receives on its investment

over a period that can extend several years - eliminates one of the principal "hedges" currently available when pursuing appraisal arbitrage in Delaware.

• *Costs*: With the exception of Alberta, the Yukon and Nunavut, dissenting shareholders in Canada who are unsuccessful at trial face potential costs awarded against them. This is in direct contrast with Delaware where, absent fee-shifting provisions in the target's by-laws, dissenting shareholders can generally bring claims without risk of liability for the target's costs, even if they are unsuccessful.

• *Timing*: A number of important Canadian corporate statutes (including the federal *Canada Business Corporations Act* and the *Business Corporations Act* (Ontario)) restrict shareholders from "buying into" appraisal claims after the record date for voting on the transaction, in contrast to Delaware where prospective dissidents can determine whether to pursue an appraisal strategy with the benefit of the target's proxy disclosure.

• *Related Party Transactions*: If the buyer is an insider, *Multilateral Instrument 61-101 – Protection of Minority Security Holders in Special Transactions* of the Canadian Securities Administrators generally requires the target to obtain (or supervise the preparation of) a formal valuation of the target's shares. While no Canadian case has considered the relationship between a formal valuation and fair value for appraisal purposes, the fact that a formal valuation must be prepared by an independent and qualified expert suggests it should be given substantial weight.

Despite these potential disadvantages, dissent rights have proven to be an effective strategy in Canada, either as a result of the court determining that the merger consideration is inadequate or, more commonly, through favourable settlements with the target. Given the trend of increasing appraisal arbitrage in the U.S., a number of unique factors in the Canadian market (including depressed resource prices) and the overall similarity between the two regimes, we expect that both domestic and foreign investors will continue to evaluate strategies involving appraisal rights north of the border in appropriate circumstances.

For further information regarding dissent rights in Canada or corporate finance in general, please contact any member of our Corporate Securities Group.

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