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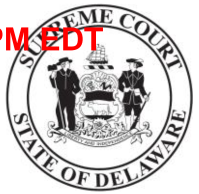

IN THE SUPREME COURT OF THE STATE OF DELAWARE

DELL INC., Respondent-Below, Appellant / Cross Appellee v. MAGNETAR GLOBAL EVENT DRIVEN MASTER FUND LTD., MAGNETAR CAPITAL MASTER FUND LTD., GLOBAL CONTINUUM FUND, LTD., SPECTRUM OPPORTUNITIES MASTER FUND LTD., MORGAN STANLEY DEFINED CONTRIBUTION MASTER TRUST, BLACKWELL PARTNERS LLC, AAMAF, LP, WAKEFIELD PARTNERS, LP, CSS, LLC, MERLIN PARTNERS, LP, WILLIAM L. MARTIN, TERENCE LALLY, ARTHUR H. BURNET, DARSHANAND KHUSIAL, DONNA H. LINDSEY, DOUGLAS J. JOSEPH ROTH CONTRIBUTORY IRA, DOUGLAS J. JOSEPH & THUY JOSEPH, JOINT TENANTS, GEOFFREY STERN, JAMES C. ARAMAYO, THOMAS RUEGG, CAVAN PARTNERS LP, and RENE A. BAKER, Petitioners-Below, Appellees / Cross Appellants	No. 565, 2016 Appeal from the Memorandum Opinion dated May 31, 2016, of the Court of Chancery of the State of Delaware, Consolidated C.A. No. 9322-VCL

APPELLEES/CROSS-APPELLANTS'
<u>REPLY BRIEF ON CROSS-APPEAL</u>

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NATURE OF PROCEEDINGS

In their opening brief on cross-appeal, Petitioners demonstrated that the trial court abused its discretion in (1) accepting baseless adjustments that Dell's expert had made to the cash flows the Court used for 50% of its DCF valuation of Dell; and (2) making deductions for restricted cash and working capital that were not supported by the record. These errors, when corrected, increase Dell's fair value to $21.33 under the Court's DCF analysis.

In opposing Petitioners' cross-appeal, Dell argues that this corrected fair value conclusion must be wrong because it is "55% higher than the merger price and more than 100% above Dell's unaffected market price."[1] This argument fails, because it presupposes that the Court should assume that either the deal price or Dell's unaffected market price is a proxy for fair value. Neither the plain language of Section 262 nor Chancery Court precedent supports the proposition that the Court should start from the premise that deal or market price is fair in determining fair value.

In addition, this argument belies the invalidity of Dell's own argument on appeal. In rejecting Petitioners' $28.61 DCF valuation, the trial court took the deal price into account by doing ***precisely*** what Dell asks the Court do here: relying on

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[1] Appellant's Reply Brief On Appeal And Cross-Appellees' Answering Brief On Cross Appeal ("RAB") at 34.

the gulf between deal price and DCF value in determining to reject Petitioners' DCF.[2] Dell cannot claim that the Chancery Court misapplied Delaware law in doing the very thing it asks this Court to do in response to Petitioners' cross-appeal.

Moreover, Dell's efforts to defend those aspects of the trial court's DCF valuation that Petitioners have challenged on appeal are unavailing. As Petitioners explained in their cross-appeal, the trial court ignored substantial record evidence that made clear that the Hubbard Adjusted BCG Case was inherently unreliable. Because the Hubbard Adjusted BCG case is fatally flawed, any use of this Case in a DCF of Dell is an abuse of discretion. Further, the trial court made adjustments to Dell's cash balance that were contrary to the record and that caused the trial court to undervalue Dell. The trial court abused its discretion in ignoring admittedly real assets in determining Dell's equity value.

Petitioners have amply demonstrated that the trial court abused its discretion in incorporating the Hubbard Adjusted BCG Case in its DCF of Dell and in deducting $4.2 billion from the Company's net cash in calculating equity value.

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[2] Post-Trial Memorandum Opinion Determining Fair Value, dated May 31, 2016 ("Op.") at 84 (finding that the argument that someone would have topped the MSD/Silver Lake offer if Dell were truly worth $28.61 was "sufficiently persuasive to negate the valuation of $28.61 per share that the petitioners advanced").

Correcting these errors in the Court's DCF increases the fair value conclusion to $21.33 per share.

ARGUMENT

I. NEITHER THE DEAL PRICE NOR DELL'S UNAFFECTED STOCK PRICE IS ENTITLED TO DEFERENCE IN DETERMINING DELL'S FAIR VALUE UNDER SECTION 262

Dell argues that the corrected $21.33 DCF valuation should be disregarded because it is "55% higher than the merger price and more than 100% above Dell's unaffected market price."[3] This argument is a non-starter, because it presupposes that the deal price and/or Dell's unaffected market price are entitled to some degree of deference in determining Dell's fair value. Nothing in the language of Section 262 or Delaware precedent supports this notion. To the contrary, Chancery Court precedent makes clear that the deal price is not entitled to deference,[4] and this Court has long eschewed market fundamentalism.[5]

Moreover, in making this argument, Dell belies the absurdity of its own assertion that the trial court failed to discharge its mandate under Section 262 by purportedly failing to take the deal price into consideration in valuing Dell. In determining that Dell was worth $17.62 per share, the trial court carefully considered the deal price and determined that it did not reflect Dell's fair value.

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[3] RAB at 34.

[4] *See, e.g.*, *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214 (Del. 2010).

[5] *See, e.g.*, Travis Laster on Appraisal Rights, Audio blog post. The CLS Blue Sky Blog, Blue Sky Banter (Feb. 28, 2017), available at http://clsbluesky.law.columbia.edu/2017/02/28/25668/ (last visited April 20, 2017).

For that reason, the trial court did not assign any mathematical weight to the deal price[6] in calculating Dell's fair value.[7] But while the court did not ***assign weight*** to

[6] Dell's assertion that the trial court "preempted" its analysis of the deal price such that it "never considered the weight to be assigned to the merger price" is an empty soundbite. RAB at 8. The fifty-page explication of the reasons why the deal price did not reflect Dell's fair value makes clear that the Court carefully considered this issue and determined the weight to give the deal price: ***zero***. Op. at 46-99. *See also* Op. at 114 ("[T]his decision does not give weight to the Final Merger Consideration."). Given the careful consideration that the trial court gave to the deal price, Dell's assertion that the trial court adopted an improper "decree" that "indicators of fair value should be ***ignored*** if they are not the 'most reliable' or 'best' evidence of fair value" is simply false. RAB at 8 (emphasis added). An input to which the trial court devoted nearly half of its Opinion cannot be said to have been "ignored."

[7] Dell makes much of the trial court's statement that it would not expressly weight the deal price "[b]ecause it is impossible to quantify the exact degree of the sale process mispricing." RAB at 9 (citing Op. at 114). Far from demonstrating that the trial court applied a "different standard" for deal price than for other valuation methodologies, the statement merely underscores the propriety of not weighting the deal price at all under the facts of this case. Having determined that the deal price was so divorced from Dell's fair value as to be an improper starting point in valuing Dell, the trial court cannot be faulted for noting its inability to quantify what the price might have been absent this mispricing in explaining its rationale for declining to incorporate it into its end point. The trial court did not "[e]ngraft[] an exactitude requirement" in rejecting the deal price but, rather, exercised its considerable discretion in determining to afford the fatally flawed input no weight. RAB at 10.

the deal price,[8] the court clearly ***took the deal price into account*** in determining Dell's fair value.[9] In fact, the trial court did ***exactly*** what Dell asks this Court to do with respect to the revised $21.33 fair value conclusion: rely on the delta between the deal price and a putative DCF valuation as a reason to reject that DCF

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[8] Respondent demands that the Court assign some minimum weight to the deal price. RAB at 5 ("The trial court committed both legal error and an abuse of discretion by failing to place any weight on the merger price in its valuation determination."). However, despite being challenged in Petitioners' opening brief as to what that minimum threshold should be, Respondent offers no suggestion. Further complicating this issue, Respondent argues that under *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983), the trial court was required to accord mathematical weight to ***all*** valuation techniques or methods that are considered generally acceptable in the financial community. *See* RAB at 7 (arguing that in declining to weight the deal price the trial court "strayed from *Weinberger v. UOP, Inc.*,'s teaching that fair value determinations '***must*** include proof of value by ***any*** techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court'") (emphasis added). Was the trial court required to weight a comparable companies analysis? A comparable transactions analysis? If so, what weight(s) was it supposed to assign to these methodologies?

[9] Vice Chancellor Laster confirmed that he did, indeed, take the deal price into account in valuing Dell during a discussion with Reynolds Holding as reported on Blue Sky Banter: Travis Laster on Appraisal Rights, Audio blog post. The CLS Blue Sky Blog, Blue Sky Banter (Feb. 28, 2017), available at http://clsbluesky.law.columbia.edu/2017/02/28/25668/ (last visited April 20, 2017) ("Once you get outside of the deal price, ***even then I personally don't throw it out entirely***. Dell is on appeal right now, but I'm certainly happy to say what I said in the decision, which was although I didn't rely on the deal price to determine fair value, I thought that the deal price was strong enough evidence to knock out the real outlier 2x valuation that the petitioners' expert initially advocated. It just didn't make sense to me that the market was off by that much.").

valuation.[10] Section 262 requires no more.[11] But the fact that the Chancery Court rejected the valuation offered by Petitioners because it substantially exceeded the deal price does not provide justification for the rejection of ***all*** valuations that exceed the deal price. Yet that is exactly what Respondent argues for here.

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[10] Op. at 84.

[11] Unable to deny that the trial court expressly cited the gulf between the deal price and Petitioners' $28.61 DCF valuation in rejecting that valuation, Dell never responded to this argument raised in Petitioners' Opening Brief.

II. THE TRIAL COURT ERRED IN ACCEPTING BASELESS, LITIGATION-DRIVEN ADJUSTMENTS TO THE CASH FLOWS IT USED IN ITS DCF VALUATION OF DELL

The Court of Chancery erred in accepting adjustments that Hubbard made to the BCG projections for purposes of litigation. Petitioners identified no fewer than five reasons why the trial court abused its discretion in using the Hubbard Adjusted BCG Case in its DCF valuation of Dell. Dell fails to offer a meaningful response to ***any*** of these reasons.

First, in relying on the Hubbard Adjusted BCG Case, the trial court effectively ignored evidence that Dell had succeeded in taking costs out of the business at a level far greater than that assumed in the Hubbard Adjusted BCG Case. In response, Dell asserts that "the evidence demonstrated that any cost-savings did not translate into increased cash flow."[12] This argument misses the mark. All cost savings – ***by definition*** – drop to the bottom line. Every dollar that Dell saves will, absent action by management, fall to the bottom line in the form of a dollar-for-dollar EBITDA increase. Here, rather than let the savings fall to the bottom line, Dell ***chose*** to reinvest the dollars it saved in the hopes of earning a higher return.[13] Hubbard seizes on this choice to construct a fallacious argument

[12] RAB at 36.

[13] A500-502 (Dell chose to reinvest cost savings because it thought that was the best return for those dollars).

that the cost savings did not make Dell a more valuable company,[14] citing the fact that Dell chose to let only $200 million (about thirteen cents on the dollar) fall to the bottom line as "proof" that the bulk of the cost savings disappeared, largely due to Dell's decision to cut prices to gain share.[15] Hubbard's claim that price cutting is a "use" of money that Dell saved from the cost takeouts is demonstrably false, because he has admitted that Dell could have cut prices ***without any cost savings***.[16] Hubbard confuses the lowering of revenue that would follow a decision to drop prices (i.e., a revenue-side impact to the financial statements) with ***a disappearance of money saved via the cost take outs*** (i.e., an expense-side reduction in the financial statements).[17] In fact, BCG itself effectively rejected this very argument, because BCG recognized that Dell's decision to trade margin for

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[14] The absurdity of this argument is underscored by the fact that – as the trial court noted – "[t]he [Special] Committee, BCG, and J.P. Morgan regarded the BCG 25% Case as a realistic and achievable set of projections for the Company." Op. at 101. The trial court's acceptance of Hubbard's litigation-driven reduction of the BCG 25% Case is inexplicable given these parties' contemporaneous ratification of the BCG 25% Case.

[15] A779-780.

[16] A860 ("Q: So the fact that you have cost savings is not something that, by definition, allows you to cut prices because you could cut prices anyway. Correct?; A: That's absolutely true.").

[17] During his deposition Hubbard admitted that if Dell dropped prices as a result of having taken costs out of the business, "[i]nstead of just having that disappear, what I would see is a 25 percent reduction in the revenue from goods sold" and "a reduction of the cost of goods sold." B1959-1960.

share had ***not*** impacted Dell's long-term earnings power.[18] For that reason, BCG told the Special Committee that its model remained sound despite the EBITA hit stemming from Dell's strategic decision to trade margin for share.[19] In other words, Dell's decision to lower prices had no impact on the Company's earnings power as reflect in the BCG 25% Case. Hubbard's "adjustment," therefore, lacked a valid factual foundation. Dell offers no response to these points.

Second, Hubbard admitted that he lacked the expertise necessary to determine how a change in industry data affecting one segment of Dell's business would affect the Company's overall cash flows.[20] Dell's assertion that the trial court "correctly determined otherwise" is simply false.[21] The trial court did not even address – let alone credibly explain – its decision to ignore Hubbard's

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[18] *See, e.g.*, BR0020 ("EUC shortfall ($450M) was caused by a Dell stated shift to trade margin for share, to drive ESS cross-selling; Not a fundamental reset"; "We don't believe the long-term earnings power of Dell will change due to Q1 but in the short-term, Dell's actions in EUC, ESG have the business trending toward $2.9B Op Inc. in FY14").

[19] B2165 at 163:14-164:16 (BCG told the Special Committee in May 2013 that its "original model was still viable" despite Dell EBITA miss in 1Q 2014; Special Committee did not ask BCG to update the model because the Committee understood that "there had been a change in the performance of the business, but it was driven by a management action that was really affecting the volume and price of the units, but [BCG] didn't think there was any underlying change in the business model").

[20] A841-842.

[21] RAB at 36. The pages of the Opinion that Dell cites for this alleged "determination" to the contrary say ***nothing at all*** about Hubbard's admitted lack of industry expertise.

admitted lack of industry expertise in relying on ***one*** industry analyst's projections[22] relating to ***one*** portion of Dell's business as a proxy for Dell's ***overall*** expected cash flows.

Third, the trial court accepted Hubbard's claim that he simply "updated" the BCG model to reflect "new" IDC data concerning PC shipments.[23] But the creator of the model, BCG's Lutao Ning, testified that there was no line-item for IDC data that Hubbard could have updated in the way he claims to have done. Dell's only response – i.e., to claim that Petitioners have "overstated" Ning's testimony[24] – does not withstand scrutiny, because Ning testified unambiguously that a swap out of new IDC data was ***simply not possible***:

> Q: Now, you consulted the IDC forecast as part of the projections. Correct?
>
> A: That's correct.

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[22] While Hubbard admitted that IDC and Gartner were the leading technology industry experts, he chose not to examine Gartner forecasts before making his downward adjustments to the BCG 25% Case. B1938 at 67:7-68:9 (IDC and Gartner are leading technology industry experts; Hubbard did not look at Gartner). This omission further underscores the impropriety of Hubbard's use of the IDC numbers as a proxy for Dell's expected performance, because Gartner – in contrast to IDC's negative predictions – projected in August 2013 that enterprise technology spending in 2014 would more than ***double*** that of 2013. *See, e.g.*, B849.

[23] Op. at 101 ("Hubbard adjusted the BCG 25% Case to account for these weaknesses . . . To make these adjustments, Hubbard used current IDC data and maintained the dynamic model's mechanics, formula and internal assumptions.").

[24] RAB at 37.

Q: But you didn't just plug in IDC's forecasts, did you?

A: No.

Q: This wasn't like a plug-and-play where you could just take IDC, put it in there, and that would make your model work. Right?

A: No.

Q: And you couldn't just decide to pull out whatever IDC had in there and put in a new IDC and that would all of a sudden make your model work. Right?

A: No.

Q: So definitely not a plug-and-play job. Right?

A: Definitely not a plug-and-play job.[25]

The trial court abused its discretion in accepting the notion that it was even ***possible*** (let alone appropriate)[26] to "update" the BCG case to reflect "new" IDC data concerning PC shipments in the face of clear and contradicted testimony from the creator of the model testified that it was not.

Fourth, Petitioners noted that the trial court had ignored evidence demonstrating that the lowered IDC numbers did not even warrant an update to the BCG projections in the first place. Specifically, (1) BCG concluded that no update was needed because it had already modeled PC declines for Dell in line with what

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[25] A676-677 (emphasis added).

[26] The impropriety of relying on IDC PC shipment data as a proxy for Dell's expected cash flows is laid bare by the fact that Dell was so distrustful of IDC's forecasting ability that it considered developing its own proprietary forecasting model to monitor expected changes in the PC industry. B1159 at 78-79.

actually ended up happening;[27] (2) Dell's own PC shipments had ***increased 8%*** at the same time IDC was projecting industry-wide slowdowns;[28] and (3) Hubbard admitted that in deciding to update the BCG projections to reflect the August 2013 IDC numbers, he had not considered that positive developments in Dell's other lines of business might have more than offset whatever negative impact the IDC forecasts might have been expected to have on Dell.[29] The trial court ignored ***all*** of this evidence. Dell offers no response, other than to suggest that Petitioners have "confuse[d] the record"[30] about what the most current IDC numbers were at the time BCG concluded that no update was warranted. Dell's quibble about what IDC numbers were the most current at the time BCG concluded that no further revision was necessary[31] is no answer to the fact that the trial court ignored

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[27] A681; A739 ("Q: And BGC had already projected what wound up occurring. Correct?; A: Correct.; Q: And, therefore, there was no need to update BCG's projections with new industry data. Correct?; A: That is correct."); B2149; B2152 ("[F]rankly, we had anticipated this [decline] in our previous analysis and modeling" "so we didn't see much of a shift to Dell's operating income relative to the Base Case because we had already incorporated that lower PC business – or PC decline").

[28] B1966.

[29] B1941-1943.

[30] RAB at 37.

[31] Despite calling two BCG witnesses to testify (Ron Nicol and Lutao Ning), Dell did not introduce any evidence that ***BCG itself*** considered the August 2013 IDC projections to have had such a material impact on Dell's expected future cash flows as to warrant a wholesale lowering of its Cases in the way Hubbard did in creating the Adjust Hubbard BCG Case.

evidence demonstrating that the August 2013 IDC PC shipment projections were not an appropriate proxy for Dell's expected cash flows. Accepting adjustments based on these projections, accordingly, was an abuse of discretion.

Finally, Petitioners noted that the trial court improperly accepted Hubbard's unilateral decision to lower the attachment rates used to estimate support and deployment revenue. While the BCG 25% Case from which Hubbard concocted the Adjusted Hubbard BCG Case incorporated attachment rates provided by Dell management,[32] Hubbard – inexplicably – rejected those attachment rates in favor of ***older*** attachment rates from the September Case. Petitioners do not, as Dell claims, "quibble [ ] with the fact that the trial court did not accept their version of the evidence."[33] Petitioners legitimately contest the trial court's unexplained decision to allow Hubbard to discard an input provided by Dell management in favor of a ***stale version of that same input***.

The Adjusted Hubbard BCG Case is inherently unreliable. The trial court, accordingly, abused its discretion in using this Case in its DCF valuation of Dell.

[32]A649 (attachment rate in BCG's model came directly from Dell management).

[33] RAB at 38.

III. THE TRIAL COURT ERRED IN ACCEPTING DEDUCTIONS FOR RESTRICTED CASH AND WORKING CAPITAL THAT WERE NOT SUPPORTED BY THE RECORD

The trial court erred in deducting $1.2 billion for restricted cash and $3 billion for working capital in calculating Dell's equity value. The trial court provided ***no explanation at all*** for its decision to deduct Dell's admittedly real $1.2 billion "restricted cash" from its net cash. As Petitioners noted in their opening brief, this cash is a real and valuable asset of Dell – a fact that is made clear by Dell's access to ***$0.8 billion*** of so-called "restricted cash" as of the closing of the MBO. In other words, as of the valuation date, $800 million of "restricted cash" was ***not*** actually restricted. Dell's answering brief ignores the restricted cash issue entirely.

With respect to the $3 billion working capital deduction, Petitioners have explained that this deduction was improper, because "even cash needed for operations can be invested in near cash investments such as treasury bills or commercial paper."[34] "Given the investment opportunities that firms (and individual investors) have today, it would require an incompetent corporate treasurer for a big chunk of the cash balance to be wasting cash."[35] Under these circumstances, the valuation literature makes clear that even cash "needed" for

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[34] B2496; B2479.

[35] B2496.

working capital should be added to the value of the firm.[36] Neither the trial court nor Dell has offered any response to this point.

Because the record evidence did not support the trial court's deduction of $1.2 billion in restricted cash and $3 billion in working capital,[37] the trial court abused its discretion in deducting these amounts in valuing Dell.

CONCLUSION

For the foregoing reasons, the Court should enter an order determining that the fair value of Dell was $21.33.

Dated: April 20, 2017

Respectfully submitted,

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[36] *Id.*

[37] The record evidence demonstrates that Dell reduced its working capital needs to $2.2 billion after the closing of the MBO by implementing a number of working capital initiatives, each of which it could have put in place before the closing. A492. Under these circumstances, even if a deduction for working capital were proper, it should have been for no more than $2.2 billion.