Published on *The National Law Review* https://natlawreview.com

M&A Update: The Delaware Supreme Court's Decision in Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.—Calculating Fair Value in Statutory Appraisal Cases

Article By:

Jason M. Halper

Joshua Apfelroth

Richard M. Brand

Nathan Bull

Ellen Holloman

William P. Mills

In a decision as notable for its criticisms of the trial court judge as its contributions to Delaware appraisal jurisprudence, the Delaware Supreme Court in Verition Partners Master Fund Ltd. v. Aruba Networks, Inc. reversed a decision of the Delaware Court of Chancery in a statutory appraisal proceeding. The lower court had relied on the 30-day unaffected stock price to determine that $17.13 per share was the fair value of Aruba Networks, Inc. at the time of its acquisition by Hewlett Packard Companies ("HP"). The Supreme Court—in a unanimous *per curiam* decision—held that Aruba's fair value per share was $19.10, representing the deal price minus synergies that were paid for by HP in the merger, and that the Court of Chancery abused its discretion by relying on the 30-day unaffected market price of Aruba's stock before the transaction was publicly announced. In so holding, the Supreme Court remarked that the decision by the trial judge to rely exclusively on the unaffected market price—even though neither party advanced that argument until the judge broached the subject in connection with post-trial briefing—"could be seen" as a "results-oriented move to generate an odd result compelled by his personal frustration at being reversed in *Dell* [*Inc. v. Magnetar Global Event Driven Master Fund Ltd*]." The Supreme Court also clarified its holdings in *DFC Global Corporation v. Muirfield Value Partners L.P.* and *Dell*, and affirmed its longstanding recognition of merger consideration as strong evidence of fair value in statutory appraisal actions involving transactions resulting from a fair and competitive sale process. Given the decision's emphasis on the agreed-upon merger consideration in determining a company's fair value (coupled with the requirement to reduce that amount by any synergies included in the deal price), appraisal arbitrage in Delaware is likely to remain at reduced levels.

Background

In 2017, the Delaware Supreme Court reversed two Court of Chancery appraisal decisions, holding that the lower courts did not properly consider deal price in calculating the fair value of the acquired company's shares. In *DFC Global*, the Supreme Court held that the lower court erred by according equal weight to the transaction price, an expert's discounted cash flow analysis, and a comparable companies analysis. According to the Supreme Court, "the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and []second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."[1] Likewise, in *Dell*, the Supreme Court held that "the trial court erred in not assigning any mathematical weight to the deal price" because "the deal price deserved heavy, if not dispositive, weight."[2] Notably, however, in its opinions in *DFC Global* and *Dell*, the Court explicitly refused to create a presumption that transaction consideration is always the best evidence of fair value. As the Court further explained in *DFC Global* (and reiterated in *Dell*), "economic principles suggest that the best evidence of fair value was the deal price," but only so long as that price "resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid."[3]

On the heels of *DFC Global* and *Dell*, Vice Chancellor Laster issued his decision in *Aruba Networks*.[4] In their pre- and post-trial briefs, plaintiffs contended that Aruba's fair value was $32.57 per share, while Aruba contended that its fair value was "deal price less synergies," or $19.10 per share. After finding that the transaction consideration provided "reliable evidence of fair value," Vice Chancellor Laster calculated his own "deal-price-less-synergies" estimate of $18.10 per share.[5] However, noting that a "deal-price-less-synergies" calculation that he performed on his own "could have errors at multiple levels," and that the calculation of fair market value would also need to exclude "reduced agency costs" (*i.e.*, costs associated with competing interests of shareholders and management), Vice Chancellor Laster arrived at a fair value of $17.13 per share—approximately 30.6% below the merger consideration—by averaging the unaffected market price of Aruba's shares in the thirty days before the merger was publicly disclosed.[6] Vice Chancellor Laster was satisfied that this calculation struck the proper balance between *DFC Global* and *Dell*'s directive that courts consider '"the collective judgement of the many'" in determining fair value and mitigating the prejudice derived from the court's "own fallible determination[.]"[7] After the Court of Chancery rejected plaintiffs' motion for reargument, plaintiffs appealed.

On appeal, the Court found that the Court of Chancery's decision "to rely exclusively" on Aruba's stock price instead of the merger price less synergies was "rooted in an erroneous factual finding that lacked record support." Accordingly, the Supreme Court reversed and remanded the case to the Court of Chancery to enter a final judgment for the plaintiffs awarding them $19.10 per share, reflecting Aruba's initial calculation of "deal price less synergies."

Takeaways:

Transaction consideration can be strong evidence of fair value even in the absence of multiple bids for the target:

The Supreme Court reaffirmed "giving important weight to market-tested deal prices" in determining fair value where that price is the result of arm's-length negotiation and otherwise the product of a robust sales process. The lower court questioned the reliability of the merger consideration as evidence of fair value because, among other things, no other strategic bidder showed interest in

Aruba when HP first approached with an offer, and there were no other bids once the merger was announced. Viewing deal price as reliable evidence of fair value would, in the Court of Chancery's view, "discount the importance of competition." The Supreme Court strongly disagreed, stating that "*DFC* and *Dell* recognized that when a public company with a deep trading market is sold at a substantial premium to the preannouncement price, after a process in which all interested buyers had access to confidential information and a fair and viable opportunity to bid, the deal price is a strong indicator of fair value." Here, Aruba engaged a financial advisor to conduct a pre- and post-signing market check whereby multiple potential strategic buyers received access to non-public information and were solicited regarding a transaction. According to the Supreme Court, the fact that the logical strategic buyers that Aruba approached both before and after signing a merger agreement with HP were not interested does not "signal[] a market failure simply because buyers do not believe the asset on sale is sufficiently valuable." In the view of the Court, "[i]f that were the jurisprudential conclusion, then the judiciary would itself infuse assets with extra value by virtue of the fact that no actual market participants saw enough value to pay a higher price. That sort of alchemy has no rational basis in economics."

Bidder's access to non-public information regarding the target supports the reliability of merger consideration as evidence of fair value:

The Supreme Court again affirmed its acceptance of the efficient capital markets hypothesis, whereby when a "market was informationally efficient in the sense that 'the market's digestion and assessment of all publicly available information concerning [the Company] [is] quickly impounded into the Company's stock price,' the market price is likely to be more informative of fundamental value." Thus, according to the Court, the unaffected market price can be "a proxy for fair value" but should not be exclusively relied upon in determining a company's fair value in an appraisal or fundamental value in economic terms. Rather, "when that market price is further informed by the efforts of arm's-length buyers of the entire company to learn more through due diligence, involving confidential non-public information, and with the keener incentives of someone considering taking the non-diversifiable risk of buying the entire entity, the price that results from that process is even more likely to be indicative of so-called fundamental value." In this case, HP had access to substantial non-public information as a result of due diligence and, as HP was aware, knew about "Aruba's strong quarterly earnings before the market did, and likely took that information into account when pricing the deal." The Court also noted that, while Section 262 requires the Court of Chancery to assess fair value as of "the effective date of the merger," the unaffected market price relied on by Vice Chancellor Laster "was a measurement from three to four months prior to the valuation date," during which it was possible for new, material information regarding the company's future earnings to emerge, and HP had a greater incentive to evaluate Aruba more closely than an ordinary trader of small blocks of Aruba's shares. Indeed, in this instance, HP became aware of Aruba's strong quarterly earnings before the market did and after the date from which the unaffected market price was determined, and the Court noted that HP likely took such updated information into account in pricing the deal.

Due process and fairness concerns:

The Supreme Court also observed that the Court of Chancery's decision implicated due process and fairness concerns. By raising the idea of using the unaffected stock price as an appropriate measure of fair value for the first time during the parties' post-trial supplemental briefing, the Court of Chancery did not provide the parties with an opportunity to develop a full factual record during pretrial discovery and at trial as to whether the stock price was, in fact, reliable evidence of fair value.

According to the Supreme Court, “the extent to which the market price approximated fair value was never subjected to the crucible of pretrial discovery, expert depositions, cross-expert rebuttal, expert testimony at trial and cross examination at trial.” These issues impacted the substantive rights of the parties because “[t]he reason for pretrial discovery and trial is for parties to have a chance to test each other’s evidence and to give the fact-finder a reliable basis to make an ultimate determination after each side has a fair chance to develop a record and to comment upon it.”

<u>Litigants need to carefully consider which arguments to raise regarding appropriate evidence of fair value before trial or risk abandoning them</u>:

The Supreme Court observed that neither party requested supplemental briefing after it issued *Dell* nor did any party advocate relying on the unaffected market price as evidence of fair value. Rather, after the lower court requested supplemental briefing on “the market attributes of Aruba’s stock,” “Aruba pivoted from its previous reliance on its expert’s discounted cash-flow model and the deal price minus synergies to ask for the first time that the court set fair value at the unaffected thirty-day average market price.” The Court was obviously skeptical of Aruba’s “pivot” at that late stage: “We chalk up this about-face to a litigant receiving a more favorable outcome than they argued for and trying to cement that unexpected victory on appeal.” While that late-stage change in position most likely did not affect the outcome in this case (*i.e.*, even had it been raised earlier, the Court seems likely to have rejected unaffected market price for other reasons), and Aruba and its advisors very well may have considered and rejected advocating for unaffected market price as fair value at an earlier stage, the decision highlights the potential consequences that result from not raising an argument in pre-trial proceedings. On the other hand and equally important, litigants need to consider the potential loss of credibility that can result from arguing in favor of relying on evidence that is questionable under the circumstances.

<u>Agency costs are encompassed by a calculation of synergies when two public companies merge</u>:

Under Delaware General Corporation Law § 262, a stockholder is “entitled to an appraisal by the Court of Chancery of the fair value of the stockholder’s shares of stock” that is “exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation[.]” The Delaware Supreme Court has interpreted Section 262 to require the Court of Chancery to exclude from any appraisal a “reasonable estimate” of any value that “‘the selling company’s shareholder would receive because a buyer intends to operate the subject company, not as a stand-alone going concern, but as part of a larger enterprise, from which synergistic gains can be extracted.’” As a result, expected synergies included in the deal price need to be deducted from merger consideration in arriving at fair value in circumstances where merger consideration is reliable evidence of value.

Here, the Supreme Court held that the Court of Chancery’s reliance on unaffected market price was erroneous for the additional reason that the Vice Chancellor did so “on the inapt theory” that he “needed to make an additional deduction from the deal price for unspecified ‘reduced agency costs.’” Such a reduction had “no basis in the record” or in “corporate finance literature given that all the cost reductions HP expected as a widely held, strategic buyer were likely to be fully accounted for by its expected synergies.” The Court further noted that “agency costs” are more likely to arise in connection with an acquisition by a private equity buyer by replacing “a dispersed group of owners with a concentrated group of owners,” which could, theoretically, “add value because the new owners are more capable of making sure management isn’t shirking or diverting the company’s profits." However, these types of costs may be difficult to prove and, even if proven, the buyer must further prove that a portion of the purchase price was attributable to all or a portion of such agency costs in order to exclude them from the calculation of fair market value in an appraisal claim. In the Aruba-HP merger, the court noted that Aruba did not present any evidence to suggest that any portion of the purchase price included agency costs that were not otherwise subsumed by its synergies calculation, which was not surprising as HP's acquisition of 100% of Aruba's shares would have "swap[ped] out one set of public stockholders for another: HP's."

Appraisal arbitrage in Delaware is likely to remain at reduced levels:

Appraisal arbitrage refers to situations where stockholders, often hedge funds, purchase shares of a target after a transaction is publicly announced and commence an appraisal proceeding in the hope that the court will find fair value to be in excess of the merger consideration. In addition, a stockholder seeking appraisal is entitled under Section 262 to receive interest on the court's fair value award at the rate of 5% above the federal funds rate, compounded quarterly, for the period the lawsuit was pending. This above-market rate could provide an additional incentive for stockholders to engage in appraisal arbitrage (although 2016 amendments to Section 262(h) provide corporations the option to prepay appraisal claimants an amount of their choosing to cut off or reduce the accrual of interest payments). Nonetheless, while the decision in *Aruba* may provide some comfort to merger arbitrageurs seeking to limit the potential downside of an appraisal claim presented by a fair market value determination at the unaffected market price, the Supreme Court's trilogy of decisions relying on merger consideration less synergies as evidence of fair value, in *Dell*, *DFC*, and now *Aruba*, may continue to provide a strong deterrent to commencing such litigation absent persuasive reasons to believe that the merger consideration is not reliable evidence of value. That would be the case, for instance, where conflicts of interest on the part of directors, officers, financial advisors, or significant stockholders undermine the quality of a company's sales process or where all logical bidders are not given access to accurate confidential information or a fair opportunity to participate in a sale process. But absent such facts, it appears that Delaware courts are likely to rely on the transaction price negotiated at arm's-length by motivated buyers and sellers, less synergies proven to be included in the transaction price.

---

1 172 A.3d 346, 366 (Del. 2017).

2 177 A.3d 1, 23 (Del. 2017).

3 172 A.3d at 349; *Dell*, 177 A.3d at 21.

4 2018 WL 922139 (Del Ch. Feb 15, 2018).

5 *Id.* at *2, 44.

6 *Id.* at *54.

7 *Id.* (quoting *DFC*, 172 A.3d at 369-70).