SULLIVAN & CROMWELL LLP

April 18, 2019

Delaware Supreme Court Again Reverses Court of Chancery Appraisal Decision

The Court Directs Entry of Judgment at Deal Price Less Synergies, 22.6% Below Deal Price

SUMMARY

For the third time in less than two years, the Delaware Supreme Court reversed a significant appraisal decision from the Court of Chancery in *Verition Partners Master Fund Ltd.* v. *Aruba Networks, Inc.*[1] Unlike the previous two reversals in *DFC* and *Dell* that reduced the Chancery appraisal awards, the Supreme Court in *Aruba* ruled that the trial court awarded petitioners too little by concluding that the fair value of Aruba's stock was equal to the unaffected market price of Aruba's shares, a price 30% lower than the deal price. In an unusually combative, unsigned decision, the Supreme Court ruled that the Vice Chancellor's "decision to use the trading price as his sole basis for determining fair value was his alone, and in no way dictated by a rational reading of *Dell*," and might be seen "as a results-orientated move to generate an odd result compelled by his personal frustration at being reversed in *Dell*."[2] Nevertheless, the Supreme Court agreed with the Court of Chancery's conclusion that, on this record, "'the deal price . . . operates as a ceiling for value.'" After properly excluding synergies "or other value the buyer expects from changes it plans to make to the company's 'going concern' business plan,"[3] the Supreme Court accepted Aruba's calculation of its fair value at $19.10 per share, 22.6% below the $24.67 per share deal price but above the trial court's $17.13 market price valuation. The *Aruba* decision reinforces recent Delaware jurisprudence finding that the deal price—assuming a reasonable sale process—ought in most cases to impose a ceiling on fair value in appraisals, subject to reduction for synergies and other pricing factors unrelated to intrinsic value.

BACKGROUND

Aruba concerned the May 18, 2015 merger between Aruba and Hewlett-Packard Company ("HP"). After HP approached Aruba in August 2014 about a potential transaction, Aruba hired financial and legal advisors and contacted five other potential strategic buyers, but none were interested. In the meantime, HP and Aruba embarked on lengthy but sporadic negotiations. On February 25, 2015, news of the potential deal leaked to the press, and Aruba's stock price increased from $18.37 to $22.24. The following day, Aruba released positive quarterly financial results, and its stock rose an additional 9.7% to $24.81 per share (above the deal price). A few days later, on March 1, 2015, HP and Aruba signed their merger agreement providing for HP to acquire Aruba for $24.67 per share.

This appraisal petition followed in the Court of Chancery. Aruba had a more complicated than usual trip through the appraisal process in part because *DFC* and *Dell* were both decided while it was pending. This shifting landscape colored the proceedings in the Court of Chancery, and is a substantial focus of the Supreme Court's decision. The December 2016 trial focused primarily on three competing valuation metrics: (1) the deal price of $24.67 per share; (2) the deal price less synergies, which Aruba argued was $19.10 per share; and (3) discounted cash flow ("DCF") analyses—petitioners' DCF suggested a price of $32.57 per share and Aruba's suggested $19.85 per share.

After the Supreme Court's August 1, 2017 decision in *DFC*, the parties made supplemental submissions that adhered to these valuation metrics, although Aruba then also argued that Aruba's stock price was "informative" and supported its valuations. Following the December 17, 2017 *Dell* decision, the Vice Chancellor invited the parties to file supplemental submissions regarding Aruba's stock price, and Aruba thereafter argued for the first time that Aruba's unaffected market price of $17.13, which was the average price for the 30-day period prior to when news of merger negotiations leaked (almost three months before the merger closed), was the best measure of fair value.

In its opinion, the Court of Chancery first considered the deal price, noting that "*DFC* and *Dell* hold that when a widely held, publicly traded company has been sold in an arm's-length transaction, the deal price has 'heavy, if not overriding, probative value.'"[4] Despite noting a number of process defects, the Vice Chancellor concluded that *DFC* and *Dell* provide that the goal of appraisal is not to determine "'whether a negotiator has extracted the highest possible bid'" and, based on that principle, these defects did not demonstrate that the deal price left a "portion of Aruba's fundamental value on the table."[5] Instead, "[p]articularly given the inclusion of synergies, there is good reason to think that the deal price exceeded fair value and, if anything, should establish a ceiling for fair value."[6] Nevertheless, after observing that the value and allocation of synergies was a difficult issue "to determine with precision,"[7] the Court of Chancery arrived at its own deal price less synergies estimate of $18.20 per share.

The Court of Chancery also considered the parties' DCF analyses, but found faults with the analyses of both sides and declined to undertake the effort to improve upon them because "[t]he *Dell* and *DFC* decisions caution against relying on discounted cash flow analyses prepared by adversarial experts when reliable market indicators are available."[8] Nor did he adopt his modified deal price of $18.20 net of synergies as fair value, recognizing that it was error prone and did not account for other external "agency costs," another merger-related benefit. He thus settled on an unaffected market price of $17.13 as fair value because it provided "the more straightforward and reliable method for estimating the value of the entity as a going concern."[9]

THE SUPREME COURT DECISION

The Delaware Supreme Court reversed, and directed entry of judgment that fair value was equal to $19.10 per share. Perhaps reflecting the tensions between the Supreme Court and the trial judge, the Supreme Court declined to remand the case to the Court of Chancery for further proceedings (as petitioners requested), but ruled on appeal that fair value was equal to the deal price less synergies, and the Court accepted Aruba's position at trial that the synergies attributable to Aruba amounted to $5.57 per share, which were deducted from the $24.67 deal price.

The Supreme Court rejected the Court of Chancery's reliance on Aruba's market price for several reasons. First, the Court took issue with the Vice Chancellor's conclusion that the deal price less synergies remained inflated because other "agency costs" not indicative of "Aruba's value as a going concern"—*i.e.*, savings "because the resulting consolidation of ownership and control would align the interests of Aruba's managers and public stockholders"—likely were embedded in the deal price, but could not be reliably estimated.[10] The Supreme Court held that "this aspect of the decision is not grounded in the record," because "HP's synergies case likely already priced any agency cost reductions" and neither party argued that that it did not. Notably, however, the Supreme Court observed that, unlike this public company merger, private equity deals do replace "public stockholders with a concentrated group of owners," and thus suggested that deal prices in private equity deals may reflect expectations for "improve[d] performance and squeeze costs" properly excluded from an appraisal fair price.[11]

Second, the Supreme Court rebuffed the Vice Chancellor's view that reliance upon market prices was compelled by *DFC* and *Dell*. The Supreme Court observed that this view "was not supported by any reasonable reading of those decisions."[12] The Court reiterated the views expressed in *Dell* that market prices "can be a proxy for fair value" and that "the price a stock trades in an efficient market is an important indicator of its economic value that should be given weight," but concluded that the Vice Chancellor erred in finding "that an informationally efficient market price invariably reflects the company's fair value in an appraisal."[13] Instead, the Supreme Court stated that an efficient market price "further informed by the efforts of arms'-length buyers" to reach a deal price with access to non-public due diligence and the "keener incentives" of a whole-company purchaser "is even more likely to be indicative of so-called fundamental value." In short, "after a process in which interested buyers all had a fair and viable opportunity to bid, the deal price is a strong indicator of fair value, as a matter of economic reality and theory."[14] The Supreme Court accepted that the process here met that test even though Aruba did not solicit any private equity buyers, noting that the petitioners did not argue below that private equity bidders could compete given the synergies a combination with HP or another strategic buyer could garner. The Court also noted with apparent approval that the merger agreement allowed for a post-signing market check, and rejected any argument that "an open chance for buyers to bid signals a market failure simply because buyers do not believe the asset on sale is sufficiently valuable for them to engage in a bidding contest against each other."[15]

Finally, the Supreme Court found, on the factual record, the deal price less synergies was "a batter assessment of Aruba's going concern value" than market prices for several reasons, including (a) the unaffected market price was from three to four months before closing, while the appraisal statute requires fair value to be measured at closing, (b) HP had access to material, non-public Aruba data, including Aruba's strong quarterly results that the market was not then aware of but ultimately pushed Aruba's stock price above the deal value when released four days before signing, and (c) the process by which the Court of Chancery raised on its own, after discovery and a full trial, the potential reliance on a market price valuation metric that Aruba had not itself posited was perhaps motivated by the Vice Chancellor's "personal frustration at being reversed in *Dell*" and "injected due process and fairness problems into the proceedings."[16]

IMPLICATIONS

Aruba further elevates the importance of deal price in appraisal cases, and represents one of the first Delaware decisions to attempt to address, albeit summarily, the deal price discount attributable to synergies. The decision provides clarity on a number of important issues, and leaves open other significant matters for appraisal litigants.

- After firmly adopting a preference for the deal price in *DFC* and *Dell* assuming a reasonable process, the *Aruba* decision adopts with equal force a preference for the deal price less synergies in a strategic merger, and recognizes that those synergies can be a substantial component of the price paid. This may lessen appraisal risks for companies in strategic mergers.
- The Court noted expressly that private equity deals and management buy-outs may indeed involve the sort of "agency costs" that the Court of Chancery alluded to in *Aruba*. This may enable parties to these transactions to argue for a fair value below the deal price based upon such "agency costs" in lieu of, or in addition to, any synergies.
- The Supreme Court left untouched the Court of Chancery's conclusion that various process defects were insufficiently material to demonstrate that they had an impact on price. Although the Supreme Court continued to emphasize the importance of a sufficient process when determining whether to give effect to the deal price, it remains unclear to what extent process defects might undermine reliance on the deal price, particularly if other metrics, such as market prices and DCF analyses, support the fairness of the deal price.
- The Supreme Court was critical of the Court of Chancery's view that the deal price in a process that results in a single bidder "discount[s] the importance of competition," because the absence of other bidders may just as easily "mean that the target's value is not sufficiently enticing to engender a bidding war above the winning price."[17] The *Aruba* decision suggests that the

relevant inquiry is not the existence of multiple bidders, but whether there was a sufficient "open opportunity for many buyers to buy" if they wish, which might include a post-signing market check.

- The Court did not reject reliance on market prices as fair value in all cases, but found doing so on this record was less reliable than the deal price because of, among other things, HP's possession of non-public information that in fact had a demonstrable stock price impact when disclosed, and timing issues. It remains to be seen whether or to what extent Delaware courts will rely upon market prices as an independent measure of fair value, rather than confirmatory evidence of the fairness of some other price.

* * *

ENDNOTES

[1] No. 368,2018, 2019 WL 1614026 (Del. Apr. 16, 2019); *see also Dell, Inc.* v. *Magnetar Glob. Event Driven Master Fund Ltd*, 177 A.3d 1 (Del. 2017); *DFC Glob. Corp.* v. *Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

[2] 2019 WL 1614026, *7 & n.58.

[3] *Id.* at *3.

[4] 2018 WL 922139, *35 (Del. Ch. Feb. 15, 2018) (quoting *Dell, Inc.*, 177 A.3d at 30).

[5] *Id.* at *44 (quoting *Dell, Inc.*, 177 A.3d at 33).

[6] *Id.* at *38.

[7] *Id.* at *44.

[8] *Id.* at *2.

[9] *Id.* at *54.

[10] 2019 WL 1614026, *4.

[11] *Id.*

[12] *Id.* at *5.

[13] *Id.* at *6.

[14] *Id.* at *5.

[15] *Id.* at *6.

[16] *Id.* at *7-*8.

[17] *Id.* at *6.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.

CONTACTS

New York		
Audra D. Cohen	+1-212-558-3275	cohena@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Scott B. Crofton	+1-212-558-4682	croftons@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Brian E. Hamilton	+1-212-558-4801	hamiltonb@sullcrom.com
John L. Hardiman	+1-212-558-4070	hardimanj@sullcrom.com
Matthew G. Hurd	+1-212-558-3122	hurdm@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
Keith A. Pagnani	+1-212-558-4397	pagnanik@sullcrom.com
George J. Sampas	+1-212-558-4945	sampasg@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerm@sullcrom.com
Matthew A. Schwartz	+1-212-558-4197	schwartzmatthew@sullcrom.com
Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com
Washington, D.C.		
Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
Los Angeles		
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
Robert A. Sacks	+1-310-712-6640	sacksr@sullcrom.com