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Delaware Chancery Court Considers Appraisal in First Major Decision Since *Dell*

Court of Chancery Chooses Unaffected Market Price, 30% Below Deal Price, as Fair Value.

SUMMARY

The evolution of Delaware law on appraisal continued in *Verition Partners Master Fund Ltd.* v. *Aruba Networks, Inc.*,[1] the first major appraisal decision from the Delaware Chancery Court since the Delaware Supreme Court's ruling in *Dell*.[2] The *Aruba* opinion was authored by Vice Chancellor Laster, who also wrote the Chancery Court decision reversed in *Dell*, and the opinion analyzes *Dell* and the Supreme Court's recent *DFC* opinion at length.[3] The principles that the Vice Chancellor takes from those two decisions led him to conclude that the fair value of Aruba's stock was best represented by the unaffected market price of Aruba's shares prior to news reports regarding its sale, a price 30% lower than the deal price. How the opinion gets to that result is an extremely interesting read that raises many questions about the future of the appraisal remedy in Delaware, most prominent among them whether the remedy is necessary at all for public companies operating in an efficient market.

THE DECISION

Aruba involved the May 18, 2015 merger between Aruba and Hewlett-Packard Company ("HP"). Aruba had a more complicated than usual trip through the Chancery Court as *DFC* and *Dell* were both decided while it was pending, causing the parties to re-order and re-emphasize their arguments. Eventually, three valuation methods were argued for by the parties: (1) 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 (February 25, 2015, almost three months before the merger closed); (2) the deal price of $24.67 per share; and (3) discounted cash flow ("DCF") analyses—plaintiffs' DCF suggested a price of $32.57 per share and Aruba's suggested $19.85 per share.

The Vice Chancellor spent much of the opinion on the first of these alternatives: the unaffected market price. In *Dell*, the Delaware Supreme Court disagreed with the Vice Chancellor's decision to give no weight to the market price due to what he perceived as a "valuation gap" between the market's valuation of Dell's prospects based on a short term profit objective and management's longer term vision for the company.[4] The Supreme Court instead observed that Dell exhibited all of the indicia of an efficiently traded stock, and it had simply not persuaded the market that its business plan was sound. Thus, Vice Chancellor Laster concluded that "[t]he Delaware Supreme Court's decisions in *Dell* and *DFC* endorse using the market price of a widely traded firm as evidence of fair value."[5] The Court noted that this endorsement of the "efficient capital markets hypothesis" was a departure from several older Supreme Court cases and other Delaware precedent that had expressed skepticism as to whether market prices reflected "fair value." The Court then addressed what were the basic attributes of an "efficient" market for a company's shares and found that *DFC* and *Dell* both seemed to agree on the following: a large market capitalization; active trading on a recognized exchange; no controlling shareholder; multiple public securities filings; and broad analyst coverage of the stock. The Court found that Aruba's stock had all of these attributes and, indeed, the market regularly and promptly reacted to developments at the company. Thus, it found that, under *Dell* and *DFC*, Aruba's unaffected market price was "likely a possible proxy for fair value."[6]

The Court noted that no expert in *Aruba*—or in *Dell* or *DFC* for that matter—opined on market efficiency, as is common in federal securities law actions when a plaintiff seeks to invoke the presumption of reliance associated with the fraud-on-the-market theory. The plaintiffs did present certain arguments for market mispricing, generally based on Aruba internal documents complaining that the market was not properly valuing the company. The Court found that these criticisms lacked any "analytical and valuation-based support," and were "considerably weaker than what I abused my discretion by crediting in *Dell*."[7]

Turning to the deal price, the Court stated 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.'"[8] The Vice Chancellor also observed—after noting that the *Dell* Supreme Court opinion had rejected his decision to afford no material weight to the deal price—that *Dell* and *DFC* identify many factors that support the materiality of the deal price but "provide less guidance for determining when a process is sufficiently bad to warrant discounting the deal price."[9] The Court then cited the following passage from *DFC* as relevant to this issue:

> [T]he purpose of an appraisal is not to make sure that the petitioners get the highest conceivable value that might have been procured had every domino fallen out of the company's way; rather, it is to make sure that they receive fair compensation for their shares in the sense that it reflects what they deserve to receive based on what would fairly be given to them in an arm's-length transaction.[10]

Citing similar language from *Dell*, the Court concluded that the Supreme Court's direction was to focus on whether shareholders got fair value and were not exploited and "rule[d] out inquiry into whether a different transaction process might have achieved a superior result."[11]

The Court then addressed specific process issues raised by plaintiffs. The first was that HP faced no real competition for Aruba as Aruba explored other acquisition alternatives but found none. The Court did not find this problematic based on *Dell*'s reasoning that if no one else is interested in buying a company, "it does not suggest a higher value, but a lower one."[12] Plaintiffs also argued that both bankers who negotiated on Aruba's behalf seemed more concerned about the impression they were making on HP rather than the job they were doing for Aruba and also that the Aruba CEO seemed at least partially motivated to pursue a sale of Aruba as a pathway to his own retirement. While finding that these arguments were supported by the evidence, the Court held that "[i]n a scenario where the underlying market price is reliable, competition and negotiation become secondary."[13] The Court then reiterated the Supreme Court's guidance that the goal of appraisal is not to determine "'whether a negotiator has extracted the highest possible bid'" and, based on that principle, held that the evidence did not convince him that the deal price left a "portion of Aruba's fundamental value on the table."[14] The Court noted that while an argument could be made that more aggressive negotiation might have extracted more of the synergy value of the transaction for Aruba, such synergies should not be considered in the fair value analysis because they resulted from the merger. In short, the Vice Chancellor concluded:

> [T]he HP-Aruba merger looks like a run-of-the mill, third-party deal. Nothing about it appears exploitive. Particularly 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.[15]

The Court then addressed an issue rarely taken head on in Delaware opinions: how to deduct from the deal price the value of synergies that do not reflect the value of the company before the merger, as they would be created by the merger. The Court conceded this was a difficult issue "to determine with precision."[16] It then reviewed the various synergy estimates prepared by the parties before and after the merger, concluded that, because of the lack of competition and the negotiator issue discussed above, Aruba probably got less of the synergy value of the deal than it otherwise might have, and discounted the deal value by an amount below the midpoint of the synergy estimates to $18.20 per share.

As for DCF analysis, in his trial court opinion in *Dell*, after rejecting market and deal prices as probative of fair value, the Vice Chancellor found fault with the DCF analyses presented by both parties and determined fair value based on a DCF analysis of his own. In *Aruba*, the Vice Chancellor again found fault with the DCF analyses of both parties, but he 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."[17] 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 reduced agency costs, another merger-related benefit. He thus settled on unaffected market price as fair value because, for Aruba, it provided "the more straightforward and reliable method for estimating the value of the entity as a going concern."[18]

IMPLICATIONS

Aruba raises very provocative issues that can be expected to generate considerable analysis from courts, commentators, and litigants. These include:

- What is the importance of process in the appraisal context? Describing the *Dell* and *DFC* opinions as lessening the importance of process by focusing on "fair" rather than "best" value is somewhat at odds with the important place that process has always held in Delaware M&A jurisprudence. *Dell* and *DFC* could just as easily be explained as finding that process imperfections caused by faithful fiduciaries are no reason to discount a deal price, while process defects that amount to a breach of duty may be reason to disregard an agreed upon merger price as evidence of fair value. On the other hand, if, as in *Aruba*, the best indicator of fair value is an unaffected market price, process issues would seem to be of little consequence in an appraisal.
- What is the "unaffected market price"? The Vice Chancellor chose the 30-day period before news of the merger negotiations was leaked. This leaves open for debate whether a longer or shorter period is appropriate, or whether the court should account for movements in the stock (or changes in value) between the unaffected price period and closing of the deal in light of Delaware precedent that the appraisal should be as of the closing date. The *Aruba* plaintiffs have sought reargument based on this latter aspect of the Court's decision.
- Will appraisal plaintiffs be mindful of the Vice Chancellor's comment that no expert reports were submitted as to the efficiency of the market for Aruba's shares? If they are and begin to challenge the efficiency of the market, appraisal proceedings may be turned into quasi-securities litigations.
- Will other courts try to measure synergies to be deducted from the deal price? If that does become the custom, the appraisal remedy may become considerably less desirable in strategic mergers, as most buyers are paying for synergies (and reduced agency costs) and therefore the risk of doing worse in appraisal than the deal price would increase considerably.
- And finally, does appraisal survive *Aruba* for large, publicly traded and widely held companies? The short answer is yes as it is not a decision of the Delaware Supreme Court, it will likely be appealed, and the Vice Chancellor went out of his way to emphasize that the opinion is limited to the *Aruba* facts and a situation where the record indicated that the best indicator of fair value was the unaffected market price. But if the Supreme Court endorses the *Aruba* reasoning, it would seem the rare case when the market price of a widely held and actively traded public company would not be the most straightforward indication of fair value, eliminating the attractiveness of the appraisal remedy in most public company deals. And, in fact, many states do not provide an appraisal remedy for public company shareholders on the theory that the market provides them with sufficient alternative liquidity.[19] Perhaps this is the debate the Vice Chancellor intended to provoke with the *Aruba* opinion and it is a debate worth having.

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ENDNOTES

[1] C.A. No. 11448-VCL, 2018 WL 922139 (Del. Ch. Feb. 15, 2018).

[2] *Dell, Inc.* v. *Magnetar Glob. Event Driven Master Fund Ltd*, --- A.3d ---, 2017 WL 6375829 (Del. Dec. 14, 2017).

[3] *DFC Glob. Corp.* v. *Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).

[4] *Aruba*, 2018 WL 922139, at *30 (quoting *In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL, 2016 WL 3186538, at *32 (Del. Ch. May 31, 2016)). Several footnotes in the opinion directly address the portions of the Vice Chancellor's opinion in *Dell* that were reversed by the Supreme Court.

[5] *Id.* at *1.

[6] *Id.* at *27 (quoting *Dell, Inc.*, 2017 WL 6375829, at *1).

[7] *Id.* at *31.

[8] *Id.* at *35 (quoting *Dell, Inc.*, 2017 WL 6375829, at *22).

[9] *Id.* at *36.

[10] *Id.* (quoting *DFC Glob. Corp.*, 172 A.3d at 370–71).

[11] *Id.*

[12] *Id.* at *39 (quoting *Dell, Inc.*, 2017 WL 6375829, at *21).

[13] *Id.* at *42.

[14] *Id.* at *44 (quoting *Dell, Inc.*, 2017 WL 6375829, at *24).

[15] *Id.* at *38.

[16] *Id.* at *44.

[17] *Id.* at *2.

[18] *Id.* at *54.

[19] *See, e.g.*, Ariz. Rev. Stat. § 10-1302(D); S.C. Code § 33-13-102(B).

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