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Aruba Appraisal: Delaware Supreme Court Rejects Chancery Court's Exclusive Reliance on Trading Price in Determining "Fair Value" Under DGCL § 262

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In an opinion highly critical of lower court's methodology, Delaware Supreme Court mandates a valuation based on "deal price minus synergies"

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INTRODUCTION

Delaware General Corporation Law § 262 ("*DGCL § 262*") allows target-company stockholders to challenge the price payable for their shares in a cash merger by dissenting and seeking an alternative—and hopefully higher—valuation from the Delaware Court of Chancery ("*Chancery Court*"). DGCL § 262 authorizes the Chancery Court to determine the "fair value" of shares owned by dissenting stockholders using "all relevant factors." However, DGCL § 262 directs the Chancery Court not to consider "any element of value arising from the accomplishment or expectation of the merger," effectively eliminating any synergistic value the dealmakers may have factored into the merger price.

The vague evaluative criteria established by DGCL § 262 gives the Chancery Court significant leeway in determining fair value. While Delaware courts generally favor the negotiated deal price (less synergies) as the basis for determining fair value, they have consistently declined to adopt a bright-line rule to that effect. Therefore, in addition to negotiated deal price, the Chancery Court frequently consults other methodologies when assessing fair value, including the target company's stock market trading price, discounted cash flow ("*DCF*"), and a myriad of other financial metrics.

There is a wealth of Chancery Court precedent applying the vague standards of DGCL § 262. These decisions demonstrate how unique facts underlying a particular transaction can drive the resulting appraisal. For instance, in a posttrial opinion in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, C.A. No. 11448-VCL, 2018 WL 2315943 (Del. Ch. May 21, 2018) ("*Aruba I*"), Vice Chancellor J. Travis Laster based his determination of the fair value of the Aruba Networks, Inc. ("*Aruba*") dissenting shares solely on the company's thirty-day average market price before announcement of an all-cash buyout by Hewlett-Packard Company ("*HP*"). This yielded an appraised value $7.54 per share *less than* the merger price of $24.67 per share negotiated by Aruba at arm's length with HP.

Nearly a year later, in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 210 A.3d 128 (Del. 2019) ("*Aruba II*"), the

Delaware Supreme Court ("*Supreme Court*") reversed, declaring that the Vice Chancellor abused his discretion in basing his determination of fair value on Aruba's premerger trading price. In a relatively harsh per curiam opinion, the Supreme Court characterized the theory underlying the Vice Chancellor's methodology as "inapt" and labelled his ultimate conclusion "troubling." Accordingly, the Supreme Court—"[r]ather than burden the parties with further proceedings"—fixed fair value based on "the deal price minus the portion of synergies left with the seller" as calculated by Aruba ("*Deal Price Minus Synergies*"). Even this methodology left the dissenting stockholders with an appraised value $5.57 per share *less than* the merger price.

I. LEGAL BACKGROUND

As has been well chronicled, the number of DGCL § 262 proceedings challenging negotiated transaction prices spiked for a period of about twelve years beginning in 2004–2005, concurrent with the rise of hedge funds devoted to appraisal arbitrage. For a discussion of this trend, *see* Robert S. Reder & Stanley Onyeador, *Delaware Chancery Disqualifies Lead Petitioners in Dell Appraisal Who Inadvertently Voted "FOR" Management Buyout*, 69 VAND. L. REV. EN BANC 279 (2016).

In recent years, however, the upturn in appraisal actions has been blunted. The turnabout can be attributed, in large measure, to two legal developments. *First*, amendments to DGCL § 262 have, among other things, enabled target companies to cut off the accrual of interest at attractive rates on appraisal awards. *Second*, two important Supreme Court decisions, both issued in 2017, have made it more difficult for dissenting stockholders to obtain appraisal awards exceeding negotiated transaction prices, at least in transactions not involving controlling stockholders or other peculiar facts.

First, in *DFC Glob. Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017) ("*DFC*"), the Supreme Court, while refusing to establish a presumption in favor of negotiated deal price in determining fair value even when presented with an exemplary sales process, acknowledged that

> corporate finance theory reflects a belief that if an asset—such as the value of a company as reflected in the trading value of its stock—can be subject to close examination and bidding by many humans with an incentive to estimate its future cash flows value, the resulting collective judgment as to value is likely to be highly informative and that, all estimators having equal access to information, the likelihood of outguessing the market over time and building a portfolio of stocks beating it is slight.

The Supreme Court instructed Vice Chancellor Laster, on remand, to better explain his decision to give equal weight to the negotiated deal price and two other methodologies in determining the fair value of the dissenting shares. *See* Robert S. Reder & Blake C. Woodward, *Delaware Supreme Court Refuses to Establish a Presumption Favoring Deal Price in Statutory Appraisal Proceedings*, 71 VAND. L. REV. EN BANC 59 (2018).

The Supreme Court again reversed Vice Chancellor Laster's determination of fair value in a DGCL § 262 proceeding in *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd*, 177 A.3d 1 (Del. 2017) ("*Dell*"). In *Dell*, the Supreme Court stipulated once again that negotiated deal price is not a presumptive indicator of fair value under DGCL § 262. However

> [w]e only note that, when the evidence of market efficiency, fair play, low barriers to entry, outreach to all logical buyers, and the chance for any topping bidder to have the support of [the CEO's] own votes is so compelling, then failure to give the resulting price heavy weight because the trial judge believes there was mispricing missed by all the Dell stockholders, analysts, and potential buyers abuses even the wide discretion afforded the Court of Chancery in these difficult cases.

With a tip of the hat to the thorough sale process employed by the Dell board of directors, the Supreme Court ruled that "heavy, if not dispositive, weight" should have been given to the negotiated deal price, rejecting the Vice Chancellor's exclusive reliance on his own DCF analysis. *See* Robert S. Reder & Micah N. Bradley, *Dell Appraisal: Delaware Supreme Court Rejects Chancery Court Valuation Giving No Weight to Deal Price in Connection with Management-Led LBO*, 72 VAND. L. REV. EN BANC 201 (2019).

Vice Chancellor Laster expressly accounted for the *DFC* and *Dell* decisions when he rejected reliance on the negotiated transaction price in *Aruba I*. But, in *Aruba II*, the Supreme Court sharply criticized the Vice Chancellor's decision to rely exclusively on recent trading prices in determining fair value.

II. FACTUAL BACKGROUND

A. HP Acquires Aruba

HP first approached Aruba "about a potential combination" of the two publicly traded technology companies in August 2014. While negotiating with HP, Aruba approached "[f]ive other logical strategic bidders," but none showed interest. Given the synergies that a combination with a strategic buyer like HP could produce, Aruba's

board of directors ("*Board*") deemed it unlikely that a private equity bidder could compete with strategic bidders.

Following months of negotiations, the Board accepted HP's $24.67 per share all-cash offer. When news of HP's offer leaked to the public, Aruba's stock price jumped from $18.37 to $22.24 per share. And when Aruba released quarterly results exceeding analyst expectations the next day, Aruba's stock price rose another 9.7% to close at $24.81 per share. Even though Aruba's market value now topped HP's offer, the Board approved the HP buyout, and the companies formally announced the transaction. Although the merger agreement allowed Aruba a "passive market check" to consider unsolicited bids, "no superior bid emerged, and the deal closed on May 18, 2015."

B. Dissenting Stockholders Seek Appraisal

On August 28, 2015, two Aruba stockholders who had dissented from the merger, Verition Partners Master Fund Ltd. and Verition Multi-Strategy Master Fund Ltd. (together, "*Verition*"), asked the Chancery Court to appraise their shares under DGCL § 262, claiming that Aruba's fair value was $32.57 per share. Aruba initially countered with a fair value of either $19.45 per share (before trial) or $19.75 per share (after trial), but in a posttrial answering brief, Aruba supported a Deal Price Minus Synergies value of $19.10 per share. Notably, neither party argued that Aruba's preannouncement stock price was the best measure of fair value.

At this point, Vice Chancellor Laster postponed a scheduled posttrial hearing "once it became clear that the Delaware Supreme Court's forthcoming decision in *DFC* . . . likely would have a significant effect on the legal landscape." After the Supreme Court issued its *DFC* opinion, on September 15, 2017, Verition and Aruba simultaneously submitted supplemental briefings on *DFC*'s implications. The parties "continued to argue for their preferred fair value calculation," while neither urged the Vice Chancellor to use Aruba's stock price as fair value. However, Aruba now contended its stock price was "'informative' of fair value," supporting its valuation range of $19 to $20 per share.

In December 2017, following release of the Supreme Court's *Dell* decision, Vice Chancellor Laster "requested supplemental briefing on 'the market attributes of Aruba's stock' in part because he 'learned how many errors [he] made in the *Dell* matter.' " In its brief, Aruba turned from its $19.10 per share Deal Price Minus Synergies valuation to a $17.13 per share valuation based on its thirty-day unaffected market price. In this connection, Aruba focused on the efficiency of the market

for its stock in arguing "for the first time" that its preannouncement stock price was "the single most important mark of its fair value."

C. Aruba I

In May 2018, Vice Chancellor Laster issued his posttrial opinion in *Aruba I*, agreeing with Aruba that fair value was $17.13 per share. Although DGCL § 262 requires a valuation as of "the effective date of the merger," the Vice Chancellor utilized the thirty-day trading period before news of HP's buyout offer leaked, some three to four months before closing. In so ruling, the Vice Chancellor "gave no weight" to either the DCF analyses submitted by two expert witnesses or his own Deal Price Minus Synergies analysis yielding a value of $18.20 per share (even lower than Aruba's $19.10 per share Deal Price Minus Synergies valuation). Vice Chancellor Laster rejected even his own Deal Price Minus Synergies valuation because he believed this methodology failed properly to "back out . . . theoretical 'reduced agency costs' " that would "result from unitary (or controlling) ownership" of Aruba following the merger. Because these savings resulted from the merger, in the Vice Chancellor's view, DGCL § 262 required that they (like other synergies) be deducted from the transaction price in determining fair value.

Verition "moved for reargument," claiming the underlying reason for Vice Chancellor Laster's rejection of a Deal Price Minus Synergies valuation was "a results-oriented move . . . compelled by his personal frustration at being reversed in *Dell*." The Vice Chancellor denied this allegation and rejected Verition's motion. In *Aruba II*, the Supreme Court did "take him at his word." Nevertheless, the Supreme Court thoroughly rejected the Vice Chancellor's approach in *Aruba I*.

III. SUPREME COURT'S ANALYSIS

In *Aruba II*, the Supreme Court rejected Vice Chancellor Laster's fair value determination from *Aruba I*, with reference to its decisions in *DFC* and *Dell*. According to the Supreme Court, the Vice Chancellor both "abused [his] discretion" by relying exclusively on Aruba's pre-leak stock price in determining fair value and made "an erroneous factual finding" in rejecting a Deal Price Minus Synergies valuation. Rather than remanding the dispute to the Chancery Court, the Supreme Court ordered that final judgment be entered in the

amount of $19.10 per share based on Aruba's Deal Price Minus Synergies analysis.

A. Vice Chancellor Laster's Rejection of Deal Price Minus Synergies

According to the Supreme Court, fair value under DGCL § 262 "is more properly described as the value of the company to the stockholder as a going concern, rather than its value to a third party as an acquisition." Thus, in arriving at fair value, it is appropriate for the Chancery Court to deduct from the negotiated purchase price "a reasonable estimate of whatever share of synergy or other value the buyer expects from changes it plans to make to the company's 'going concern' business plan that has been included in the purchase price as an inducement to the sale."

Vice Chancellor Laster abandoned his own, as well as Aruba's, Deal Price Minus Synergies analysis because he believed the valuation improperly failed to "back out" savings to be realized by HP from "reduced agency costs" occasioned by Aruba's transformation from a publicly traded enterprise to one controlled by HP. The Supreme Court criticized this approach on two principal grounds:

- *Inapt Theory*: The Supreme Court reasoned that the theory underlying Vice Chancellor Laster's rejection of a Deal Price Minus Synergies analysis "appears to be" that "replacing a dispersed group of owners with a concentrated group of owners can be expected to add value because the new owners are more capable of making sure management isn't shirking or diverting the company's profits." As such, "that added value must be excluded under § 262 as 'arising from the accomplishment or expectation of the merger or consolidation.' " Whatever the merits of this theory in general, the Supreme Court viewed it as "inapt" when applied to HP's buyout of Aruba: "unlike a private equity deal, the merger at issue . . . would not replace Aruba's public stockholders with a concentrated group of owners; rather, it would swap out one set of public stockholders for another: HP's."
- *No Support in the Record*: Further, according to the Supreme Court, "neither party presented any evidence to suggest that any part of the deal price paid by HP, a strategic buyer, involved the potential for agency cost reductions that were not already captured by its synergies estimate." In short, the Vice Chancellor "ignore[d] the reality that HP's synergies case likely already priced any agency cost reductions it may have expected." Not only was there "no reasonable basis to infer that Aruba was

cheating itself out of extra agency cost reductions by using only the cost reductions that were anticipated in commercial reality," but Aruba's Deal Price Minus Synergies valuation "was corroborated by the standalone DCF models used by Aruba's and HP's boards in agreeing to the transaction."

B. Vice Chancellor Laster's Interpretation of DFC *and* Dell

The Supreme Court also took issue with Vice Chancellor Laster's interpretation of *DFC* and *Dell*, finding that *Aruba I* "was not supported by any reasonable reading of those decisions or grounded in any direct citation to them." In this connection, the Supreme Court took the opportunity to clarify several points:

- *Market Price as an Indicator of Fair Value*: Vice Chancellor Laster "seemed to suggest" that *DFC* and *Dell* signaled "trading prices should be treated as exclusive indicators of fair value." To the contrary, the Supreme Court explained: "*Dell* and *DFC* did not imply that the market price of a stock was necessarily the best estimate of the stock's so-called fundamental value at any particular time. Rather, they did recognize that 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."
- *Deal Price as an Indicator of Fair Value*: The Supreme Court criticized Vice Chancellor Laster's suggestion "that rote reliance on market prices was compelled based on [his] reading of *DFC* and *Dell*." According to the Supreme Court, "*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 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." And "the long history of giving important weight to market-tested deal prices in the Court of Chancery" testified that this was not a novel concept.
- *Significance of Number of Bidders*: *Aruba I* stressed the importance of competition among bidders to the meaningfulness of deal price as an indicator of fair value. To this point, the Supreme Court suggested that the number of bidders is not necessarily determinative of the probative value of deal price. In fact, "when there is an open opportunity for many buyers to buy

and only a few bid (or even just one bids), that does not necessarily mean that there is a failure of competition; it may just mean that the target's value is not sufficiently enticing to buyers to engender a bidding war above the winning price." Moreover "*DFC* and *Dell* . . . recognized that a buyer in possession of material nonpublic information about the seller is in a strong position (and is uniquely incentivized) to properly value the seller when agreeing to buy the company at a particular deal price, and that view of value should be given considerable weight by the Court of Chancery absent deficiencies in the deal process."

- *Deal Price vs. Market Price*: Finally, the Supreme Court listed several factors for choosing deal price over pre-leak market price in determining the fair value of the dissenting shares:
    - The market price used by the Vice Chancellor "was a measurement from three to four months prior to the valuation date, a time period during which it is possible for new, material information relevant to a company's future earnings to emerge."
    - "HP had more incentive to study Aruba closely than ordinary traders in small blocks of Aruba shares, and also had material, nonpublic information that, by definition, could not have been baked into the public trading price."
    - "In particular, HP had better insight into Aruba's future prospects than the market because it was aware that Aruba expected its quarterly results to exceed analysts' expectations."

C. Due Process and Fairness

Finally, according to the Supreme Court, Vice Chancellor Laster "not only abused [his] discretion by double counting agency costs but also injected due process and fairness problems into the proceedings." In this connection, the Supreme Court seemed particularly troubled that it was the Vice Chancellor who first introduced the idea of relying on Aruba's unaffected market price in his request for supplemental posttrial briefing, even though neither Verition nor Aruba had previously argued that market price was the appropriate metric for assessing fair value. As such, "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." The Supreme Court described the

lack of process as "antithetical to the traditional hallmarks of a Court of Chancery appraisal proceeding."

CONCLUSION

Consistent with *DFC* and *Dell*, *Aruba II* reaffirmed the important, if not dispositive, role that deal price usually plays in determining "fair value" for purposes of DGCL § 262. One cannot ignore the fact that the Chancery Court retains broad discretion under DGCL § 262 to consider "all relevant factors," and the Supreme Court will not lightly find that the Chancery Court abused its discretion in determining "fair value." Nonetheless, as *Aruba II* demonstrates, the Chancery Court must provide a clear and compelling justification before it can fully or even partially discount deal price or other market-based data abundantly supported by the record in favor of its own analysis.