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Delaware Court of Chancery Appraises Company below Merger Price Based on Unaffected Market Price

Recently in *Veriton Partners Master Fund Ltd* v. *Aruba Networks, Inc.*, the Delaware Court of Chancery, in an opinion by Vice Chancellor Laster, appraised the fair value of Aruba Networks, Inc. to be about 30.6% less than the agreed deal price in its acquisition by Hewlett-Packard Company. The court found Aruba's 30-day average unaffected stock price, and not the deal price, to be the most reliable indication of fair value, despite the existence of arm's-length negotiations and Aruba's status as a widely held, public company. Recent appraisal decisions by the Delaware Supreme Court, including *Dell, Inc.* v. *Magnetar Global Event Driven Master Fund Ltd.* and *DFC Global Corp.* v. *Muirfield Value Partners, L.P.*, have strongly urged reliance on deal price in determining fair value in such situations, but the *Aruba* court found that possible human error involved in estimating the deal's significant synergies (which must be subtracted from the deal price in a Delaware appraisal action) made the deal price a less reliable indication of fair value than the unaffected stock price. The likely impact of this decision is to continue to decrease the attractiveness of appraisal litigation as an arbitrage strategy, given that recent cases have tended to result in appraisal values at or less than deal price.

Background/Holding

In 2015, HP acquired Aruba for $24.67 per share—a price that reflected the transaction's significant synergies—in what the Court of Chancery labeled a "run-of-the-mill, third-party deal." Approximately 80% of the outstanding shares of Aruba voted in favor of the merger. Following the merger, the petitioners filed an action in the Delaware Court of Chancery seeking appraisal of their Aruba shares.

After examining the evidence presented at trial, the court determined that the 30-day unaffected stock price of Aruba of $17.13 per share and the deal-price-less-synergies value of $18.20 per share provided the two most probative indications of fair value of Aruba. The court concluded, however, that due to the human error element in estimating the synergies, as well as the fact that the deal-price-less-synergies value still reflected an element of value resulting from the merger (*i.e.*, reduced agency costs), the unaffected market price provided the most reliable indication of fair value and awarded the petitioners $17.13 per share.

Takeaways

There are several notable aspects of the court's opinion:

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- *The unaffected market price of the stock of a company is persuasive evidence of fair value if the company's shares trade in a market consistent with the assumptions underlying "a traditional version of the semi-strong form of the efficient capital markets hypothesis."* According to the Delaware Supreme Court's decisions in *Dell* and *DFC*, a market is likely to be sufficiently efficient if the company has many stockholders, no controlling stockholder, highly active trading and is widely covered in the market. Here, the *Aruba* court observed that Aruba's stock reflected these attributes, thereby concluding that the company's unaffected stock price provided reliable evidence of fair value. Evidence of market mispricing—such as that the deal coincided with a trough in the market or that the company bundled the announcements of the deal and favorable quarterly results (making it difficult to ascertain the company's standalone value)—did not, according to the court, make the unaffected market price unreliable, because "in an efficient market, you can trust prices, for they impound all available information about the value of each security."

- *While the deal price often provides the most reliable evidence of fair value for widely held, public companies sold in arm's-length transactions, when synergies are backed out from the deal prices, the result may provide a less reliable indication of fair value.* Because the HP-Aruba merger looked like a "run-of-the-mill, third-party deal" and was not "exploitive," the court observed that "there [was] good reason to think that the deal price exceeded fair value and, if anything, . . . establish[ed] a ceiling for fair value," particularly given the inclusion of synergies in the deal price. Moreover, in the court's view, the deal price's reliability was not compromised by, among other things, the lack of competition in the deal process. Because the deal generated significant synergies, however, those synergies must by law be backed out from the deal price when determining fair value in a Delaware appraisal action. According to the court, the human error element of estimating the value of these synergies caused the deal-price-less-synergies calculation to be a less reliable indication of fair value in these circumstances. Moreover, the court found that the deal-price-less-synergies calculation continued to incorporate another element of value resulting from the merger, namely reduced agency costs. Therefore, the court concluded that the unaffected market price of Aruba's stock was a more reliable indication of fair value than the deal-price-less-synergies calculation.

- *Where reliable market indicators are available, the court likely will not consider discounted cash flow analyses in its determination of fair value in appraisal cases.* Instead, "[d]iscounted cash flow models are 'often used in appraisal proceedings when the . . . company was not public or was not sold in an open market check.'" Here, the court concluded that there was no reason to believe that the market could not be relied upon, and therefore the court gave no weight to the experts' discounted cash flow analyses in its determination of fair value of Aruba.

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