FRIED FRANK
M&A/Private Equity BRIEFING™

friedfrank.com

Another Nail in the Coffin for Arm's-Length Merger Appraisal Cases Without Fatal Process Flaws–Delaware Supreme Court Embraces the Merger-Price-Less-Synergies Approach for Determining "Fair Value"–Aruba

In *Verition v. Aruba* (April 16, 2019), the Delaware Supreme Court (i) rejected the Court of Chancery's novel approach of determining appraised "fair value" based on the "unaffected market price" of the target stock; (ii) confirmed the primacy of the deal price in determining fair value in cases involving an arm's-length merger with a sufficiently robust sale process; and, most importantly, (iii) fully embraced the concept (which is statutorily mandated but historically has been mostly ignored) that the value of expected synergies must be excluded from fair value. While the Supreme Court's appraisal result is higher than the Court of Chancery's result was, it is still well below the merger price--thus, the dissenting stockholders still will experience a "loss" as a result of having exercised their appraisal rights rather than accepting the merger consideration.

Background

In 2015, Hewlett-Packard Company acquired Aruba Networks, Inc. in an arm's-length cash merger for $24.67 per share. The deal price represented an almost 49% premium to Aruba's 30-day average unaffected market price. With 81% of the outstanding shares voting, the merger was approved by a 98% vote. Two Verition funds exercised their appraisal rights. The Court of Chancery (Feb. 15, 2019) determined that Aruba's "fair value" was $17.13 per share, based on the 30-day average unaffected market price of the Aruba stock (a metric never before used to determine appraised fair value and for which the parties had not originally advocated). The appraisal result was about 31% below the deal price. Verition appealed. The Delaware Supreme Court reversed that decision; stated that the Court of Chancery should have relied on the merger price less the value of expected merger synergies; and ordered that the Court of Chancery enter a final judgment for the petitioners in the amount of $19.10 per share. The Supreme Court's appraisal result is about 22% below the deal price.

Key Points

- **The Delaware Supreme Court has fully embraced the merger-price-less-synergies approach to determining fair value in arm's-length merger appraisal cases.** This approach can be expected to further accelerate the recent significant decline in appraisal petitions.

- **The Supreme Court clarified how to calculate merger-price-less-synergies.** Although certain issues were clarified, significant issues relating to the calculation remain open. We observe that these are likely to remain unresolved, as appraisal actions involving arm's-length mergers are likely to become increasingly rare.

- ***Aruba* is another example of the Delaware courts considering a sale process without competition as sufficiently robust for purposes of reliance on the deal price.** The *Aruba* process involved a limited pre-signing solicitation, a post-signing no-shop, and no competitive bidding. Moreover, the negotiations were conducted against a backdrop of what the Court of Chancery viewed as serious conflicts of interest by Aruba's management and bankers. In addition, Aruba's stock was at a 52-week low (due to a "misperception in the market" that the company was going to miss quarterly estimates, which the company actually was on track to, and did in fact, meet).

Discussion

The Supreme Court fully embraced the merger-price-less-synergies approach to determining fair value in arm's-length merger cases. Importantly, the Supreme Court confirmed that, when an appraisal is based on the deal price, the value of expected merger synergies included in the deal price must be deducted from the deal price to satisfy the statutory command (under DGCL Section 262) that any value "arising from the merger itself" must be excluded from the fair value determination. This statutory command historically was largely ignored. Indeed, we note that, in the recent, seminal *DFC Global* and *Dell* decisions, while the Supreme Court mandated that the Court of Chancery rely on the deal price, the Supreme Court did *not* in those cases direct the Court of Chancery, on remand, to adjust the deal price to deduct merger synergies, did not itself make an adjustment to the deal price, and did not provide guidance as to how such an adjustment would be made. Rather, in those cases, the Supreme Court appeared to emphasize that the deal price *itself* is the best *overall* proxy for fair value. In recent months, however, the statutory command received more attention from the Court of Chancery and practitioners, and the Supreme Court has now clearly endorsed that approach.

The Supreme Court's adoption of the merger-price-less-synergies approach can be expected to further accelerate the recent significant decline in appraisal petitions. In appraisal cases involving arm's-length mergers, determining fair value based on the merger-price-less-synergies will, obviously, almost always produce an appraisal result that is below (or at) the deal price. (The only exception, possibly, would be the highly unusual case where there are "negative" synergies--that is, costs of the merger, that exceed the expected synergies.) At-or-below-the deal price appraisal results will, of course, severely limit the incentive for stockholders to exercise appraisal rights in arm's-length merger cases. Even before *Aruba*, based on the courts' emphasis on the deal price in determining fair value (albeit without clarity as to the need to deduct the value of merger synergies), appraisal petition filings decreased significantly--down 66% in 2018 from 2017, after steady increases every year from 2009 through 2016.

The Supreme Court rejected the Court of Chancery's novel approach in *Aruba* of relying on the "unaffected market price" to determine appraised fair value. The Court of Chancery had concluded, based on the Supreme Court's emphasis on the reliability of market-based indications of value in *DFC Global* and *Dell*, that there were two reasonable methods of valuation for Aruba: the deal-price-less-synergies or the average market price of the Aruba stock for the 30 days prior to news of the transaction leaking to the media. The Court of Chancery viewed the latter as more reliable than the former primarily because it involved fewer uncertainties in calculation. The Supreme Court rejected that conclusion. The Supreme Court acknowledged that the merger-price-less-synergies approach involves uncertainties in estimating the value of synergies and the amount of synergies "included in the purchase price." However, this inherent "imprecision" is no greater than that involved in other valuation methodologies, the Supreme Court stated (noting that a DCF analysis requires estimates of future free cash flow, the weighted cost of capital, and the perpetuity growth rate). The Supreme Court explained that its references to "market efficiency" in *Dell* were focused on "informational efficiency--the idea that markets quickly reflect publicly available information and can be a proxy for fair value--not the idea that an informationally efficient market price invariably reflects the company's fair value in an appraisal or fundamental value in economic terms."

The Supreme Court rejected the Court of Chancery's method of calculating merger-price-less-synergies--and accepted the respondent company's estimate. *Aruba* is one of only less than a handful of cases in which the Court of Chancery has actually calculated an adjustment to deduct synergies from the deal price (although, as discussed, the court decided to rely instead on the unaffected market price). To calculate deal-price-less-synergies, the Court of Chancery started with an estimate of the total amount of all of the synergies HP expected to realize (based on HP's own planning estimates). Then, to determine how much of the value of those synergies HP had included in the deal price, the court took the midpoint of a study that suggested that "on average, sellers collect 31% of the capitalized value of synergies, with the seller's share varying widely from 6% to 51%." The Supreme Court rejected the Court of Chancery's calculation and instead accepted Aruba's calculation--on the basis that the Court of Chancery had not "explain[ed] why [its] estimate of $18.20 per share was more reliable than Aruba's own estimate of $19.10 per share." Moreover, the Supreme Court found that Aruba's estimate was "well corroborated" by the record--specifically, by the DCF analyses that Aruba and HP had relied on when agreeing to the transaction (which reflected a midpoint in the range of values for Aruba of about $20 and $21, respectively).

The Supreme Court clarified certain issues relating to a calculation of merger-price-less-synergies.

- ***No deduction for reduced agency costs.*** The Supreme Court rejected the Court of Chancery's view that the calculation of merger-price-less-synergies requires a deduction of "theoretical reduced agency costs" beyond any agency cost reductions specifically included in the expected merger synergies. As such a deduction would be based on the theory that a "concentration of ownership" resulting from an acquisition creates value by permitting a better alignment of the interests of the owners and the managers, the deduction would be inapplicable in a case, such as *Aruba*, where the merger simply results in the substitution of one group of public stockholders (Aruba's) for another (HP's). Notably, the Supreme Court suggested that its view could be different in the case of an acquisition by a private equity firm (where there actually would be a concentration of ownership).

- ***Deduction for synergies.*** It has been an open issue whether, when excluding value "arising from the merger itself," the court should exclude the value only of synergies arising uniquely from the particular merger at issue or also the synergies that would arise from *any* merger. The Supreme Court (without discussion) wrote in *Aruba* that it interprets the statutory command "as ruling out consideration of not just the gains that the *particular merger* will produce, but also the gains that might be obtained from *any merger*" (emphasis added).

- ***Judicial valuation of synergies.*** The Supreme Court's acceptance of the buyer's estimate of the value of merger synergies *may* suggest that, at least in some cases (for example, where, as in *Aruba*, the court views the buyer's estimate as having corroboration in the record), a *judicial* valuation of merger synergies is not necessarily required.

Open issues remain relating to the calculation of merger-price-less-synergies--but they are likely to remain unresolved as appraisal cases involving arm's-length mergers become increasingly rare. Remaining open issues include (i) whether any part of a control premium included in the deal price (beyond that reflecting the value of synergies) should be deducted from the deal price and (ii) whether any of the expected synergies that could be achieved by the target company *on a standalone basis* should *not* be deducted from the deal price (on the theory that that value would not "arise from the merger itself" but would be inherent in the company's going concern value). We surmise that, as appraisal actions involving arm's-length mergers (without clearly, seriously flawed sale processes) are likely to become increasingly rare, these open issues may effectively become moot, without resolution by the court.

***Aruba* is another example of the Delaware courts considering a sale process without competition as sufficiently robust for purposes of reliance on the deal price.** Reliance on the merger price in appraisal cases has been predicated on the merger price having been negotiated at arm's-length in a "robust sale process." The Court of Chancery, which has provided only limited definition of the phrase, initially emphasized the concept of "meaningful competition" in the sale process. However, the Court of Chancery has found the merger price to be fully reliable even in the context of some fairly limited sale processes--including where there was not any actual competition, so long as the sale process was designed to promote or not be prohibitive of competition. Consistent with this approach, in *Aruba*, the Court of Chancery found the targeted, non-public sale process, with no competing bidder, to have been sufficiently robust. The sale process involved six strategic parties being contacted pre-signing, with none of them expressing interest; a merger agreement that (as is customary) prohibited post-signing shopping (but included a fiduciary out for a superior offer and a non-prohibitive termination fee); internal HP analyses that estimated the pro forma value of Aruba as potentially as high as $32.50 per share (while the deal price was $24.65); negotiations that were conducted against a backdrop of conflicts of interest by Aruba's management and bankers (as the lower court found that HP had engaged the CEO in discussions about post-merger employment and that the bankers "catered to" HP, likely to curry favor with HP for future business); and a 52-week low for Aruba's stock which, according to Aruba's bankers, was due to a "misperception in the market" that the company was going to miss quarterly estimates, which the company actually was on track to, and then did, meet.

The Court of Chancery observed in *Aruba* that the purpose of appraisal is not to ensure that dissenting stockholders receive the "highest possible" that would have been obtainable in the merger, but only to ensure that the stockholders were not "exploited" in the merger (which, the court stated, is clearly not the case when, in an arm's-length merger, the deal price represents a significant premium, as was the case in *Aruba*). The Supreme Court noted that the *Aruba* merger agreement effectively allowed for a passive post-signing market check and that financial buyers were not solicited because the board viewed them as unable to compete given the high level of synergies in the HP deal. Further, the Supreme Court observed: "Of course, 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."

Thus, while the courts have not specifically articulated the relationship between the *Revlon* standard and the "robust sale process" standard, *Aruba* suggests that "robust sale process" is a *lower* standard (which is unsurprising, given that appraisal actions do not require or entail a predicate finding of fiduciary breach). It appears, however, that as a practical matter a near confluence of the two standards is developing--given the erosion in recent years of the *Revlon* standard under, for example, the Delaware Supreme Court's *C&J Energy* decision (which made clear that the *Revlon* standard of seeking to obtain the best price reasonably obtainable can be satisfied even without solicitation of competing bids if there is an effective passive-only post-signing market check).

(We note that an exception to the generally low standard for “robust”-ness of the sale process applied by the Court of Chancery in appraisal cases is Vice Chancellor Glasscock’s *AOL* decision--which was issued just days after the Court of Chancery’s *Aruba* decision. In *AOL*, the Court of Chancery found that a flawed sale process--albeit, we would note, one that appears at first blush to have been more robust than that in *Aruba*--was *not* sufficiently robust to support reliance on the deal price. In finding the sale process not reliable, Vice Chancellor Glasscock emphasized the comments made by AOL’s CEO, post-signing, to the effect that the “deal was done,” the buyer was the “natural” buyer, and AOL was fully “committed” to seeing the deal through to closing. The court characterized these comments as “unusually preclusive” in their likely effect on the emergence of potential topping bids. *See* “What constitutes a “robust” sale process for appraisal purposes?” in our Fried Frank M&A/PE Briefing, *When Appraisal Is Likely to Be Below the Deal Price in Arm’s-Length Mergers…and When It Is Not* (March 14, 2018).)

Above-the-deal-price appraisal results may still occur in cases involving *non*-arm’s-length mergers or arm’s-length mergers with a *seriously* flawed sale process. In these contexts, the courts have relied, and can be expected to continue to rely, on the discounted cash flow methodology to determine fair value. Historically, appraisal results based on DCF analyses were above (often well above) the deal price. The variability of possible DCF results (given the many subjective inputs) explains why appraisal results in *non*-arm’s-length merger cases generally would be *above* the deal price notwithstanding that the deal may be synergistic (and the DCF methodology would not take the synergies value into account while the deal price would include it). In our view, *Aruba*, because of its focus on the deduction of the value of synergies from fair value, will help to justify (and therefore likely will reinforce the recent trend of) DCF-based appraisal results that have been near or *below* the deal price (*see*, for example, the 2017 *Sprint-Clearwire* appraisal decision, where the court explained a well-below-the-merger-price DCF result as attributable to the significant synergies expected from the deal, and, as the most recent example, the February 28, 2019 *Trussway* decision).

Practice Points

- ***Aruba* underscores the minimization of appraisal risk that accompanies a transaction that is viewed by the court as negotiated at “arm’s-length” in a “robust” sale process.** Accordingly, consideration should be given, where practicable, to efforts to avoid characterization of a buyer as a “controller” and to meet the (hardly stringent) standard of “robust”-ness in the sale process suggested in *Aruba* and other recent decisions.

- ***Arm’s-length transactions.*** In an appraisal proceeding relating to an arguably arm’s-length merger, a respondent company should:

    - ***Synergies:*** Argue for reliance on the deal-price-less-synergies to determine fair value;

    - ***Record:*** Maintain (and provide to the court) an adequate record relating to the buyer’s anticipated synergies and negotiations with respect to sharing the value of synergies with the target stockholders; be prepared that the court, for corroboration, may look to the DCF analyses the parties relied on when agreeing to the transaction; and understand that public disclosure about expected synergies may be used as evidence in an appraisal proceeding;

- ***"Agency costs":*** In calculating the deal-price-less-synergies, *not* deduct from the deal price value based on a theoretical reduction in "agency costs"--except in the case of a private equity buyer (*see* the discussion above);
- ***"Negative" synergies:*** Be aware that the petitioners may assert that there are "negative synergies" (*i.e.*, negative effects or costs of the merger) that might mitigate any downward adjustment of the deal price to satisfy the statutory command to exclude value arising from the merger itself (this issue has been addressed only once that we know of--in the Court of Chancery's 2017 *SWS Group* appraisal decision, where the court expressed the view that positive synergies would have to be offset by any "negative synergies");
- ***Control premium:*** Consider arguing for a deduction from the deal price of any "control premium" included in the sale price beyond that payable with respect to expected merger synergies; and
- ***Post-signing developments:*** Consider whether there were positive or negative developments at the target company between signing and closing that may affect fair value (given that fair value is measured as of the time immediately preceding the merger closing).

- ***<u>Non</u>-arm's-length transactions:* MFW *and bankers' third-party sale valuation analyses.*** As noted, in the context of *non*-arm's-length transactions (such as controller take-privates), the courts have relied on the DCF methodology to determined appraised fair value. Although there has not yet been a case addressing the issue, we would expect that in a non-arm's-length transaction that is *MFW*-compliant the court would rely on the deal price to determine appraised fair value, given that the *MFW* prerequisites are designed to replicate an arm's-length transaction. It is also an open question whether, in a controller take-private that is not *MFW*-compliant, and where the controller indicates that it is only a buyer and not a seller, a court might take board consideration of banker analyses of third-party sale value into account as another permissible valuation to be accorded some weight (in addition to the DCF analysis) in determining fair value--given that, in *MFW*, the court emphasized the careful and extensive consideration by the special committee of the bankers' analyses of third party sale value.

*   *   *

<u>Fried Frank M&A/PE Group</u>:

Andrew J. Colosimo
Warren S. de Wied
Steven Epstein
Christopher Ewan
Arthur Fleischer, Jr.*
Andrea Gede-Lange
David J. Greenwald
Erica Jaffe
Randi Lally
Mark H. Lucas
Scott B. Luftglass
Brian T. Mangino
Shant P. Manoukian
Amber Meek
Philip Richter
Steven G. Scheinfeld
Robert C. Schwenkel
David L. Shaw
Peter L. Simmons
Matthew V. Soran
Steven J. Steinman
Gail Weinstein*
Maxwell Yim

This Briefing is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this Briefing, please call your regular Fried Frank contact or an attorney listed below:

Contacts:

New York

Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Erica Jaffe	+1.212.859.8442	erica.jaffe@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Shant P. Manoukian	+1.212.859.8617	shant.manoukian@friedfrank.com
Amber Meek	+1.212.859.8522	amber.meek@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com
Maxwell Yim	+1.212.859.8214	maxwell.yim@friedfrank.com

Washington, D.C.

Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com

*Senior Counsel