M&A Update

A Trio of Delaware Decisions Discount Deal Price In Appraisal Litigation

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In a trio of appraisal decisions, Delaware courts declined to use the deal price as the best evidence of fair value, instead using discounted cash flow analyses ("DCF") and the unaffected market price to determine fair values below the merger consideration. Building on the trend reflected in the Delaware Supreme Court's high-profile 2017 decisions in *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd*. and *DFC Global Corp. v. Muirfield Value Partners* (discussed in our 2017 year-in-review), *L.P.*, the Delaware Court of Chancery's recent decisions in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*[1] and *In re Appraisal of AOL Inc.*,[2] and the Delaware Supreme Court's decision in *Merlin Partners, L.P. v. SWS Group, Inc.*[3] further underscore the ability of companies and their boards to successfully contest dissenting shareholders seeking appraisal.

Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.

On February 15, 2018, Vice Chancellor J. Travis Laster of the Delaware Court of Chancery issued a lengthy post-trial decision in *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, a statutory appraisal proceeding arising out of the Hewlett-Packard Company's ("HP") May 2015 acquisition of Aruba Networks, Inc. ("Aruba") for $24.67 per share. The Court held that Aruba's 30-day unaffected stock price of $17.13 per share, 30.6% less than the deal price, was the most reliable indication of fair value despite Aruba's status as a widely held, publicly traded company that was sold in an arm's-length transaction. In making its determination, the Court stated that it was following the Delaware Supreme Court's preference for market indications in *Dell* and *DFC* and, in the presence of reliable market indicators, courts "should be chary about imposing the hazards" of human judgment, such as expert and DCF analyses.

Vice Chancellor Laster considered three valuation methods for Aruba advanced by the parties: (i) the deal price; (ii) competing DCF analyses advanced by each side's expert; and (iii) Aruba's unaffected market price. With respect to deal price, the Court observed the "heavy, if not overriding, probative value" given to deal price under *Dell* and *DFC* where a widely held, publicly

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

[2] No. CV 11204-VCG, 2018 WL 1037450 (Del. Ch. Feb. 23, 2018).

[3] No. 295, 2017 (Del. Feb. 23, 2018).

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traded company is sold in an arm's-length transaction, as was the case with Aruba. According to Vice Chancellor Laster, the HP-Aruba merger "looks like a run-of-the-mill, third-party deal. Nothing about it appears exploitive." The Court rejected the petitioner's attempt to undermine the deal price by showing a lack of competition, relying on *Dell* and *DFC* to hold that, to the contrary, "the lack of competition supports the reliability of the deal price." The Court observed that, for a challenge based on a lack of competition to be successful, the petition "should be able to point to a likely bidder and make a persuasive showing that increased competition would have led to a better result." The Court also was unpersuaded by arguments regarding deficiencies in the performance of Aruba's financial advisors. While acknowledging that "the petitioners proved that Aruba's bankers catered to HP," including evidence that Aruba's financial advisors sought to leverage the transaction to gain future business from HP, the Court held "that is not enough to call into question the deal price for purposes of appraisal." According to the Court, "[i]n a scenario where the underlying market price is reliable, competition and negotiation become secondary." Quoting *Dell*, Vice Chancellor Laster further explained that "[t]he issue in an appraisal is not whether a negotiator has extracted the highest possible bid. Rather, the key inquiry is whether the dissenters got fair value and were not exploited."

However, because the transaction generated "substantial synergies," which under the Delaware appraisal statute must be excluded from the determination of fair value, the Court calculated its own deal-price-less synergies estimate of approximately $18.20 per share. Nonetheless, it found that estimate to be a "judgment-laden exercise" subject to potential human error, including imperfect synergy predictions and estimated allocation of synergies to the sell-side of the transaction. Additionally, the deal-price-less-synergies estimate still included "value derived from the merger itself" in the form of reduced agency cost (*i.e.*, a "control premium"). Accordingly, the Court held that the deal-price-less-synergies estimate was not the best indicator of fair value.

The Court also rejected the DCF valuations put forth by the parties' experts, who argued that the fair value of Aruba was either $32.57 (plaintiffs) or $19.75 (Aruba). Relying on *Dell*, the Court observed that "this appraisal case does not present the classic scenario in which there is reason to suspect that market forces cannot be relied upon to ensure fair treatment of the minority."

Vice Chancellor Laster therefore determined that the fair value of Aruba shares was the unaffected market price, which, under the efficient capital markets hypothesis, "provides a direct route to the same endpoint, at least for a company that is widely traded and lacks a controlling stockholder." Although the Court observed that neither party offered experts to testify on the efficiency of the market for Aruba stock, the Court was persuaded that the Aruba market "had basic attributes" of efficient markets recognized in *Dell* and *DFC*, including shares traded on a public exchange, lack of a controlling shareholder, coverage by a group of seasoned securities analysts, a high weekly trading volume, and a bid-ask spread that was indicative of market efficiency.

On February 20, 2018, the plaintiffs filed a motion for reargument pursuant to Court of Chancery Rule 59(f), which the Chancery Court subsequently rejected. The Chancery Court's decision is currently pending appeal to the Delaware Supreme Court.

Merlin Partners, L.P. v. SWS Group, Inc.

On February 23, the Delaware Supreme Court affirmed the Delaware Court of Chancery's determination of fair value in *In re SWS Group Inc.* and adopted its findings in a two-page opinion. The plaintiffs filed an appraisal action in connection with Hilltop Holdings, Inc.'s 2015 acquisition of SWS Group, Inc. ("SWS") for $6.92 per share in cash and stock. Vice Chancellor Glasscock applied a DCF analysis to determine a fair value of $6.38 per share, significantly below the merger consideration.

As we discussed in our analysis of the case last year, the Court assigned no weight to the merger consideration because (i) neither party relied on it for their fair value calculations, and (ii) the Court found the merger consideration to be unreliable due to a "problematic process," including a credit agreement that in certain circumstances granted Hilltop a veto over competing offers. Instead, the Court considered DCF analyses offered by both parties. The Court used its own DCF analysis to exclude merger-related synergies and held that the fair value was $6.38 per share. According to the Court, that figure was "not surprising" because the deal was a "synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS." The Court did not address the efficiency of the market for SWS stock or whether the market price of SWS stock prior to announcement of the transaction was a superior indicator of fair value in such a synergies-driven transaction because the parties did not advocate for appraisal value on the basis of market price.

In re Appraisal of AOL, Inc.

On February 23, 2018, Vice Chancellor Glasscock issued a post-trial decision in *In re Appraisal of AOL Inc.*, deciding an appraisal proceeding that arose out of Verizon Communications Inc.'s June 2015 acquisition of AOL Inc. ("AOL") for $50 per share. The Court declined to use the deal price as determinative of fair value, and instead conducted a DCF analysis to determine a fair value of $48.70, more than 2% below the deal price.

In determining whether the deal price should be accorded weight in the calculation of fair value, Vice Chancellor Glasscock first evaluated whether the deal was "*Dell* Compliant." According to the Court, a transaction is "*Dell* Compliant" where "(i) information was sufficiently disseminated to potential bidders, so that (ii) an informed sale could take place, (iii) without undue impediments imposed by the deal structure itself." Vice Chancellor Glasscock observed that "before [the Court] may consider the deal price as persuasive evidence of statutory fair value, [it] must find that the deal process developed fair market value."

The Court found the matter of whether the transaction was "*Dell* Compliant" to be a "close question." On the one hand, the Court found the front-end market canvas sufficient, including

because the company was "traded frequently," "well-covered by analysts," "widely known to be in play" and AOL engaged numerous potential purchasers in discussions, several of which performed due diligence. The Court was untroubled by the decision made by AOL's Board of Directors not to run an auction, finding that decision to be "reasonable" in light of the "dynamics" of the technology industry in which running an auction may affect a company's relationship with business partners and impair talent acquisition. In addition, the Court found that the agreement was unlikely to preclude another interested suitor given that there was not a prohibitive termination fee and AOL's independent directors appeared to run a process in compliance with their fiduciary duties.

On the other hand, the post-agreement process concerned the Court, including the merger agreement's inclusion of a "no-shop" and Verizon's unlimited three-day matching right with respect to superior bids, as well as Verizon's lengthy access to the data room, which could create an "informational and structural" disadvantage for other prospective bidders. Importantly, the Court also observed that AOL's CEO publicly made "unusually preclusive statements," including comments that he was "committed to doing the deal with Verizon" because he "gave the team at Verizon my word that, you know [w]e're in a place where this deal is going to happen and we're excited about it." According to the Court, the CEO's comments, together with the CEO's prospects of continued employment with the combined company, "signaled to potential market participants that the deal was 'done,' and that they need not bother making an offer." The Court held that the CEO's "declared intent" to "consummate a deal with Verizon," in combination with the other post-agreement factors, created a "considerable risk of informational and structural disadvantages dissuading any prospective bidder." Accordingly, the Court held that the deal price was not the best evidence of fair value, and determined to use the merger consideration as "'a check' on [its] analysis, while granting it zero explicit weight." The Court pledged to "revisit [its] assumptions" should the discounted cash flow analysis result "in a valuation grossly deviant from deal price."

While acknowledging Vice Chancellor Laster's recent opinion in *Aruba*, the Court explained that it did not consider AOL's unaffected market price because no party advocated for such a valuation or produced evidence that the market for AOL stock was efficient. Based on its DCF analysis, which largely relied on the analysis of AOL's expert with a few adjustments, the Court determined that the fair value for AOL stock at the time of the merger was $48.70, a value lower than the $50 per share deal price. The Court addressed the apparent incongruity in holding that the deal process was inadequate to warrant deal price deference while also holding that the fair value of AOL's stock was *below* the merger consideration, explaining that "a deal price may contain synergies that have been shared with the seller in the deal but that are not properly included in fair value."

On March 2, the plaintiffs and defendants filed separate motions for reargument. Both parties contend that the Court made computational errors in its DCF analysis by using allegedly improper

assumptions, with plaintiffs asserting that the proper calculations would lead to a fair value of $51.98 per share and defendants advocating for a $45.54 per share value.

Takeaways

- Unaffected Market Price, Deal Price, and DCF Analysis Are All on the Table. Appraisal litigants should offer evidence regarding all possible indicators of fair value, including the unaffected market price, deal price and DCF analyses. In *AOL*, Vice Chancellor Glasscock stated that he would not use the unaffected trading price as the measure of fair value because none of the parties advocated for its application. Had the defendants submitted such evidence, the Court may have determined the fair value of AOL's shares at the unaffected trading price of $42.59 per share rather than $48.70 per share derived from DCF analysis. In *Aruba*, Vice Chancellor Laster observed that litigants may retain experts to offer testimony regarding the efficient capital markets hypothesis, as is common in federal securities law actions to invoke the presumption of reliance associated with the fraud-on-the-market theory. Furthermore, given the seemingly contradictory approaches taken in *Aruba* and *AOL* with respect to scrutiny of the deal process in determining which methodology to use in calculating fair value, litigants would be well-served to ensure that they put forth strong arguments for each possible indicator.
- Appraisal Arbitrage Offers Diminishing Returns for Plaintiff Stockholders. In 2017, we observed that appraisal litigation should no longer be viewed as a win-win proposition for plaintiffs, as Delaware courts determined fair values below the merger consideration through DCF analyses and the exclusion of synergy-driven value. The recent embrace by the Court of Chancery of the unaffected market price as an indicator of fair value only increases the ability of companies and their boards to resist appraisal claims. Furthermore, defendants in appraisal cases have increasingly sought to benefit from their ability to prepay a portion of the amount in question in the appraisal proceeding, thus cutting off the plaintiffs' right to the generous statutory interest payments they would otherwise be entitled to on such amounts upon a final determination of fair value. As a result, and given the unpredictability of the potential outcome, stockholders may think twice before bringing appraisal cases in the future. Thus, these rulings may have a chilling effect on stockholders' reliance on appraisal actions to seek increased transaction consideration. Instead, stockholders and merger arbitrageurs that perceive a value gap with respect to a particular transaction may be more likely to seek increased consideration through private and public engagement with the seller and its stockholders prior to a vote of the seller's stockholders on the transaction.
- Deals Must Be *Dell* Compliant to Rely on Deal Price; But What Is *Dell* Compliant? In *AOL*, Vice Chancellor Glasscock announced a three factor-test to evaluate the sale, judging that a transaction is "*Dell* Compliant" where "(i) information was sufficiently disseminated to potential bidders, so that (ii) an informed sale could take place, (iii) without undue impediments imposed by the deal structure itself." Companies must heed these criteria to keep deal price on the table as a viable indicator of fair value. There, the Court pointed to fairly standard deal protection provisions in the merger agreement (*e.g.*, a no-shop and a matching right), combined with

certain preclusive post-signing statements made by AOL's CEO and the AOL CEO's promise of future employment with the combined company to support its holding that the transaction was not *Dell* Compliant, and thus the deal price could not be relied upon. In contrast, in *Aruba* Vice Chancellor Laster held that "the *Dell* test turns on exploitation" and that "the purpose of an appraisal 'is not to make sure that the petitioners get the highest conceivable value,'" but instead to ensure that the transaction was not "exploitive" to the target's stockholders. Vice Chancellor Laster went on to conclude that "in a scenario where the underlying market price is reliable, competition and negotiation become secondary," noting that "under those circumstances, an arm's-length deal at a premium over the market price is non-exploitive." Again, these types of unpredictable outcomes may result in fewer appraisal cases being brought and less certainty about their outcome, absent additional clarity from the Delaware Supreme Court.

- Directors and Officers Are on the Record. Directors and officers should take care to avoid statements that appear to signal to potential competing bidders that the transaction is a *fait accompli*, which may have the effect of foreclosing topping bids. These types of statements will be given even more weight where the individual making the statement is particularly influential and has other potential conflicts of interest that would motivate him or her to complete a particular transaction, such as a promise of future employment. While this type of behavior should be avoided generally, the *AOL* case highlights an additional risk associated with these types of statements; namely that a Court may decline to pay deference to the deal price in an appraisal action. Indeed, the Court in *AOL* concluded that post-signing comments by AOL's CEO were "unusually preclusive," including his statement that, "I gave the team at Verizon my word that, you know, [w]e're in a place where this deal is going to happen and we're excited about it."
- Appraisal Actions May Result in Fair Value Calculations Below the Deal Price Due to the Disregarding of Synergies and Reduced Agency Costs in the Fair Value Calculation. The *Aruba*, *SWS,* and *AOL* decisions confirm the very real risk that the appraisal value may be less than deal price due to the elimination of synergies and reduced agency costs from the calculation of fair market value. Appraisal challenges to strategic transactions, which are often driven, at least in part, by synergies, appear to be especially ripe for companies to make this argument as merger created value must be deducted from fair value under Delaware's appraisal statute. Appraisal challenges to "*Dell* Compliant" transactions, where the deal price is deemed to offer the best evidence of fair value, are also particularly susceptible to these types of below deal price valuations. The *Aruba* case highlights each of these points as a strategic transaction that was deemed to be "*Dell* Compliant" by the Court. In such a scenario, it would be the rare circumstance where the fair value determined for appraisal purposes would exceed the deal price, as synergies and reduced agency costs will need to be backed out of the deal price to determine fair value. In *AOL*, while the Court did not find the deal price to be persuasive, the Court stated that one factor driving the fair value below the deal price may have been "synergies that have been shared with the seller in the deal but that are not properly included in the fair value." Similarly, in *SWS*, the Court found that a fair value lower than the deal price was "not

surprising" in "a synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS." Accordingly, companies may be emboldened to vigorously contest appraisal claims challenging transactions that included substantial merger-created value, such as synergies and reduced agency costs, as such transactions very well may result in a determination of a fair value below the deal price.

- Plaintiffs Seeking Appraisal Should Consider Changes to the Business of the Target Between Signing and Closing to Overcome Deference to Deal Price. The Court in *Aruba* reminded litigants that "if the value of the corporation changes between the signing of the merger and the closing, the fair value determination must be measured by the 'operative reality' of the corporation at the effective time of the merger." Thus, a shareholder seeking appraisal may be able to overcome the deference provided to the deal price or the unaffected market price resulting from an "efficient market" and a "*Dell* Compliant" transaction if it can prove that the fair value of the target as of the closing is in excess of the deal price as a result of events arising between signing and closing.

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Questions regarding this M&A Update can be directed to your Cadwalader contact or to any of the following attorneys.

Joshua Apfelroth	+1 212 504 6391	joshua.apfelroth@cwt.com
Richard Brand	+1 212 504 5757	richard.brand@cwt.com
Nathan Bull	+1 212 504 5973	nathan.bull@cwt.com
Jason Halper	+1 212 504 6300	jason.halper@cwt.com
William P. Mills	+1 212 504 6436	william.mills@cwt.com
William Simpson	+1 212 504 6199	william.simpson@cwt.com
Jared Stanisci	+1 212 504 6075	jared.stanisci@cwt.com
Marianna Wonder	+1 212 504 6155	marianna.wonder@cwt.com