The Treatment of Synergistic Value in Dissenting Shareholder Appraisal Rights Matters

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The Delaware Court of Chancery decisions on the treatment of synergistic value in dissenting shareholder appraisal rights cases provide meaningful guidance to valuation analysts ("analysts"), legal counsel ("counsel"), and other courts. This discussion focuses on recent judicial decisions issued by the Delaware Court of Chancery where synergistic value was a consideration in a dissenting shareholder appraisal rights matter. This discussion provides insights related to the treatment of synergistic value within the context of a statutory appraisal rights fair value controversy.

Introduction

The Delaware Court of Chancery (the "Chancery Court") is known for providing legal guidance related to business disputes. The Chancery Court is considered by many to be a preeminent forum for business law matters. That is because, the Chancery Court chancellors are experienced in overseeing business dispute actions and other business-related matters.

In other words, the Chancery Court has become an authoritative voice on matters relating to business valuation and security analysis. Counsel and analysts often review Chancery Court opinions for guidance on valuing business interests for purposes of dissenting shareholder appraisal rights actions.

The Chancery Court is a nonjury trial court, and it hears all matters relating to equity. The Chancery Court primarily adjudicates cases related to trusts, real property, guardianships, and commercial litigation.

A typical issue in many shareholder disputes is the interpretation of fair value. Fair value is defined in the Delaware court system as a value that is

> exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation . . . In determining such fair value, the Court shall take into account all relevant factors.[1]

In a recent judicial decision, the Chancery Court ruled that, in a fair value matter, its "Ultimate goal in an appraisal proceeding is to determine the 'fair or intrinsic value' of each share on the closing date of that merger."[2] Pursuant to this, the Chancery Court observes the premerger company as a "going concern"[3] and stand-alone entity. Furthermore, the Chancery Court has stated that it should exclude "any synergies or other value expected from the merger giving rise to the appraisal proceeding."[4]

DFC Global and *Dell*

Recently, in two Delaware Supreme Court ("Supreme Court") decisions, the valuation opinions issued by the Chancery Court were reversed and remanded. These two judicial decisions are *DFC Global Corporation v. Muirfield Value Partners,*

L.P. ("*DFC*") and *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd.* ("*Dell*").

In *DFC*, an appraisal action was sought after DFC Global Corporation ("DFC Global"), a publicly traded company, was bought by a private equity fund.

In the initial decision issued by the Chancery Court, the court arrived at fair value by applying equal weight to the discounted cash flow method, comparable company analysis, and the transaction price. According to the Chancery Court, each of the valuation methods applied in *DFC* suffered from limitations arising from the tumultuous regulatory environment around DFC Global leading up to its sale.[5]

Because of these perceived limitations, the Chancery Court weighted each method equally. The Chancery Court arrived at a value for DFC Global stock that was approximately 8 percent higher than the transaction price.[6]

On appeal, the Supreme Court reversed and remanded the *DFC* matter back to the Chancery Court. According to the Supreme Court, in *DFC*, the purpose of the fair value judicial determination "is not to make sure that the petitioners get the highest conceivable value," but rather "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 in an arm's length transaction."[7]

The Delaware Supreme Court found that "market prices are typically viewed superior to other valuation techniques, because unlike, for example, a single person's discounted cash flow model, the market price should distill the collective judgement of the many based on all the publicly available information about a given company and the value of its shares."[8]

Although market price data are typically considered to provide superior price indications, the Supreme Court cautioned that this is not always the case—such as in matters involving a less than robust sale process.

Following the *DFC* decision, the Delaware Supreme Court provided similar guidance in its appraisal opinion in the *Dell* matter. In its original opinion, the Chancery Court found confidence in and completely relied on the discounted cash flow method. The Chancery Court applied zero weight to the market indicators (i.e., unaffected stock price and deal price).

The Supreme Court overturned the Chancery Court decision by way of it finding that the market for the Dell publicly traded stock was efficient—that is, the Dell sale process was efficient. The Supreme Court ruled that the Chancery Court erred by disregarding the Dell transaction pricing.

Regarding the Dell transaction deal price, the Delaware Supreme Court found that "it is clear that Dell's sale process bore many of the same objective indicia of reliability" as the one in *DFC*.[9]

The Supreme Court summarized its decision to rely on the deal price in this case as follows:

> In so holding, we are not saying the market is always the best indicator of value, or that it should always be granted some weight. We 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 Mr. Dell'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 shareholders, analysts, and potential buyers abuses even the wide discretion afforded the Court of Chancery in these difficult cases.[10]

The Supreme Court decisions suggest that efficient market principles tend to support negotiated market price transacted values. However, the deal price is only reliable when a robust sales process has taken place. These principles are discussed in the following paragraphs.

The conditions by which a subject matter fair value is estimated and the methodology applied are essential considerations in determining if a value indication includes synergies. For certain matters, the Chancery Court—and analysts—may need to determine:

1. if synergies influenced transaction pricing and how to quantify them and
2. the most appropriate valuation method to apply and which data to rely on in order to yield fair value so not to include synergistic value in the value determination.

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

In *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.* ("*Verition*"), the Chancery Court addressed an issue that was not addressed in *DFC* or *Dell*. In *Verition*, the subject transaction pricing included certain economic synergies.

As can sometimes be the case, the opposing analysts arrived at materially different estimates of fair value. As a result, the Chancery Court was tasked

with deciding the best indicator of fair value in a synergy-driven transaction.

Background of the Case

In May 2015, Hewlett-Packard Company ("HP") acquired Aruba Networks ("Aruba") through a merger transaction. According to the transaction merger agreement, shareholders of Aruba common stock received $24.67 per share. Following the merger transaction announcement, the petitioners invoked their statutory right to forgo the merger consideration and to seek an appraisal for the fair value of their Aruba stock.[11]

Prior to the merger talks with HP, Aruba's publicly traded stock price was pressured following the release of its third quarter of 2014 performance results. In May of 2014, Aruba announced that it had exceeded its own revenue guidance and the Wall Street consensus estimates. However, Aruba also announced that its gross profit margin was 70.5 percent, which was 1.5 percent below consensus estimates and Aruba's own target of 71.0 percent to 73.0 percent.

Following the announcement, the Aruba stock price decreased by 12.1 percent from $20.06 to $17.63 per share.[12]

Because of the profit margin underperformance, Aruba management developed a cost optimization plan called "Project Greyhound."

In August of 2014, Aruba announced its fourth quarter and fiscal year 2014 results. In fiscal year 2014, Aruba achieved record revenue. Aruba's chief executive officer Dominic Orr told investors that the company had achieved "significant market share gains" and had a "strong platform for future growth."[13]

At the same time, Aruba announced its Project Greyhound cost optimization plan to its investors. Following these announcements, the Aruba stock price increased by 8.7 percent, from $20.24 to $22.01. Shortly after the announcements, HP approached Aruba regarding a potential merger transaction. After a series of negotiations, the companies formally announced the merger transaction on March 2, 2015.

Synergistic Value

At trial, both analysts in the *Verition* case applied a discounted cash flow method that incorporated some synergistic value to conclude a fair value of Aruba stock. In the *Verition* opinion, Vice Chancellor Laster stated that "the *Dell* and *DFC* decisions recognize that a deal price may include synergies and endorse deriving an indication of fair value from the deal price by deducting synergies."[14]

The Chancery Court has recognized the difficulty in quantifying synergies in these types of cases. For example, in *Union Illinois*,[15] Chief Justice Strine (a Vice Chancellor at the time) discounted the transaction deal price by 13 percent to reflect synergies captured by the seller. In another Chancery Court matter, *Highfields*,[16] Vice Chancellor Lamb concluded that the respondent analysts' shared synergies of 25 percent were too high and ultimately settled on a synergistic value per share that resulted in a 13 percent discount.

In *Verition*, during the course of the merger transaction negotiations and the appraisal action, a range of synergy estimates emerged. The HP deal team anticipated $1.4 billion in synergistic value due to the transaction. McKinsey and Company, the transaction financial advisor to HP, projected $1.6 billion in synergies from the transaction. In the instant case, Vice Chancellor Laster considered applying a 13 percent discount for synergies based on the guidance provided by the *Union Illinois* and *Highfields* cases.

However, the Vice Chancellor relied on a study by the Boston Consulting Group that was cited by Aruba's analyst. The Boston Consulting Group study advised that sellers collect 31 percent of the capitalized value of synergies, with the sellers share varying widely from 6 percent to 51 percent.[17]

Ultimately, Vice Chancellor Laster concluded that a fair value based on the (1) the deal price less (2) synergies value was equal to (3) $18.20 per share. The discount from the transaction pricing was based on the midpoint of the Boston Consulting Group range of estimates. The other indication of fair value that Vice Chancellor Laster considered in *Verition* was the Aruba 30-day unaffected market price of $17.13.

In *Verition*, Vice Chancellor Laster provides guidance related to two issues with applying the deal-price-less-synergies indication of value:

1. The calculation of the value may have "errors at multiple levels."[18]
2. The "deal-price-less-synergies figure continues to incorporate an element of value resulting from the merger."[19]

In his discussion of the first issue, Vice Chancellor Laster cites several factors. These factors include (1) a possible misinterpretation of the synergy data provided by the Aruba analyst, (2) a possible error in making a case-specific allocation of synergies to the sell-side, and (3) possible errors in the data itself as reasons why a "judgement-laden exercise

of backing out synergies"[20] may be problematic.

In regard to the second issue, Vice Chancellor Laster found that "when an acquirer purchases a widely traded firm, the premium that an acquirer is willing to pay for the entire firm anticipates incremental value both from synergies and from the reduced agency costs that result from unitary (or controlling) ownership."[21]

The Chancery Court's Decision

In *Verition*, Vice Chancellor Laster found that applying the Aruba "unaffected market price provides the more straightforward and reliable method for estimating the value of the entity as a going concern."[22]

In other words, by invoking the efficient market hypothesis argument used in both Dell and DFC Vice Chancellor Laster ruled that "the market has more data and is more reliable than any one analyst," including himself.

In his decision, Vice Chancellor Laster found that the "Delaware Supreme Court's expressed preference in Dell and DFC for market indicators over discounted cash flow valuations"[23] to determine fair value in a merger case. Therefore, the court did not have confidence in either analyst's discounted cash flow analyses in favor of its own analysis, using the previously discussed market indicators.

Post *Dell* and *DFC*, the Chancery Court appears to be moving away from the dependence on discounted cash flow analyses in favor of sale transaction pricing—with adjustment for synergistic value, if appropriate.

Chancery Court Decisions Not Favoring Transaction Sales Pricing

In contrast to *Verition*, there are instances in which the Chancery Court has deviated from the subject transaction deal price. These instances arise when the Chancery Court determined that the subject transaction deal process was flawed.

For example, in *Blueblade Capital Opportunities LLC v. Norcraft Cos.* ("*Norcraft*"), sales price was found to be unreliable. In *Norcraft*, Vice Chancellor Slights ruled that the merger price of $25.50 was an unreliable indicator of fair value. That was because the Chancery Court considered the sale process to be flawed for the following reasons:[24]

- Norcraft and its advisors were fixated on one buyer (Fortune Brands) and did not shop for other potential buyers.
- Norcraft's lead negotiator was focused on securing benefits for himself.
- The 35-day post-signing go-shop process was deemed ineffective as deal-protection measures constrained the process.

Norcraft was tried before, but decided after, the *Dell* decision was announced. In *Norcraft*, Vice Chancellor Slights cited consideration for the Delaware Supreme Court decisions in "*DFC* and *Dell*."[25]

Vice Chancellor Slights gave specific consideration to the deal-price-less-synergies method of calculating fair value.

However, in *Norcraft*, the court found that the transaction sales process was a flawed process. Therefore, the court did not rely on the deal-price-less-synergies calculation that the respondents' expert provided. Similarly, the court ruled that it could not rely on the unaffected market price.

Vice Chancellor Slights concluded that, because Norcraft had gone through an initial public offering only 18 months prior to the acquisition transaction, it had limited trading history. In other words, the Norcraft equity market price was not a reliable indicator of value.

In *Norcraft*, the court ultimately relied on a discounted cash flow method using certain components provided in one of the analyst's discounted cash flow analyses. The count was mindful to exclude synergistic value and arrived at an equity value per-share of $26.16. The $26.16 per share

price was greater than the transaction deal price of $25.50.

Another example where the Chancery Court did not rely on market indicators is *In re AOL Inc.* ("*AOL*"). In *AOL*, the Chancery Court relied on the discounted cash flow method. That was because the court concluded that the deal process was not "*Dell Compliant.*"

According to the Chancery Court, "*Dell Complaint*" means:

> (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.[26]

In *AOL*, the Chancery Court agreed with both analysts that the discounted cash flow method was the best indicator of fair value. However, in *AOL*, the petitioners abandoned their analysts' opinion and agreed with the Chancery Court finding that the AOL analysts' opinion would be the starting point. After making some adjustments to the respondent analyst's discounted cash flow analysis, Vice Chancellor Glasscock determined that the fair value per share of AOL, as of the merger date, was $48.70.

A fair value price of $48.70 was less than the $50.00 per share deal price. The court explained the difference by suggesting that the deal price included synergies.[27]

In *Norcraft*, the Chancery Court determined fair value by applying the discounted cash flow method, arriving at share prices greater than the deal price. In *AOL*, the Chancery Court applied the same valuation method but concluded that the fair value was less than the deal price. These matters illustrate the risk shareholders should consider in deciding to enact their appraisal rights as opposed to the receipt of transaction consideration.

In re Appraisal of Solera Holdings, Inc.

In re Appraisal Solera-Holdings, Inc. ("*Solera*"), Vice Chancellor Bouchard concluded that synergies can exist even when a financial sponsor is the acquiring firm. In the instant case, the Chancery Court determined the value of Solera Holdings, Inc. ("Solera") as of March 13, 2016. On that date the Solera was acquired by Vista Equity Partners ("Vista") for $55.85 per share.[28]

In *Solera*, Vice Chancellor Bouchard concluded that the Supreme Court's emphasis on the efficient market hypothesis, in recent rulings, now requires the Chancery Court to assess whether a transaction is "*Dell Compliant*." In *Solera*, the court ruled that the sale process was adequate and that the transaction was "*Dell Compliant*." Therefore, the Chancery Court relied on market indicators as applied in *Dell* and *DFC*.

After the *Solera* trial, and before the Chancery Court made its ruling, the *Verition* case was decided. As a result of that decision, the analysts in the instant case were given the opportunity by Vice Chancellor Bouchard to adjust their fair value analyses. The Solera analyst prepared an analysis based on the company's 30-day unaffected stock price as the "best evidence"[29] of fair value.

Ultimately Vice Chancellor Bouchard dismissed the unaffected share price because, among other reasons, it had not been introduced or argued as fair value by either side prior to the *Verition* decision being made public.

Vista owned four other portfolio companies that were similar to Solera. This ownership provided a basis for the acquisition of Solera because Vista had significant "touch points" (i.e., synergies) with Solera. These perceived "touch points" were quantified into synergies by the respondents' analyst.

Because the Chancery Court concluded that the transaction had been "Dell Compliant" and the Supreme Court guidance endorses the use of market efficiency principles in appraisal actions,[30] Vice Chancellor Bouchard determined that the deal price less estimated synergies value of $53.95 provided by the respondents' analyst, was the Solera fair value at the time of the acquisition.

In *Solera*, the Chancery Court again invoked the guidance provided by the DFC and Dell decisions to determine fair value. However, the courts analysis in the instant case differs from the previously discussed cases presented in this discussion. For example, in the instant case, the Chancery Court decided to go with the respondents' analyst and use the deal price less estimated synergies calculation. It is noteworthy that, in this instance, much of the analysis performed by the respondents' analyst went largely uncontested by the petitioners.

Another major take-away from the Chancery Court's decision in *Solera* is that Vice Chancellor Bouchard dismissed Vice Chancellor Laster's finding that the deal price less synergies calculation is prone to "human error" due to the fact that fair value should account for reduced agency costs. Vice Chancellor Bouchard found that Vice Chancellor Laster did not interpret the *DFC* and *Dell* decisions to suggest that agency costs had a separate value attributable to the merger price and should be excluded.

Vice Chancellor Bouchard goes on to say that "had that been the Supreme Court's intention, I believe it would have said so explicitly."[31]

The Chancery Court applies this reasoning to support its use of the deal price less estimated synergies in this case.

Finally, it is noteworthy that, in the instant case, perceived synergies were considered in matters involving a financial-buyer and not a pure synergistic-type buyer. Vista was able to demonstrate that Solera had what it called "touch points" with Vista's other portfolio companies and that its expert was able to quantify them. In this case, the Chancery Court said that "synergies do not only arise in the strategic-buyer context."[32]

Here the Chancery Court confirmed that it believes synergies may also exist in a financial buyer context.

Summary and Conclusion

Due to the court's extensive experience in deciding valuation-related matters, the decisions of the Chancery Court are closely followed by counsel, analysts, and other courts. The Chancery Court has repeatedly addressed issues related to the treatment of synergistic value in a transactional context.

It is clear that the court may consider and determine if a transaction is deemed "Dell Compliant." This determination is an important variable that may have fair value implications. The Chancery Court appears to be favoring market indicators when there is:

1. an efficient market for a company's stock and
2. a robust sales process in its recent decisions.

However, with each fair value decision, the Chancery Court provides more information about its interpretation of *DFC* and *Dell* decisions. Analysts involved in fair value matters should be aware of the recent Chancery Court decision and should be mindful of future decisions related to these issues.

This discussion provided insight as to how the Chancery Court adopted the guidance provided by the *Dell* and *DFC* decisions. The *Dell* and *DFC* decisions are relevant to and should be considered in Chancery Court fair value case matters. While the consideration of the transaction deal price is an important consideration in fair value matter, the analyst should also consider how synergistic value may be included in the transaction deal price.

Notes:

1. 8 Delw. C. Sect. 262(h)
2. Verition Partners Master Fund Ltd. and Verition Multi-Strategy Master Fund Ltd. v. Aruba Networks, Inc., C.A. No. 11448-VCL 13, 2018 WL 922139 (Del. Ch. Feb. 15, 2018).
3. Id.
4. Id.
5. In re Appraisal of Solera Holdings, Inc., Consolidated C.A. No. 12080-CB 10, 2018 WL 3625644 (Del. Ch. July 30, 2018).
6. Id.
7. Id.
8. Id.
9. Id.
10. Id.
11. Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., 2018 WL 922139.
12. Id.
13. Id.
14. Id.
15. Id.
16. Id.
17. Id.
18. Id.
19. Id.
20. Id.
21. Id.
22. Id.
23. Id.
24. Blueblade Capital Opportunities LLC v. Norcraft Companies, Inc., C.A. No. 11184-VCS 1, 2018 WL 3602940 (Del. Ch. July 27, 2018).
25. Id.
26. "Chancery Relies on DCF Where Deal Process Is Not 'Dell Compliant'," BVLAW Case Update (May 2018), accessed December 5, 2018. www.bvresources.com.
27. Id.
28. In re Appraisal of Solera Holdings, 2018 WL 3625644.
29. Id.
30. Id.
31. Id.
32. Id.

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