The Treatment of Synergistic Value

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In Dissenting Shareholder Appraisal Rights Matters (Part I of II)

The Delaware Court of Chancery decisions on the treatment of synergistic value in dissenting shareholder appraisal rights cases provide meaningful guidance to valuation analysts, legal counsel, and other courts. In this two-part article, the author discusses 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.

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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 consider all relevant factors.[1]

In a recent judicial decision, the Chancery Court ruled that, in a fair value matter, its "[u]ltimate 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, LP* (*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 eight 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 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 seller's share varying widely from six 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.

In Part II of this article, the author discusses Chancery Court decisions not favoring transaction sales pricing.

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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. *Ibid*.
4. *Ibid*.
5. In re Appraisal of Solera Holdings, Inc., Consolidated C.A. No. 12080-CB 10, 2018 WL 3625644 (Del. Ch. July 30, 2018).
6. *Ibid*.
7. *Ibid*.
8. *Ibid*.
9. *Ibid*.
10. *Ibid*.
11. *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc*., 2018 WL 922139.
12. *Ibid*.
13. *Ibid*.
14. *Ibid*.
15. *Ibid*.
16. *Ibid*.
17. *Ibid*.
18. *Ibid*.
19. *Ibid*.
20. *Ibid*.
21. *Ibid*.
22. *Ibid*.
23. *Ibid*.