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Highlights of 2019 Delaware Valuation Decisions

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This year to date has been another active period for valuation cases in the Delaware courts. The Supreme Court reversed one 2018 Court of Chancery decision and affirmed another, and the Court of Chancery decided four valuation cases; these decisions are discussed below. The predominant theme is that, in arm's-length transactions, appraisal value continues to be based primarily on the transaction price rather than on discounted cash flow.

The exhibit on page 3 shows that, since 2006, transaction price has been the dominant metric in arm's-length transactions, while most appraisals in related party transactions have been determined using DCF. Since 2013, only one appraisal in an arm's-length transaction (*AOL Inc.*[1]) was based on the court's DCF calculation; the others that used DCF considered it only as confirmatory of the valuation based on transaction price.

Aruba Networks

The most important 2019 decision was the Supreme Court's reversal of the lower court's decision in *Aruba Networks*. Vice Chancellor Travis Laster had valued Aruba at "unaffected market price"—the average price during the 30 days prior to a news article that leaked the pending transaction.[2] He appraised the company at 69.4% of the deal price.

Neither petitioners nor respondent had discussed unaffected market price at trial. After the Supreme Court issued its opinion reversing Laster's decision in *Dell*,[3] Laster requested "supplemental briefing on 'the market attributes of Aruba's stock' in part because he 'learned how many errors [he] made in the *Dell* matter.'"[4] The respondent then argued for unaffected market price in its subsequent post-trial brief. Laster's decision ruled that "Aruba's unaffected market price provides the best evidence of its going concern value."[5]

The vice chancellor had noted that:

> Aruba management knew internally that Aruba was having an excellent quarter and would beat its guidance. But … [it] time[d] the announcement of the merger to coincide with the announcement of Aruba's February 2015 earnings.[6]

1 In *re Appraisal of AOL Inc.,* 2018 WL 1037450 (Del. Ch. Feb. 23, 2018); *modified,* 2018 WL 3913775 (Del. Ch. Aug. 15, 2018). In this case, the court concluded that the seller's commitment to a single buyer compromised the sale process, making the negotiated transaction price unreliable as a measure of value.

2 *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.,* 2018 Del. Ch. LEXIS 52 (Del. Ch. Feb. 15, 2018) (*"Aruba I"*); *rev'd,* 210 A.3d 128 (Del. 2019) (*"Aruba II"*). The author discussed *Aruba I* in *Business Valuation Update,* October 2018.

3 *In re Appraisal of Dell Inc.*, 2016 Del. Ch. LEXIS 81 (May 31, 2016); *rev'd, Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd*, 2017 Del. LEXIS 518 (Del. Dec. 14, 2017).

4 *Aruba II* at 131, quoting the court's letter to the parties.

5 *Aruba I* at *4.

6 *Aruba I* at *63.

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Nonetheless, he concluded:

> [T]he record does not provide a persuasive reason to question the reliability of Aruba's trading price based on the decision by Aruba management to bundle together two pieces of information.[7]

The Supreme Court disagreed, concluding that the not-yet-disclosed information had affected the public market:

> HP [the buyer] … had material, nonpublic information that, by definition, could not have been baked into the public trading price…. In particular, HP had better insight into Aruba's future prospects than the market because it was aware that Aruba expected its quarterly results to exceed analysts' expectations.[8]

The Supreme Court criticized the Court of Chancery's decision that the unaffected market price was fair value:

> The lack of a developed record on whether the stock price was an adequate proxy for fair value buttresses our holding that the Court of Chancery abused its discretion by awarding the thirty-day average unaffected market price of $17.13 per share.[9]

Because of requirements for SEC review and a shareholder vote, an acquisition of public companies necessarily cannot close until well after the announcement of a transaction. The Supreme Court pointed out that the Delaware appraisal statute requires that the company be valued at the closing date:

> Although §262 requires the Court of Chancery to assess Aruba's fair value as of "the effective date of the merger," the Court of Chancery arrived at the unaffected market

7 *Aruba I* at *66..
8 *Aruba II* at 139.
9 *Aruba II* at 140.

Valuation Methods Used in Delaware Appraisal Decisions							
	Number of Valuations	DCF or Similar	Comparable Companies	Comparable Transactions	Asset Value	Transaction Price	Unaffected Mkt. Price
	Arm's-Length Transactions						
1998-2005	2	2	0	0	0	1	0
2006-2013	4	3	1	0	0	2	0
2014-2019	14	6	2	1	0	12	1
Total	20	11	3	1	0	15	1
	Related Party Transactions						
1998-2005	14	8	7	4	0	0	0
2006-2013	7	7	1	1	1	0	0
2014-2019	9	9	0	0	0	0	0
Total	30	24	8	5	1	0	0
Note: Some decisions used more than one method.							

price by averaging the trading price of Aruba's stock during the thirty days before news of the merger leaked, which was three to four months prior to closing.[10]

The Supreme Court directed a final judgment that petitioners be awarded $19.10 per share, which was Aruba's estimate of the deal price ($24.67) minus synergies. It agreed with the lower court's conclusion that the transaction price included substantial synergies.[11] The Supreme Court noted that the $19.10 valuation, which was 77.4% of the deal price and 11.5% above the unaffected market price, "was corroborated by … Aruba's [expert's] DCF, comparable companies, and comparable transactions analyses."[12]

PLX Technology

In this fiduciary duty case, a hedge fund's representative who was a director of the publicly traded company, among other things, had conversations with the buyer and its investment banker that were not disclosed to other board members. The Court of Chancery agreed with plaintiffs that the hedge fund had aided and abetted breaches of the board's duties to shareholders. However, Vice Chancellor Laster rejected the plaintiffs' claim that the $6.50 deal price was unfair. He concluded that plaintiffs "were unable to prove that the breaches resulted in damages."[13]

Laster determined that the projections the plaintiffs' expert used in his DCF calculations were flawed in three respects:

1. The projections included "a new line of business involving a new set of customers with a new set of requirements" and "evidence at trial did not give [the Court] sufficient confidence to base a damages award on this element of the projections"[14];

10 *Aruba II* at 132.

11 Laster concluded that the transaction prices minus synergies was $18.20 per share. [*Aruba I* at *45.]

12 *Aruba II* at 142.

13 *In re PLX Technology Inc. S'holders Litig.*, 2018 WL 5018353 (Del. Ch. Oct. 16, 2018) at *56; *aff'd,* 211 A.3d 137 (2019).

14 Ibid. at *52.

2. "PLX management had a track record of missing its projections"[15]; and

3. "[B]idders do not appear … to have believed that [the projection] supported valuations in the range that [plaintiffs' expert] posited…. If the projections were sufficiently reliable to support a credible valuation of $9.82 per share, then it seems likely that another buyer would have competed."[16]

Also, Laster concluded that plaintiffs' expert's discount rate was too low. He faulted expert's beta because it was based on daily returns rather than weekly or monthly returns:

> [W]hen the return interval is shortened, the following occurs: Securities with a smaller market value than the average of all securities outstanding (the market) will generally have a decreasing beta, whereas securities with a larger market value than the average of all securities outstanding will generally have an increasing beta.[17]

Defendants' expert did not fully credit the projections for the new line of business, and his DCF calculation valued PLX at less than the transaction price.[18] The court ruled:

> Although flawed from a fiduciary standpoint, the details of the sale process that the Board conducted and the nature of the synergistic deal with Avago that it generated means that the plaintiffs received consideration that exceeded the value of the Company on a stand-alone basis.[19]

The Supreme Court affirmed the trial court's decision that plaintiffs failed to prove that they suffered damages.

Trussway

In February 2019, a shareholder who was squeezed out of Trussway Holdings Inc., a private company, was awarded an amount 5% higher than the merger value. Vice Chancellor Sam Glasscock III determined fair value solely on DCF, rejecting petitioner's expert's comparable company analysis because the "supposed 'comparable companies' are too divergent from [Trussway], in terms of size, public status, and products, to form meaningful analogs for valuation purposes."[20]

The court averaged DCF calculations based on two periods: a nine-year management projection and the first five years of that projection. It described the five-year period as "more standard."[21] (However, the reason it is "more standard" does not stem from valuation theory but simply reflects the fact that few companies make projections beyond five years.) The valuation based on the five-year period was 15% lower than the valuation based on the nine-year period.

The management projections included "strategic initiatives" that included, among other things, selling new products to be added to the company's product line and gaining additional market share through sales to market segments in which the company did not yet participate.[22] Both experts adjusted their valuations to reflect their concerns that the longer-term projections were optimistic. Petitioner's expert increased his discount rate by 1% after the first five years, and respondent's expert gave 25% weight to the

15 Ibid.

16 Ibid. at *53.

17 Ibid. at *54, quoting Gabriel Hawawini, "Why Beta Shifts as the Return Interval Changes," *Fin. Analysts J.*, May-June 1983 at 73.

18 Ibid. at *52.

19 Ibid. at *56.

20 *Hoyd v. Trussway Holdings LLC,* 2019 WL 994048 (Del Ch. Feb. 28, 2019) at *5.

21 Ibid. at *7.

22 Ibid. at *2.

nine-year projection and 75% weight to the five-year period.[23]

In using the five-year period, the court effectively substituted the 2.3% perpetual growth rate (as to which both experts agreed) for the higher growth rate that management expected in the final four years. The court agreed with the experts' view that an adjustment should be made to a value based on the nine-year projection, and it explained its decision to give partial weight to the shorter period:

> Of more concern to me is Trussway management's ability (or that of any human prognosticator) to accurately predict corporate performance nine years out, particularly concerning new facets of a business. I am also aware that there is a degree of huckster's optimism in these predictions.[24]

Jarden

The *Jarden* decision in July 2019 determined the appraisal price in a third-party transaction solely on the unaffected market price, the closing price immediately before *The Wall St. Journal* published rumors of the transaction.[25] Vice Chancellor Joseph Slights III relied on "expert testimony … including an event study that analyzed the market's response to earnings and other material announcements."[26] He noted that: (i) Jarden had no control shareholders; (ii) 94% of its shares were in the public float; (iii) the bid-ask spread was only 0.02%; and (iv) approximately 20 analysts had published reports on Jarden in the year prior to the merger.[27] He also concluded that the unaffected market price was not "stale" on the closing date.[28]

Petitioners' expert posited that a "conglomerate discount "depressed the market price. The court rejected this discount, noting that "it is not clear that this notion is accepted within the academ[ic community] or among valuation professionals"[29]

The court determined that the transaction price was not an applicable valuation standard in this matter, explaining:

> I place less weight on this market-based valuation approach in this case because the sales process was not well-conceived or well-executed and the expert analysis of the transaction synergies raised more questions than it answered.[30]

Even though the court agreed with petitioners' claim that the negotiating approach of Jarden's executive chairman "may well have set an artificial ceiling on what Newell was willing to pay,"[31] it nonetheless based its valuation on unaffected market price.

The vice chancellor dismissed the petitioners' valuation based on comparable companies, saying, "After considering the evidence, I am satisfied that Petitioners' comparable companies analysis is not credible because Jarden had no reliable comparables."[32] Several appraisal decisions in recent years have arrived at a similar conclusion.

Slights noted that his valuation was confirmed by his DCF calculation and by "the most reasonable estimate" of "the Merger price less synergies."[33] In his DCF calculation, he used the midpoint of the experts' inflation and GDP growth estimates

23 Ibid. at *6.

24 Ibid.

25 *In re Appraisal of Jarden Corp.*, 2019 WL 3244085 (Del. Ch. July 19, 2019) at *28-*29; *modified*, 2019 WL 4452209 (Sept.16, 2019). The court defined unaffected market price as a single price rather than an average over a period of time. [Ibid. at *19-*20.]

26 Ibid. at *2.

27 Ibid. at *27.

28 Ibid. at *31.

29 Ibid.

30 Ibid. at *26.

31 Ibid. at *24.

32 Ibid. at *3.

33 Ibid. at *50.

as the perpetual growth rate,[34] an approach the Court of Chancery often uses.

Columbia Pipeline

An August 2019 decision by Vice Chancellor Laster based appraisal value in a third-party transaction solely on the deal price.[35] Deal price has become the predominant standard of value in appraisals of companies acquired in arm's-length transactions.

The vice chancellor rejected petitioners' claim that the company's value increased between signing and closing.[36] He also rejected the unaffected market price as a measure of value in this case[37] and rejected its DCF analysis.

Petitioners' DCF valuation was 24% over the deal price and 57% over unaffected market. Laster rejected their DCF analysis as contrary to contemporaneous market evidence:

> [Expert]'s opinion that the value of Columbia materially exceeded the deal price conflicts with the market behavior of other potential strategic acquirers who had shown interest in Columbia, and who did not step forward to top TransCanada's price.[38]

He also expressed concern about the terminal value petitioners' expert calculated:

> [T]he terminal value represented 125% of his valuation of Columbia…. This court has questioned the utility of a DCF in a case where the terminal value represented 97% of the result, finding that "[t]his back-loading highlights the very real risks" presented by using that methodology and "undermin[ing] the reliability of applying the DCF technique."[39]

Laster observed, "The wide swings in output that result from legitimate debate over reasonable inputs undermine the reliability of [petitioner's expert]'s DCF model."[40]

He did not reduce the price for synergies, noting that the synergy adjustment proposed by respondent was excessive:

> [Respondent] did not meet its burden of proof. [It] likely could have justified a smaller synergy deduction, but it claimed a larger and unpersuasive one. This decision therefore declines to make any downward adjustment to the deal price.[41]

Stillwater Mining

A second August 2019 decision by Laster also ruled that appraisal value in an arm's-length transaction was the deal price.[42] He rejected trading price, given the availability of "a market-tested indicator like the deal price."[43] He also rejected DCF in this case:

> The legitimate debates over [contested] inputs and the large swings in value they create undercut the reliability of the DCF model as a valuation indicator.[44]

Laster determined that the trading price was not a measure of fair value because inadequate disclosure of Stillwater's reserves impacted it. He observed that SEC limitations on disclosure of

34 Ibid. at *32.

35 *In re Appraisal of Columbia Pipeline Group, Inc.*, 2019 WL 3778370 (Del. Ch. Aug. 12, 2019) at *43.

36 Ibid.

37 Ibid. at *49.

38 Ibid. at *50.

39 Ibid. at *51, quoting *Union Ill. 1995 Investment LP v. Union Finl. Group, Ltd.*, 847 A.2d 340, 361 (Del. Ch. 2003).

40 Ibid. at *52.

41 Ibid. at *45.

42 *In re Appraisal of Stillwater Mining Co.,* 2019 WL 3943851 (Del. Ch. Aug. 21, 2019) at *50.

43 Ibid. at *59.

44 Ibid. at *61.

reserves that did not rise to the "probable" level affected the viability of trading price as a valuation indicator:

> [The SEC did] not permit a mining company to disclose information about inferred resources, which are mineral deposits where the quantity, grade, and quality "can be estimated" based on "geological evidence," "limited sampling," and "reasonably assumed, but not verified, geological and grade continuity."[45]

Stillwater is the only U.S. source of "platinum group metals," palladium, platinum, and rhodium. The vice chancellor observed, "Between signing and closing, the prices of palladium and platinum increased materially, with a direct effect on Stillwater's value."[46] He did not adjust his appraisal for this price movement because petitioners did not argue for it or quantify its effect on value.

> [W]hether to adjust the deal price for an increase in value between signing and closing presents numerous difficult questions. In this case, the petitioners did not argue for an adjustment to the deal price, and so the parties did not have the opportunity to address these interesting issues…. The petitioners accordingly failed to prove that the deal price should be adjusted upward to reflect a change in value between signing and closing.[47]

Expert Witness Testimony

The Court of Chancery often rejects not only expert testimony that is not persuasive, but also testimony that is not supported in the valuation literature, e.g., the conglomerate discount rejected in *Jarden* and the beta based on daily price changes rejected in *PLX Technology*.

The court on several occasions has criticized experts who overreach in their valuations. As discussed above, it faulted the petitioners' expert's DCF analysis in *Columbia Pipeline* as contrary to market evidence. Also, the respondent's expert in *Columbia Pipeline* was deemed to have been unpersuasive as to the amount of synergies included in the transaction price; the court commented that respondent "likely could have justified a smaller synergy deduction."

On the other hand, the absence of testimony on relevant valuation issues can be harmful. Because there was no testimony as to the impact of increased palladium and platinum prices prior to closing in *Stillwater Mining*, the court was unable to quantify the impact of this change on the appraised value.

In both *Columbia Pipeline* and *Stillwater Mining*, Laster quoted a 2016 opinion:

> An argument may carry the day in a particular case if counsel advance it skillfully and present persuasive evidence to support it. The same argument may not prevail in another case if the proponents fail to generate a similarly persuasive level of probative evidence or if the opponents respond effectively.[48]

He added in both decisions:

> Likewise, the approach that an expert espouses may have met "the approval of this court on prior occasions," but may be rejected in a later case if not presented persuasively or if "the relevant professional community has mined additional data and pondered the reliability of past practice

45 Ibid. at *58, quoting the SEC's *Industry Guide 7* [17 C.F.R. 229.801(g)]. *Industry Guide 7* was rescinded on Oct. 31, 2018 [sec.gov/corpfin/secg-modernization-property-disclosures-mining-registrants].

46 Ibid. at *48.

47 Ibid. at *50

48 *Merion Capital L.P. v. Lender Processing Services, L.P.*, 2016 WL 7324170 (Del. Ch. Dec. 16, 2016) at *16.

> and come, by a healthy weight of reasoned opinion, to believe that a different practice should become the norm."[49]

The valuation approaches that the Court of Chancery will accept necessarily depend on the facts of the specific case.

> The appraisal exercise is, at bottom, a fact-finding exercise, and our courts must appreciate that, by functional imperative, the evidence, including expert evidence, in one appraisal case will be different from the evidence presented in any other appraisal case. Different evidence, of course, can lead to different decision paths and different outcomes.[50]

Conclusion

These recent cases demonstrate the importance of high-quality expert testimony in valuation litigation. Although each decision is fact-specific, experts should be familiar with past practice in the Court of Chancery and with the its interpretation of fair value and operative reality. Experts should be careful to utilize practices that are supported in the academic and valuation communities and should be aware of current developments in the profession. *Columbia Pipeline's* criticism of petitioners' DCF calculation and of respondent's synergies claim are warnings against overreaching, while the court's inability in that case to determine the market impact of higher product prices shows how the absence of relevant testimony can impact a decision.

In the past, event studies were often used in other types of security cases but not in appraisals. The current focus on deal prices and historical market prices in arm's-length transactions has necessitated testimony on event studies in appraisal cases where the court relies on market factors rather than corporate valuations.

In recent cases, many experts have not used comparable companies and comparable transactions. This may be a consequence of the Court of Chancery's frequent rejection of these approaches. Nonetheless, these valuation methods are widely used in the investment community. Comparable companies are frequently used in research reports, and both approaches are commonly included in investment bank presentations to corporate clients and in fairness opinions. In investment bank fairness opinions issued in connection with the acquisitions of companies that were appraised in Delaware since 2010, 97% used comparable companies and 76% used comparable transactions as a valuation method. Chancellor William B. Chandler III wrote in 2011:

> [I]t is preferable to take a more robust approach involving multiple techniques—such as a DCF analysis, a comparable transactions analysis (looking at precedent transaction comparables), and a comparable companies analysis (looking at trading comparables/multiples)—to triangulate a value range, as all three methodologies individually have their own limitations."[51]

Comparable transactions can be useful in appraisals when they can be adjusted for the impact of synergies. Experts should continue to use comparable companies when they deem it appropriate and should explain to the court the basis for their selection of the comparables and why they are relevant to the subject company. ◆

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49 *Columbia Pipeline* at *16 and *Stillwater Mining* at *20, quoting *Global GT v. Golden Telecom, Inc.*, 993 A.2d 497, 517 (Del. Ch. 2010); *aff'd,* 11 A.3d 214 (Del. 2010).

50 *Jarden* at *1.

51 *Muoio & Co. v. Hallmark Entm't Invs. Co.,* 2011 Del. Ch. LEXIS 43 (Mar. 9, 2011) at *83-*84.

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