

# BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

## Aruba Networks: Should Appraisals Rely on Unaffected Market Price?

By Gilbert E. Matthews, CFA  
Sutter Securities Inc. (San Francisco, Calif., USA)

Delaware appraisal decisions in recent years have effectively endorsed the concept that the price paid in an arm's-length transaction is "fair value" when there has been a "robust" sales process. A series of decisions since 2013, shown in the exhibit, have arrived at appraisal values at or close to the deal price in such situations. The two 2016 Court of Chancery decisions that arrived at values above the deal price in arm's-length transactions (*Dell*<sup>1</sup> and *DFC Global*<sup>2</sup>) were reversed and remanded.

In contrast, Vice Chancellor Travis Laster's February 2018 *Aruba Networks* decision<sup>3</sup> appraised the company at 69.4% of the transaction price. Given the substantial synergies that the buyer anticipated from the transaction, it was reasonable to

conclude that fair value in this case was substantially lower than the negotiated price. However, it is troubling that the court based its appraisal solely on the unaffected market price:

In this case, the best evidence of Aruba's fair value as a going concern, exclusive of any value derived from the merger, is its thirty-day average unaffected market price of \$17.13 per share. I recognize that no one argued for this result. I also recognize that the resulting award is lower than Aruba's proposed figure of \$19.75 per share. That figure relied on its expert's discounted cash flow analysis, which this decision has found unpersuasive.<sup>4</sup>

The court based its valuation on the average price during the 30 days prior to a Bloomberg News article on Feb. 25, 2015, that disclosed the pending transaction.

The vice chancellor explained that his decision relied on the Supreme Court's rulings in *Dell* and *DFC Global*, noting that the Supreme Court had discussed the efficient market theory<sup>5</sup> and stating, "The Delaware Supreme Court's decisions in *Dell* and *DFC* endorse using the market price of a widely traded firm as evidence of fair value."<sup>6</sup> However, neither decision had directed the lower court to consider the preannouncement

- 1 *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.*, 177 A.3d 1 (Del. 2017). We include the *Dell* case as arm's length; the Supreme Court said, "[T]his was not a buyout led by a controlling stockholder. Michael Dell only had approximately 15% of the equity. He pledged his voting power would go to any higher bidder, voting in proportion to other shares." [p. 30]
- 2 *In re Appraisal of DFC Global Corp.*, 2016 Del. Ch. LEXIS 103 (Del. Ch. July 8, 2016); *modified*, C.A. No. 10107-CB [unpublished] (Del. Ch. Sept. 14, 2016); *rev'd*, *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017).
- 3 *Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.*, 2018 Del. Ch. LEXIS 52 (Del. Ch. Feb. 15, 2018) ("*Aruba I*"); *reargument denied*, 2018 Del. Ch. LEXIS 160 (Del. Ch. May 21, 2018) ("*Aruba II*").

- 4 *Aruba I* at \*107. Although the decision considers synergies (discussed later in this article), the valuation is based solely on unaffected market price.
- 5 *Ibid.* at \*2, fn. 5; \*47; \*58; \*59, fn. 307; \*65; \*98, fn. 466.
- 6 *Aruba I* at \*1-\*2 (citations omitted).

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price on remand and, as the *Aruba* decision points out, "The Delaware Supreme Court's decisions in *Dell* and *DFC* endorse using the deal price in a third-party, arm's-length transaction as evidence of fair value."<sup>7</sup>

Appraisal value in Delaware and in most other states is "fair value," generally described as the value of the company as a going concern, excluding any appreciation arising from the transaction, with no minority or marketability discount. In contrast, Ohio uses "fair cash value."<sup>8</sup> This unusual appraisal statute and Ohio case law effectively limit shareholders seeking appraisal to the preannouncement value of their shares, i.e., unaffected market value. A seminal article on appraisal criticized this standard:

[T]he appraisal remedy [is] useless to minority shareholders of publicly traded [Ohio] corporations.... No matter how low the merger price, it will invariably exceed the prevailing market price prior to the announcement of the merger; thus no sensible shareholder would elect to dissent.<sup>9</sup>

The *Aruba* decision is similarly flawed in relying on preannouncement market prices.

Under Delaware law, the appraisal value should be determined as of the closing date of the transaction. The *Aruba* decision states that "neither side proved that *Aruba's* value had changed materially by closing, so this decision sticks with the unaffected market price and the deal price less synergies."<sup>10</sup> Although the market did not move materially between February 24 and the May 18 closing date (the S&P 500 was up a mere 0.6% based on both the closing price and the 30-day average), the "unaffected

<sup>7</sup> *Aruba I* at \*2.

<sup>8</sup> Ohio Rev. Code Ann. §1701.85(b).

<sup>9</sup> Barry M. Wertheimer, "The Shareholders' Appraisal Remedy and How Courts Determine Fair Value," 47 *Duke L. J.* 613, 656 (1998), fn. 207.

<sup>10</sup> *Aruba I* at \*53.

Recent Court of Chancery Appraisal Decisions in Arm's-Length Transactions	
	Premium (Discount) vs. Deal Price
<i>Merion Capital, L.P. v. 3M Cogent, Inc.</i> , 2013 Del. Ch. LEXIS 172 (Del. Ch. July 8, 2013)	3.5%
<i>Huff Investment Fund v. CKx, Inc.</i> , 2013 Del. Ch. LEXIS 262 (Del. Ch. Nov. 1, 2013); <i>aff'd</i> , 2015 Del. LEXIS 77 (Del. Feb. 12, 2015)	0.0%
<i>In Re Appraisal of Ancestry.com, Inc.</i> , 2015 Del. Ch. LEXIS 21 (Del. Ch. Jan. 30, 2015)	0.0%
<i>Merlin Partners LP v. AutoInfo, Inc.</i> , 2015 Del. Ch. LEXIS 128 (Del. Ch. Apr. 30, 2015)	0.0%
<i>Longpath Capital, LLC v. Ramtron Intl. Corp.</i> , 2015 Del. Ch. LEXIS 177 (Del. Ch. June 30, 2015)	(1.0%)
<i>Merion Capital LP v. BMC Software, Inc.</i> , 2015 Del. Ch. LEXIS 265 (Del. Ch. Oct. 21, 2015)	0.0%
<i>Merion Capital LP v. Lender Processing Servicing, Inc.</i> , 2016 Del. Ch. LEXIS 189 (Del. Ch. Dec. 16, 2016)	0.0%
<i>In Re Appraisal of PetSmart, Inc.</i> , 2017 Del. Ch. LEXIS 89 (Del. Ch. May 26, 2017)	0.0%
<i>In re Appraisal of AOL Inc. ("AOL I")</i> , 2018 Del. Ch. LEXIS 63 (Del. Ch. Feb. 23, 2018); <i>modified</i> , 2018 WL 3913775 (Del. Ch. Aug. 15, 2018)	(3.4%)
<i>Blueblade Capital Opportunities LLC v. Norcroft Cos., Inc. ("Norcroft")</i> , 2018 WL 3602940 (Del. Ch. July 27, 2018)	2.6%
<i>In re Appraisal of Solera Holdings, Inc. ("Solera")</i> , 2018 Del. Ch. LEXIS 256, 2018 WL 3625644 (Del. Ch. July 30, 2018)	(1.9%)
<i>Note: Digests of these decisions and the courts' opinions are available at <a href="#">BVLaw</a>.</i>	

market price" did not reflect a material positive factor—higher-than-expected earnings—not then known by the market. The Vice Chancellor wrote:

Contrary to the market's perception, Aruba management knew internally that Aruba was having an excellent quarter and would beat its guidance. But, rather than correcting the market's perception, Aruba management proposed to time the announcement of the merger to coincide with the announcement of Aruba's February 2015 earnings.... In this case, Aruba management believed that an increase in the stock price would hurt their chances of getting the deal approved. Providing both pieces of information simultaneously would blur the market's reaction to Aruba's strong quarterly results and help get the deal approved.<sup>11</sup>

<sup>11</sup> *Aruba I* at \*62-\*63. [footnotes omitted]

He added:

Releasing information simultaneously or in close proximity might make it difficult for an expert to disentangle the price reaction for purposes of an event study, but the market still would have the information and would respond.... Aruba's stock traded briefly above the deal price, indicating the market took into account both the announcement of the deal and Aruba's strong results.

Nonetheless, the court 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.<sup>12</sup>

<sup>12</sup> *Aruba I* at \*66. [footnote omitted]

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After the Bloomberg News report, Aruba's closing stock price rose from \$18.38 to \$22.24. Two days later, after Aruba announced both the transaction and the improved quarterly earnings, its closing price rose from \$22.61 to \$24.81. The vice chancellor did not adjust the "unaffected market price" to reflect the improved earnings, explaining in his decision on reargument:

[T]he petitioners could have used the conjunctive announcement as an opportunity to engage with the respondent's proffered measure of the unaffected market price and argue for a higher figure. Had they done so, then in my view the respondent would have had a strong argument that to the extent the market price reacted to news of the deal, the resulting valuation impact represented an "element of value arising from the ... expectation of the merger."<sup>13</sup>

The petitioners "argued broadly that the market price was unreliable and should be disregarded because investors were undervaluing Aruba"<sup>14</sup> and that the court's selection of a 30-day period reached an anomalous conclusion:

[H]ad the Court selected 1 day, the fair value would have been \$18.38; had it selected 90 days, it would have been \$18.81; had it selected 120 days, it would have been \$19.51; had it selected the opening price the day HP first approached Aruba about a deal, it would have been \$22.01.<sup>15</sup>

The court responded:

In response to the Reargument Motion, the respondent has cited authorities indicating that using a 30-day period is both "generally considered acceptable in the financial

community" and within a court's discretionary judgment.<sup>16</sup>

\* \* \*

I have not delved into the valuation and academic literature on this point, but I suspect many treatises and other articles could be cited to support the general acceptance of a 30-day average as a common metric for calculating the unaffected trading price.<sup>17</sup>

The 30-day average is indeed a common metric. Based on the author's experience and research, investment bankers' fairness opinions have been considering premiums over the 30-day unaffected market price (as well as premiums over the latest unaffected closing price) for more than five decades. However, financial professionals have considered unaffected market price not as a measure of the value of the target company, but simply as the denominator for calculating the premium being offered.

Prior to concluding that appraised value was Aruba's unaffected market price, the court had determined that "[t]he two probative indications of value in this case are the unaffected market price of \$17.13 and the deal-price-less-synergies value of approximately \$18.20 per share."<sup>18</sup> It arrived at the \$18.20 figure by deducting synergies from the deal price of \$2.651 billion and synergies estimated for the buyer by McKinsey and "a March 2013 study by the Boston Consulting Group which suggested that, on average, sellers collect 31% of the capitalized value of synergies, with the seller's share varying widely from 6% to 51%"<sup>19</sup>:

Using the low-end synergy deduction of \$93 million implies a standalone value of \$2.558 billion, or \$21.08 per share. Using

<sup>13</sup> *Aruba II* at \*14-\*15 (quoting the Delaware appraisal statute).

<sup>14</sup> *Aruba II* at \*15.

<sup>15</sup> *Aruba II* at \*8 (quoting Petitioners' Reargument Motion, ¶ 7).

<sup>16</sup> *Aruba II* at \*10.

<sup>17</sup> *Aruba II* at \*10, fn. 42.

<sup>18</sup> *Aruba I* at \*5.

<sup>19</sup> *Aruba I* at \*86.

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the high-end synergy deduction of \$793 million implies a standalone value of \$1.858 billion, or \$15.32 per share. The midpoint is a standalone value of \$2.208 billion or \$18.20 per share.<sup>20</sup>

Determining fair value by deducting an amount for synergies from the deal price is an approach that has been adopted in numerous Court of Chancery decisions. Indeed, in one recent case, the appraised value in a related party transaction was only 42.6% of the transaction price.<sup>21</sup> The court's \$18.20 number, which is less than 75% of the deal price and below the \$19.75 valuation by Aruba's expert, is consistent with the Delaware appraisal statute's provision that "any element of value arising from the accomplishment or expectation of the merger" must be excluded.<sup>22</sup>

The concept of "unaffected" prices, as used by investment bankers, encompasses market prices prior to either public knowledge of a transaction or public information that a company is seeking a transaction. The fact that many companies' shares are deemed to be potential acquisition targets may positively impact their prices; in these situations, it is possible that fair value could be less than market price. Although fair value is usually higher than "unaffected" price for the simple reason that buyers are more likely to acquire underpriced companies than overpriced companies, market price could also be greater than fair value in periods of market exuberance for a particular sector, such as internet businesses in 1999.

Three subsequent decisions have cited *Aruba*. In *Solera*, Chancellor Andre Bouchard rejected respondent's post-trial argument that unaffected market price should be considered, and instead

<sup>20</sup> *Ibid.*

<sup>21</sup> *ACP Master, Ltd. v. Sprint Corp.*, 2017 Del. Ch. LEXIS 125 (July 21, 2017). In this case, Sprint's control shareholder purchased a publicly traded company 51% owned by Sprint for \$5.00 per share and the court awarded dissenting shareholders only \$2.13 per share.

<sup>22</sup> 8 Del. Code Ann. § 262(h).

he adjusted for synergies<sup>23</sup> and valued the shares at 98.1% of the deal price. In *Norcroft*, Vice Chancellor Joseph R. Slight III stated that he did not consider market price because "Norcroft was fresh off an initial public offering of its stock, was relatively thinly traded ... and was also thinly covered by analysts."<sup>24</sup> Vice Chancellor Sam Glasscock III's decision in *AOL*, issued eight days after *Aruba I*, did not consider the unaffected market price because the respondents did not propose using it.<sup>25</sup> He utilized discounted cash flow to value AOL at a discount to the deal price and wrote:

[O]ur Supreme Court's recent decisions in *DFC* and *Dell*, ..., in distilled form, provide ... that no presumption in favor of transaction price obtains. Where, however, transaction price represents an unhindered, informed, and competitive market valuation, the trial judge must give particular and serious consideration to transaction price as evidence of fair value. Where information necessary for participants in the market to make a bid is widely disseminated, and where the terms of the transaction are not structurally prohibitive or unduly limiting to such market participation, the trial court in its determination of fair value must take into consideration the transaction price as set by the market.<sup>26</sup>

Historically, some writers had posited that the unaffected market price reflects an "inherent minority discount" (IMD) so that fair value is necessarily greater than market price. The concept of an IMD was included in several appraisal

<sup>23</sup> *Solera* at \*34.

<sup>24</sup> *Norcroft* at \*2.

<sup>25</sup> "[N]o evidence concerning the efficiency of the market for AOL stock is before me. Moreover, the use of trading price to determine fair value requires a number of assumptions that, to my mind, are best made or rejected after being subject to a forensic and adversarial presentation by interested parties. Thus, I do not consider stock trading price further." *AOL I* at \*25, fn. 118.

<sup>26</sup> *AOL I* at \*2.

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decisions prior to 2002, but no later decisions have applied it. Several academic articles have questioned the concept of an IMD and served to discredit it.<sup>27</sup> In 2007, Vice Chancellor Stephen Lamb acknowledged the criticisms and cited the Hamermesh/Wachter and Booth articles.<sup>28</sup> The older cases were cited in *Solera* in rejecting the use of market price as a valuation standard without reference to the academic articles or the 2007 decision.<sup>29</sup>

Appraisal necessarily depends on the financial condition and prospects of the company. Delaware law specifies that appraised value should be determined as of the effective date of the transaction. Unaffected market price as of the

announcement date is stale data at the closing date. For public companies, it is common for a transaction to close more than three months after the announcement date, sometimes materially later.

Moreover, the market price necessarily reflects only facts known to the market at a specific date. The market rarely knows a company's long-term forecasts, which are the basic component of the discounted cash flow approach the Delaware courts currently favor. In the infrequent case where the court determines that neither the deal price nor the available financial analyses are a reliable measure of value and that the appraised value should not exceed an "unaffected price," it should examine the facts not known to the market, as well as subsequent developments in the company and in the market rather than use market prices that are outdated and may not reflect all knowable information. ♦

**Gilbert E. Matthews, CFA**, is chairman of the board and a senior managing director of Sutter Securities Inc. (San Francisco). He has more than 50 years of experience in investment banking and has spoken and written extensively on fairness opinions, corporate valuations, and litigation relating to valuations.

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27 Lawrence A. Hamermesh and Michael L. Wachter, "The Short and Puzzling Life of the 'Implicit Minority Discount' in Delaware Appraisal Law," 156 *U. Pa. L. Rev.* 1 (2007); William J. Carney and Mark Heimendinger, "Appraising the Nonexistent: The Delaware Courts' Struggle With Control Premiums," 152 *U. Pa. L. Rev.* 845 (2003); Richard A. Booth, "Minority Discounts and Control Premiums in Appraisal Proceedings," 57 *Business Lawyer* 127 (2001).

28 *Highfields Capital, Ltd. v. AXA Financial, Inc.*, 2007 Del. Ch. LEXIS 126 (June 27, 2007) at \*67.

29 *Solera* at \*33-\*34.