Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825 | mlehner@zbtcpa.com
www.zbtcpa.com

zbt Certified Public Accounting
& Consulting, LLC

Viewpoint on Value

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Court turns to stock price as best evidence of fair value

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

In recent years, Delaware's Supreme Court has shown its preference, under the right circumstances, for market-based indicators of value in statutory appraisal cases. For example, in *Dell*, the court used the deal price produced by an efficient market to determine fair value. Following similar logic, the court in *Verition* recently concluded that the best evidence of fair value was the target company's unaffected stock price. The common denominator in both cases was the *reliability* of market-based indicators of value.

What is an "efficient" market?

Verition is a dissenting shareholders case, involving Hewlett-Packard Company's acquisition of Aruba Networks for $24.67 per share. Delaware's Chancery Court considered two market-based amounts as the most probative indicators of fair value:

1. The 30-day average unaffected (premerger) market price of Aruba's stock ($17.13), and
2. The deal price less synergies ($18.20).

Under Delaware's appraisal statute, synergies are specifically excluded from fair value.

In 2017, the Delaware Supreme Court in *Dell* ruled that the price "produced by an efficient market is generally a more reliable assessment of fair value than the view of a single analyst, especially an expert witness who caters her valuation to the litigation imperatives of a well-heeled client." Based on that legal precedent, the chancery court determined that Aruba Networks' stock had all of the characteristics of an efficient market:

- The company had many stockholders.
- There was no controlling stockholder.
- Trading was highly active.
- Information about the company was widely available and easily disseminated to the market.

The court also noted that merger price can be highly persuasive, under the right circumstances, when a public company is sold in an arm's length transaction. Those circumstances include an efficient market and a sales process characterized by fair play, low barriers to entry and outreach to all logical buyers.

In *Verition*, the issue wasn't whether Aruba Networks had negotiated the highest possible price, but whether the dissenting shareholders had received fair value without being exploited. It concluded that Aruba Networks' transaction was a third-party, arm's length merger accomplished through a robust sales process. In addition, there were no indicators of potential unfairness or exploitation, such as a controller squeezeout or management buyout. Moreover, Aruba Networks' board was disinterested and independent.

How did DCF methods measure up?

Both sides hired business valuation experts who valued Aruba Networks' stock using the discounted cash flow (DCF) method. However, there was a substantial variance between the experts' conclusions. Verition's expert valued the stock at $32.57 per share, and Aruba Networks' expert valued it at $19.75 per share.

The court gave no weight to either expert's analysis. It found that the analysis performed by Verition's expert diverged substantially from market-based indicators of value, casting doubt on its reliability. Further, the court ruled that Aruba Networks' expert lacked "methodological rigor," even though his analysis was more in line with market and deal prices.

In *Dell*, the court warned that, when reliable market evidence is available, courts should be cautious about making "a point estimate of fair value based on widely divergent partisan expert testimony." The court acknowledged that the DCF method is the best valuation tool only when there's neither credible market information nor an "open market check."

In deciding between the two market-based approaches in *Verition*, the court chose the unaffected stock price as the best measure of value, because it provided "direct evidence of the collective view of market participants as to [Aruba Networks'] fair value as a going concern during the period before the announcement of the transaction." While the deal price less synergies was somewhat persuasive, the court felt that the process of estimating the value of synergies was uncertain and potentially error prone.

Bottom line

Objective market-based indicators of value generally trump speculative valuation analyses, including DCF techniques, but only if the market is efficient and the sales process is arm's length. So, in statutory appraisal cases, it's critical to focus on market efficiency and the sales process to determine the most appropriate valuation methods.

Sidebar: DCF prevails when sales process is flawed

In a statutory appraisal case similar to *Verition* (see main article), the Delaware Chancery Court relied on an expert's discounted cash flow (DCF) analysis in the absence of reliable market-based indicators of value. This dissenting shareholders' case involved the acquisition of Norcraft Companies for $25.50 per share.

In *Norcraft*, the court found several significant flaws in the sales process that undermined the reliability of the deal price as an indicator of fair value:

- There was no presigning market check.
- Norcraft considered no other potential merger partners.
- Norcraft's lead negotiator focused as much on securing benefits for himself as he did on securing the best price for Norcraft.

The court also rejected the unaffected market price as evidence of value because Norcraft was "fresh off" an IPO. As a result, its stock was thinly traded and analyst coverage was sparse. Without market-based evidence of value, the court turned to the business valuation expert's DCF analysis to determine a fair value of $26.16 per share.

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Michael B. Lehner, CPA/ABV, CFE, ASA
732.412.3825
mlehner@zbtcpa.com
www.linkedin.com/in/michaellehnercpa
@MLehnerCPA
BusinessValuationNJ
www.zbtcpa.com