Valuation Decisions by the Delaware Supreme Court, 2017 – 2019

GILBERT E. MATTHEWS, CFA

Sutter Securities Incorporated
San Francisco, CA
gil@suttersf.com

In the past three years, the Delaware Supreme Court has affirmed four valuation decisions and reversed three. It affirmed the Court of Chancery's decisions in the valuations of ISN Software, SWS Group, Clearwire, and PLX Technology, and it issued important detailed decisions reversing appraisals in Dell, DFC Global, and Aruba Networks.

Vice Chancellor Sam Glasscock III appraised ISN Software, a private company, using DCF only, even though all three experts used comparable companies. The Supreme Court affirmed the decision, which valued ISN's shares at a 158 percent premium over the transaction price.[1]

The Supreme Court affirmed Vice Chancellor Glasscock's appraisal of SWS Group, a broker-dealer at 92% of the deal price. He based his valuation solely on discounted cash flow (DCF). He rejected the petitioners' claim that that a broker-dealer's excess regulatory capital was a non-operating asset that was additive to value, stating, "Petitioners seem to conflate distributable cash or assets with a balance sheet increase in regulatory capital as the result of the conversion of debt to equity."[2] He ruled that the exercise of warrants after the merger agreement but before closing was not contingent on the merger and thus "the exercise was part of the Company's operative reality as of the merger date."[3]

ACP Master v. Sprint (Clearwire)

Clearwire, a telecom company, owned a large block of 2.5 GHz spectrum. Clearwire's unaffected market price was about $1.30. Sprint owned 51 percent of Clearwire but did not have voting control. When news of the potential acquisition of Sprint by Softbank deal leaked, Clearwire shares rose to $2.22.

In connection with Softbank's proposed acquisition of 70 percent of Sprint, Softbank wanted Sprint to have control of Clearwire. Sprint bought out a 5 percent holder at $2.97 to obtain 50.4 percent of the vote, and Clearwire's Special Committee then approved a merger with Sprint at $2.97. After minority shareholder opposition, Sprint raised its bid to $3.40. DISH made a hostile tender offer at $4.40, and Sprint topped at $5.00.

Dissenting shareholders of Clearwire objected to the $5.00 transaction price and sought appraisal. Their expert valued Clearwire at $16.08. Vice Chancellor Travis Laster relied on respondent's expert's DCF analysis (which included the value of a non-operating asset, Clearwire's unused spectrum[4]) and awarded the dissenters $2.13 per share[5]—43 percent of the transaction price. No previous Delaware appraisal had awarded dissenters less than 80 percent of transaction price. Laster concluded:

> There is also no evidence that anyone at Sprint or Softbank believed that Clearwire was worth $5.00 per share. Rather, they agreed to pay that price because of the *massive synergies from the transaction* and the threat that DISH posed as a hostile minority investor.[6] [Emphasis added.]

He observed, "The deal price also provided an exaggerated picture of Clearwire's value," noting that "Sprint estimated that the merger yielded synergies ranging from $1.5 to $2 billion, or $1.95 to 2.60 per share."[7]

Laster relied on Clearwire management's projections and rejected projections made by Sprint:

> Sprint management created the Full Build Projections to convince Softbank to increase the merger consideration by showing what Sprint's business would look like if the merger failed and Sprint nevertheless decided – contrary to the evidence – to use Clearwire's spectrum as Sprint would have if the merger had closed. Sprint and Softbank would not have done that. The Full Build Projections did not reflect Clearwire's operative reality on the date of the merger.[8]

The Supreme Court affirmed Laster's opinion.

Continued on next page

expert TIP

DCF valuations involve many inputs, and even slight differences in these inputs can produce large valuation gaps.

PLX Technology

Vice Chancellor Laster agreed with plaintiffs in a fiduciary duty case that a hedge fund investor had aided and abetted breaches of the board's duties to shareholders. The hedge fund's representative on the PLX board of directors failed to inform other board members that he had discussions with the buyer and its investment banker. However, although plaintiffs were successful in their breach of fiduciary duty claim, the Court rejected plaintiffs' argument that the $6.30 per share transaction price was unfair. Thus, it ruled that plaintiffs "were unable to prove that the breaches resulted in damages."[9]

The trial court stated that it did not have confidence in management projections that included "a new line of business involving a new set of customers with a new set of requirements" and noted that the company had a history of not achieving its projections.[10] Laster observed, "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."[11]

Laster rejected plaintiffs' expert's beta because it was based on daily returns, rather than weekly or monthly returns, explaining:

> [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.[12]

The Supreme Court affirmed Laster's conclusion that the plaintiffs failed to prove that they suffered damages.

DFC Global

Chancellor Andre Bouchard valued DCF Global at $10.30 per share, giving equal weight to each of the deal price ($9.50), comparable companies ($8.07), and DCF ($13.07, raised to $13.33 after reargument). He gave only one-third weight to the deal price because the purchaser was a financial buyer that was focusing on achieving a certain IRR. After reargument, he made an adjustment to working capital that reduced his valuation and then changed the perpetual growth rate used in his DCF calculation from 3.1 percent to 4.0 percent.[13]

The Supreme Court accepted the comparable company analysis but reversed the decision on several points:

1. It rejected the concept that an LBO buyer's winning bid in a contested deal was negatively impacted by its target IRR.
2. It rejected the higher growth rate used in the revised opinion.
3. It rejected the trial court's weighting of the three valuation methods it used.

The Supreme Court endorsed the lower court's application of the comparable company method that had been used by both experts, commenting that "this was a rare instance where both experts agreed on the comparable companies the Court of Chancery used and so did several market analysts and others following the company."[14]

It faulted the Chancellor's upward adjustment to the growth rate:

> [T]he Court of Chancery then substantially increased its perpetuity growth rate from 3.1% to 4.0%, which resulted in the Court of Chancery reaching a fair value akin to its original estimate of the company's value. But, no adequate basis in the record supports this major change in growth rate.[15]

It pointed out the impact of that error on the lower court's valuation, saying:

> With that [growth rate] error corrected, and addressing certain foreign exchange adjustments, the Court of Chancery's discounted cash flow model would yield $7.70 per share [rather than $13.33].[16]

The Supreme Court instructed the lower court that if it elects to weight different valuation methods, it must explain its weighting:

> [T]he Court of Chancery must exercise its considerable discretion while also explaining, with reference to the economic facts before it and corporate finance principles, why it is according a certain weight to a certain indicator of value... In this case, the decision to give one-third weight to each metric was unexplained and in tension with the Court of Chancery's own findings about the robustness of the market check.[17]

Dell

Vice Chancellor Laster valued Dell at 27 percent above the deal price, solely using DCF.[18] He enunciated several reasons why he gave no weight to the deal price:

1. Deal prices in management buyout (MBO) transactions are unreliable as measures of fair value.[19]
2. The price that leveraged buyout (LBO) sponsors would pay is limited by the need to achieve IRRs of 20 percent or more, and by limits on financial leverage.[20]
3. The market for Dell's shares was inefficient, and a valuation gap existed between market perception and Dell's operative reality, driven by analysts' focus on short-term results.[21]
4. The shopping process was inadequate.[22]

Continued on next page

5. Financial sponsors are concerned about a "winner's curse."[23]

The Supreme Court disagreed with each of the trial court's reasons for rejecting the deal price:

1. The transaction was not a management buy-out:

   [T]his was not a buyout led by a controlling stockholder. Michael Dell only had approximately 15% of the equity.[24]

   [A]ny outside bidder who persuaded stockholders that its bid was better would have access to Mr. Dell's votes.[25]

   [T]here is no evidence that management was critical here given both Blackstone's and Icahn's doubts about Mr. Dell's leadership and [their] apparent willingness to pursue transactions without his continued involvement.[26]

2. As discussed in *DCF Global*, LBO sponsors' IRR requirements did not justify rejecting their bids as a measure of fair value:

   The trial court's complete discounting of the deal price due to financial sponsors' focus on obtaining a desirable IRR and not "fair value" was also error.[27]

   [T]o the extent that the Court of Chancery chose to disregard Dell's deal price based on the presence of only private equity bidders, its reasoning is not grounded in accepted financial principles, and this assessment weighs in favor of finding an overall abuse of discretion.[28]

3. The market for Dell's shares was efficient and there was no "valuation gap":

   The trial court believed that short-sighted analysts and traders impounded an inadequate – and lowball – assessment of all publicly available information into Dell's stock price, diminishing its worth as a valuation tool. But the record shows just the opposite: analysts scrutinized Dell's long-range outlook when evaluating the Company and setting price targets.[29]

4. The shopping process was satisfactory:

   The Committee, composed of independent, experienced directors and armed with the power to say "no," persuaded Silver Lake to raise its bid six times. Nothing in the record suggests that increased competition would have produced a better result.

   [The lower court's] assessment that more bidders . . . should have been involved assumes there was some party interested in proceeding. Nothing in the record indicates that was the case. *Fair value entails at minimum a price some buyer is willing to pay – not a price at which no class of buyers in the market would pay.*[31] [Emphasis added.]

5. The Special Committee addressed the information asymmetry problem and the "winner's curse" risk as best it could:

   [T]he likelihood of a winner's curse can be mitigated through a due diligence process where buyers have access to all necessary information. And, here, Dell allowed Blackstone [during the go-shop period] to undertake "extensive due diligence," diminishing the "information asymmetry" that might otherwise facilitate a "winner's curse."[32]

The Supreme Court rejected the lower court's DCF valuation. It commented:

> [W]here a robust sale process … occurred, the Court of Chancery should be chary about imposing the hazards that always come when a law-trained judge is forced to make a point estimate of fair value based on widely divergent partisan expert testimony.[33]
>
> DCF valuations involve many inputs—all subject to disagreement by well-compensated and highly credentialed experts—and even slight differences in these inputs can produce large valuation gaps.[34]

The Supreme Court concluded that transaction price should be the dominant factor in determining Dell's fair value. It ruled, "Overall, the weight of evidence shows that Dell's deal price has heavy, if not overriding, probative value."[35]

Aruba Networks

Although neither side had addressed unaffected market price at trial, Vice Chancellor Laster valued Aruba at "unaffected market price," which he defined as the average price during the 30 days prior to a news article that discussed the pending transaction.[36] The Court's appraised value was 69.4 percent of the $24.67 deal price.

Subsequent to the *Aruba* trial, the Supreme Court issued its opinion reversing Laster's decision in *Dell*. Laster then requested

Continued on next page

"supplemental briefing on 'the market attributes of Aruba's stock' in part because he 'learned how many errors [he] made in the Dell matter.'"[37] 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."[38]

The decision 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.[39]

Although the market had no information as to the unexpectedly good quarter prior to the merger announcement, the trial 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.[40]

The Supreme Court reversed the Court of Chancery's decision. It disagreed with the lower court's conclusion as to the reliability of the trading price, observing:

> [The buyer] had *material, nonpublic information* that, by definition, *could not have been baked into the public trading price* … In particular, HP [the buyer] 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.[41] [Emphasis added.]

The Supreme Court pointed out that the Delaware appraisal statute requires that the company be valued at "the effective date of the merger," and that the unaffected market price was "three to four months prior to closing."[42] It firmly rejected the use of unaffected market price to value Aruba:

> 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.[43] [Emphasis added.]

The Supreme Court awarded petitioners $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.[44] It noted that "Aruba's estimate of $19.10 … was corroborated by … Aruba's [expert's] DCF, comparable companies, and comparable transactions analyses."[45]

CONCLUSION

The Supreme Court, under now-retired Chief Justice Leo Strine, Jr., actively reviewed valuation cases and did not hesitate in reversing decisions that it deemed incorrect. With valuation standards more clearly defined by these recent decisions, it seems likely that fewer major Supreme Court valuation decisions will be forthcoming in the near future. ℘

---

1 *In re ISN Software Corp. Appraisal Litig.*, 2016 Del. Ch. LEXIS 125 (Del. Ch. Aug. 11, 2016); *aff'd, ISN Software Corp. v. Ad–Venture Capital Partners, L.P.*, 173 A.3d 1047 (Del. 2017).

2 *In Re Appraisal of SWS Group, Inc.*, 2017 Del. Ch. LEXIS 90 (Del. Ch. May 30, 2017) at *41; *aff'd*, 2018 Del. LEXIS 77 (Feb 23, 2018).

3 *Id.* at *38.

4 *Id.* at *93.

5 *Id.* at *97.

6 ACP *Master, Ltd. v. Sprint Corp.*, 2017 Del. Ch. LEXIS 125 (Del. Ch. July 21, 2017) at *75, *aff'd*, 184 A.3d 1291 (Del. 2018).

7 *Id.* at *79.

8 *Id.* at *87.

9 *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).

10 *Id.* at *52.

11 *Id.* at *53.

12 *Id.* at *54, quoting Gabriel Hawawini, "Why Beta Shifts as the Return Interval Changes," *Financial Analysts Journal*, May-June 1983, p. 73.

13 *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). The case settled shortly after the Supreme Court's decision; terms were not announced.

14 *DFC Global Corp. v. Muirfield Value Partners* at 351.

15 *Id.* at 350.

16 *Id.* at 361.

17 *Id.* at 388.

18 *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).

19 Appraisal of Dell at *87-*88.

20 *Id.* at *90-*97.

21 *Id.* at *101-*115.

22 *Id.* at *115-*125.

23 *Id.* at *139-*142.

24 *Dell v. Magnetar* at 30.

25 *Id.* at 11.

26 *Id.* at 32.

27 *Id.* at 27. The Supreme Court decision in *DFC Global* was issued subsequent to the Court of Chancery decision in *Dell*.

28 *Id.* at 31.

29 *Id.* at 24.

30 *Id.* at 28.

31 *Id.* at 29.

32 *Id.* at 32.

33 *Id.* at 35.

34 *Id.* at 38.

35 *Id.* at 30.

36 *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*).

37 *Aruba II* at 131, quoting the Court's letter to the parties.

38 *Aruba I* at *4.

39 *Id.* at *63

40 *Id.* at *66.

41 *Aruba II* at 139.

42 *Id.* at 132.

43 *Id.* at 140. Subsequently, Laster appraised two companies acquired in arm's-length transactions at the deal price. [*In re Appraisal of Columbia Pipeline Group, Inc.*, 2019 WL 3778370 (Del. Ch. Aug. 12, 2019) and *In re Appraisal of Stillwater Mining Co.*, 2019 WL 3943851 (Del. Ch. Aug. 21, 2019)].

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

45 *Aruba II* at 142.