# Valuation & Litigation Briefing

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

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

# Court turns to stock price as best evidence of fair value

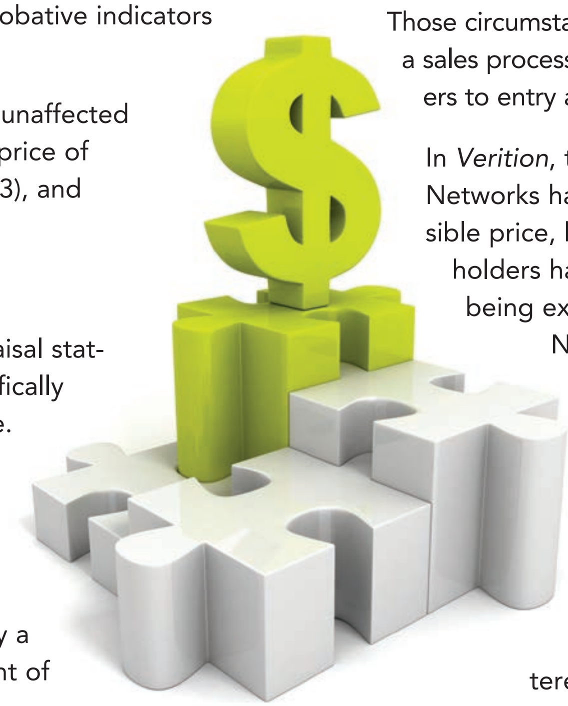
In recent years, Delaware's Supreme Court has shown its preference, under the right circumstances, for market-based indicators of value in statutory appraisal cases. For example, in *Dell*, the court used the deal price produced by an efficient market to determine fair value. Following similar logic, 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.

## 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.

## 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.

# Buyer beware

## Hire a business valuation pro to help with due diligence

The U.S. merger and acquisition (M&A) market hit a record high in 2018, according to data published by Thomson Reuters. And many more deals are expected to follow in 2019. If you're considering a business combination, a business valuation professional can help you vet a prospective deal and improve your chances of success.

### Conducting due diligence

M&A due diligence typically starts with a review of the company's historical financial performance. Audited financial statements offer prospective buyers greater assurance than reviews, compilations or internal statements. Nonaudited financial statements may require a so-called "quality of earnings" report to get a clearer picture of what to expect.

Even so, what you see may not be what you get. Adjustments to the historical financial statements may be needed to estimate the buyer's expected return. Examples of these adjustments include:

- Unusual and nonrecurring items (such as costs to settle a lawsuit or a gain from the sale of a nonoperating asset),
- Write-offs for bad debts and obsolete inventory,
- Excess owners' compensation,
- Non-arm's length shareholder loans,
- Unreported cash receipts, and
- Discretionary expenses (such as the owners' country club dues, sporting event tickets or nonbusiness travel expenses).

Valuation experts also can spot hidden costs and help buyers evaluate whether the seller owns the intellectual property it claims it does. Inexperienced buyers may not realize how difficult it can be to dispose of real estate holdings, or how costly it can be to train newly merged employees or integrate IT systems.

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Likewise, a valuation expert will assess whether the seller has positioned the company for long-term growth by investing in equipment maintenance and staff training. And they'll evaluate potential risk factors that might warrant a lower offer price, such as weak internal controls, reliance on key people, aggressive tax strategies and unfavorable contract terms (or lack of formal contracts).

## Projecting financial results

When determining the offer price in M&As, historical financial performance is only relevant to the extent that future performance will mirror what's happened in the past. Starting in 2018, future performance may differ significantly for many companies in light of major tax reform legislation — known as the Tax Cuts and Jobs Act (TCJA) — that passed in December 2017.

Under the TCJA, most businesses are expected to pay less tax and, therefore, generate more cash flow. But not all of the TCJA provisions are business friendly. Each business will be affected somewhat differently. So, it's important to factor all of the TCJA changes into the company's projected financial statements.

If a seller's financial projections were prepared in-house, ask how well the person who prepared them understands the TCJA. In some cases, a valuation professional who's familiar with the TCJA may need to prepare (or adjust) the company's projections.

## Structuring a fair deal

How much are others paying for similar businesses in today's hot M&A market? Don't rely on industry rules of thumb to answer this question. A valuation expert can use private company transaction databases to generate pricing multiples based on real-world transactions.

Moreover, private company transaction databases provide insight into typical deal terms in the company's industry. In general, sellers prefer stock sales, because they provide a clean break — the buyer purchases all assets and assumes all liabilities, including undisclosed and contingent obligations. Stock sales also may lower the seller's tax obligations, because proceeds are taxed at long-term capital gains tax rates, which have historically been lower than ordinary-income tax rates.

In an asset sale, proceeds are typically taxed as a combination of ordinary income and capital gains. Buyers like this type of deal because it allows them to cherry-pick what's included (and excluded) in the deal. And asset purchasers generally are responsible for only the liabilities expressly assumed and those secured by the purchased assets.

The TCJA generally lowered ordinary-income tax rates, so the disparity between stock and asset deals may be narrower under current law than it was in the past. This may make an asset sale more attractive to some sellers.

## Need help?

M&A transactions can be complicated and require expertise that most private business owners simply don't have. A business valuation professional brings critical assets to the negotiating table — including M&A experience, modern tax know-how and objectivity. ■

# How to calculate terminal value

Under the discounted cash flow method, the value of a business is derived from a series of projected annual cash flows. At the end of the discount period, cash flow is expected to stabilize — or the business is presumed to be sold or liquidated. This final part of the analysis is critical, but can be confusing.

## Demystifying terminal value

The *International Glossary of Business Valuation Terms* defines terminal (or residual) value as "the value as of the end of the discrete projection period in a discounted future earnings model." Terminal value is discounted to present value. Then it's added to the net present value of annual cash

flows over the discrete projection period to arrive at the value of the business under the discounted cash flow method.

Business valuation experts typically consider the capitalization of earnings method and the market approach when estimating terminal value. Either (or both) may be appropriate, depending on the nature of the business, purpose of the valuation, reliability of the company's financial projections and availability of market data.

## Capitalizing earnings

The capitalization of earnings method is based on the assumption that cash flow will stabilize in the final year of the projection period. However, this is also the time period that's subject to the greatest margin for error because it's the furthest into the future.

Under the capitalization of earnings method, terminal value equals expected future cash flow (the numerator) divided by a capitalization rate (the denominator). Long-term growth is used in the numerator to determine cash flow in the final projection period. Then it's used again in the denominator, because the capitalization rate equals the discount rate minus the long-term sustainable growth rate.

Because it's in both the numerator and the denominator, the long-term sustainable growth rate can have a significant impact on terminal value. A minor change in the long-term growth rate can have a major impact on business value.

## Applying the market approach

Another way to estimate terminal value is to assume that the business could be sold at the end of the discrete period in an arm's length transaction. Using the market approach, a business valuation expert considers comparable public stock prices and sales of comparable private businesses. Although the market approach sounds straightforward, it can sometimes be difficult to find comparable transactions, especially for small private firms.

Comparable market data also might serve as a sanity check. For example, a valuation expert might compare 1) the implied pricing multiples from a terminal value that's been calculated using the capitalization of earnings method, and 2) average pricing multiples from comparable transactions involving similar companies in recent years.

**Experts typically consider the capitalization of earnings method and the market approach when estimating terminal value.**

There may be cause for concern if, say, a company's terminal value generates a price-to-revenues multiple of 5.0 and comparable transactions during the last 12 months indicate an average price-to-revenues multiple of 0.9. The expert would need to explain the reason for such a discrepancy — or adjust his or her analysis.

## Need help?

Terminal value can be a major part of the valuation puzzle, so it's important to get it right. Contact a business valuation professional to develop a terminal value that's based on reliable projections and objective market data.

# Warning: Expert admissibility standards may vary

In federal court, the admissibility of expert testimony is governed by the strict *Daubert* standard. The U.S. Supreme Court decided this landmark case in 1993.

For more than 25 years, it's become routine for litigants in federal cases to challenge the methodologies of their opponents' experts under *Daubert*. Courts in most states have also adopted the *Daubert* standard, but others may apply the less stringent *Frye* standard. Which one applies in your case?

## *Daubert* vs. *Frye*

For 70 years, federal courts turned to the *Frye* standard when deciding whether to admit expert testimony. Under this standard, expert testimony is admissible if the expert's methods are generally accepted as reliable in the relevant scientific community.

Criticism of *Frye*, in particular its focus on consensus rather than scientific validity, led the Supreme Court in *Daubert* to establish a new test starting in 1993. In ruling on the admissibility of expert testimony, a trial judge must determine "whether the reasoning or methodology underlying the testimony is scientifically valid, and … whether that reasoning or methodology properly can be applied to the facts in issue."

The Court listed several factors, including general acceptance, that a judge should consider in assessing whether an expert's methods are scientifically valid. In its 1999 decision in *Kumho Tire Co. v. Carmichael*, the Court clarified that similar principles apply to financial and other nonscientific expert testimony.

## Determine the relevant standard

Often, the admissibility of expert testimony can make or break a case. So, it's critical to understand the applicable standard in state court. Just because a standard is memorialized in a state's evidence rules doesn't necessarily mean it will hold up in court.

For example, in the personal injury case *Delisle v. Crane*, Florida's Supreme Court upheld the trial court's admission of expert medical testimony regarding whether the plaintiff's cancer was caused by exposure to asbestos. The court applied the *Frye* standard — even though Florida's legislature had amended the state's evidence code five years earlier to incorporate the more rigorous *Daubert* standard. The legislature's amendment was unconstitutional, the court said, because it encroached on the court's authority to establish procedural rules.

## Be prepared

It's important to ascertain the relevant standard early in the litigation process. This dictates the steps you must take to ensure that your experts are permitted to testify. Establishing general acceptance under *Frye* generally requires less work than demonstrating scientific validity under *Daubert*. Therefore, the standard that applies may affect the scope of your expert's work and, ultimately, the cost of litigation. ■