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IN THE SUPREME COURT OF THE STATE OF DELAWARE

VERITION PARTNERS MASTER FUND LTD. and VERITION MULTI-STRATEGY MASTER FUND LTD.,	
Petitioners-Below, Appellants,	
	C.A. No. 368, 2018
v.	
	Court below: Court of Chancery
ARUBA NETWORKS, INC.,	C.A. No. 11448-VCL
Respondent-Below, Appellee.	

CORRECTED
BRIEF OF AMICI CURIAE PROFESSORS AUDRA BOONE, BRIAN BROUGHMAN, ALBERT CHOI, JESSE FRIED, MIRA GANOR, ANTONIO MACIAS, AND NOAH STOFFMAN
IN SUPPORT OF APPELLANT AND REVERSAL

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INTEREST OF *AMICI CURIAE*

Amici are professors of law and professors of finance whose teaching and research interests include corporate law, corporate finance, mergers and acquisitions (including appraisal), corporate valuation and related topics. They are regularly cited as authorities on these topics and several have conducted research directly related to judicial appraisal. *Amici* have no economic interest in the case on appeal. They write solely because they believe that M&A transactions should be regulated sensibly. The names and titles of the *amici* are set forth in Exhibit 1.

SUMMARY OF ARGUMENT

Amici submit this narrow brief to address two topics: (1) the appropriate application of the efficient market hypothesis to the record of this case and (2) empirical scholarship regarding the effect of Delaware judicial decisions and amendments to 8 *Del. C.* § 262 on premia in public M&A transactions.

Even if Aruba stock traded in an efficient market—an issue on which no evidence was presented at trial—such trading would not imply that the trading price itself reflected fair value. And even if Aruba's stock price was accurate as of the merger announcement date, that price would tell us little about the value of the company as a whole on the *closing* date. This is so first because the market price would fail to reflect information that was not publicly available at the time of the announcement. In addition, the pre-announcement price would reflect the value of a share of Aruba stock only to the marginal minority stockholder, rather than the value of a pro-rata share of the company as a going concern.

In most cases, deferring to the pre-announcement market price would render the appraisal remedy a nullity since in most cases it inherently understates fair value because it is based on minority trades. Doing so would not only be bad economics, it would also generate bad policy results. Recent empirical scholarship demonstrates that Delaware stockholders benefit from the protection provided by judicial appraisal, and by extension suggests that even passive (non-dissenting) minority investors would be harmed if appraisal valuations collapse down to a target's pre-announcement market price.

ARGUMENT

Relying on the unaffected market price in an appraisal proceeding is inconsistent with the Delaware appraisal statute because it does not estimate fair value at the close of the merger and well-reasoned Delaware case law interpreting "fair value." More importantly, it would be harmful to Delaware stockholders, as a matter of economic policy. Part I addresses the efficient market hypothesis and part II reviews recent empirical scholarship on appraisal.

I. Valuing Respondent's Stock at its Pre-announcement Trading Price is Inconsistent with Fair Value under Delaware Law

Following *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983), Delaware courts are instructed to use valuation techniques—including discounted cash flow analysis—that are "generally considered acceptable in the financial community." As the trial court acknowledged in the re-argument opinion, the present case appears to be the first decision in Delaware to "hold that the unaffected market price was the best evidence of fair value and award that figure."[1]

Resorting to market prices has a superficial appeal. It removes the court from the messy task of setting value. It also appears supported by evidence suggesting that markets are efficient.[2] However, it is critical to realize exactly what that evidence supports—and what it does not. Evidence supporting market efficiency primarily applies to the speed and direction of price adjustment in response to new information—what is known as "informational" efficiency.

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[1] *See* Reargument opinion dated May 21, 2018.

[2] Michael Jensen famously quipped: "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis." *See* Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. of Fin. Econ. 95-101 (1978). Even when Jensen made this statement, however, there were already numerous studies showing patterns in historic price data (e.g. momentum) inconsistent with market efficiency (Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. of Fin. 1575-1617 (1991)), and subsequent behavioral research documents additional deviations from market efficiency (Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioural Finance*, Oxford Press UK (2000)).

Informational efficiency implies that publicly available information will, through trading activity, quickly move market prices. Informational efficiency, however, does not imply "fundamental" efficiency—that the market's response is appropriate (neither too large nor too small) or that market prices reflect intrinsic share value, propositions that are inherently untestable.[3]

Nonetheless, our view that market price makes a poor proxy for fair value is not primarily based on skepticism of market efficiency. Even if we assume that the market for Aruba's stock in the period prior to announcement of the acquisition with HP was efficient with respect to publicly available information, the trading price of Aruba's stock prior to announcement can be expected to systematically understate fair value, for at least two reasons.

First, market prices reflect information that is publicly available at the time.[4] In the M&A setting, however, deal planners are often aware of nonpublic

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[3] The accuracy of market prices can only be tested relative to an equilibrium pricing model (such as CAPM), and because any selected asset pricing model may be misspecified in unknown ways, any effort to test pricing accuracy suffers from what is known as the "joint-hypothesis" problem. Eugene F. Fama, *Two Pillars of Asset Pricing*, Nobel Prize Lecture (Dec. 8, 2013), https://pdfs.semanticscholar.org/d901/028175d0560bc1b4d7f5e2f076eaae32c0fb.pdf. ("Tests of [value] efficiency basically test whether the properties of expected returns implied by the assumed model of market equilibrium are observed in actual returns. If the tests reject, we don't know whether the problem is an inefficient market or a bad model of market equilibrium.").

[4] To be sure, a small number of investors with private information, may sometimes move market prices by taking a large position. This leakage of private information

information regarding a target's prospects. In fact, the target typically shares nonpublic information with the bidder under a confidentiality agreement to help the bidder prepare an accurate valuation of the target's business.[5] Such information can be expected to enable deal planners to more accurately forecast a target's future cash flows (and consequently more accurately price its equity) than outsiders trading in the market. It need not be publicly released before the merger announcement, and there are strategic reasons for keeping such information private until after a signed merger agreement is announced.[6]

And, this appears to be exactly what happened in the Aruba-HP deal. The parties strategically leaked the existence of a merger immediately prior to Aruba's disclosure of stronger than expected quarterly results. The timing of the deal

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into market prices, however, is limited by securities regulation. Evidence that prices often move substantially on public disclosure, emphasizes that the distinction between public and private information is meaningful.

[5] *See* Audra L. Boone & J. Harold Mulherin, *How Are Firms Sold?*, 62 J. of Fin. 847-75 (2007).

[6] On a related point, in stock for stock deals acquirers have an incentive to strategically release positive information about their firm to improve the exchange ratio (Kenneth R. Ahern & Denis Sosyura, *Who Writes the News? Corporate Releases During Merger Negotiations*, 69 J. of Fin. 241-91 (2014)). Furthermore, the existence of private information may cause a target to initiate a transaction with a prospective acquirer (Ronald W. Masulis, Serif Aziz Simsir, *Deal Initiation in Mergers and Acquisitions* (ECGI - Finance Working Paper No. #371 (forthcoming 2015), *available at,* SSRN: https://ssrn.com/abstract=2297817; Carol Anilowski Cain, et al., *Buyer Beware: Ethics, Adverse Selection, and Target Method of Sale Strategies* (2017), *available at,* SSRN: https://ssrn.com/abstract=1339963.

announcement appears to have been based on a concern that disclosure of Aruba's quarterly results would cause a run-up in the stock price, making it difficult to close the deal at the negotiated price. Indeed, in a semi-strong form efficient market one would *expect* a significant positive price movement in response to an above-guidance quarterly earnings announcement. Paradoxically, empirical support for market efficiency helps the petitioner here, as it suggests that one thing we can say with some confidence is that the pre-announcement trading price was downward biased.

This setting is not unique to the Aruba-HP deal. The existence of nonpublic information known to deal planners is likely to undermine reliance on market prices in many M&A deals, and the precise nonpublic information may be difficult to observe *ex post*. Even if such information is observable at trial and even if—unlike in the present case—there is expert testimony related to market efficiency, it may still be impossible to follow the trial court's suggestion and "disentangle" the counterfactual impact that such nonpublic information would have had if disclosed prior to the announcement of the deal.

To the extent that nonpublic information is disclosed in *connection-with* or *after* a deal is announced, any subsequent market reaction will be muted by the pending merger and fail to reflect how the data point of the merger itself affects market participants' views on the stock's value. Post-announcement, a company's stock trades based on the likelihood of either deal consummation or a topping offer, making it impossible to reliably determine what prices would have looked like if such nonpublic information were disclosed pre-announcement. Even more problematic, post-announcement prices lack the benefit of the market's knowledge of the full evidentiary record in the appraisal action making ex-post predictions of price movements highly speculative (at best) and a poor substitute for more reliable valuation evidence such as a discounted cash flow analysis.

More generally, the pre-announcement trading price does not account for information that is revealed or events that take place between the announcement date and the closing date—the valuation date sensibly required by the appraisal statute. Events that occur in the weeks or months between announcement and closing, whether they are macroeconomic developments, industry-specific developments, or firm-specific events, will necessarily not be reflected in the pre-announcement trading price. This is no small consideration. In this case, three months elapsed between the announcement of the merger and the closing date.

Second, at best market prices reflect the value that a marginal investor assigns to the cash-flow rights associated with a single share of stock. For purposes of appraisal this is problematic. Delaware law has properly recognized that courts must value the entire firm as a going concern and then assign each dissenter its pro-rata interest in the firm. A dissenter's pro-rata interest is likely to diverge from the value assigned the shares by a marginal investor for at least two reasons. One reason is that the market trading price fails to account for the value of control that comes with a large block of stock. An investor purchasing a controlling block of stock is willing to pay more per share (a "control premium") than an atomistic investor because the former gains the right to determine how the assets are used. As a consequence, the market price for a single share of stock will generally be less—by what is known as a "minority discount"[7]—than such share's pro-rata interest in the value of the firm as a going concern. Failure to account for minority discounts in trading prices would be inconsistent both with existing case

[7] Some academic commentators have criticized adjustment for minority discounts. Their argument applies most clearly to the use of minority discounts in models that rely on a comparable company multiple to calculate terminal value. *See* Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. Pa. L. Rev. 1, 26-28 (2007).

law[8] and with empirical evidence showing that dual class voting shares[9] and large block sales both require a significant premium over the listed market price.[10]

A second reason for the discrepancy between the value assigned by a marginal investor and a dissenter's pro-rata share is simply that target stockholders have different reservation prices for selling their stock. To secure stockholder approval, an acquirer must, at a minimum, pay the price demanded by the median target shareholder. The market trading price, on the other hand, reflects the valuation demanded by the lowest valuing (i.e. marginal) stockholder. While some models in finance assume homogeneous valuation (i.e. all stockholders value the stock at the same price) as a simplifying assumption, there is increasing recognition that this is inaccurate.[11] A large body of empirical research documents

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[8] *See, e.g., Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989) ("[T]o fail to accord to a minority shareholder the full proportionate value of [the petitioner's] shares imposes a penalty for lack of control, and unfairly enriches the majority shareholders who may reap a windfall from the appraisal process by cashing out a dissenting shareholder, a clearly undesirable result.").

[9] *See e.g*. Ronald C. Lease, John J. McConnell, & Wayne H. Mikkelson, *The Market Value of Control in Publicly-Traded Corporations*, 11 J. of Fin. Econ. 439-71 (1983); Luigi Zingales, *The Value of the Voting Right: A Study of the Milan Stock Exchange Experience*, 7 Rev. of Fin. Studies 125-48 (1994).

[10] *See e.g*. Michael J. Barclay & Clifford G. Holderness, *Private Benefits From Control of Public Corporations*, 25 J. of Fin. Econ. 371-395 (1989); Alexander Dyck & Luigi Zingales. *Private Benefits of Control: An International Comparison*, 59 J. of Fin. 537-600 (2004).

[11] For an overview see Eugene F. Fama & Kenneth R. French, *Disagreement, Tastes, and Asset Prices*, 83 J. of Fin. Econ. 667-89 (2007); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. of Fin. 579-90 (1986); and Edward

heterogeneity in shareholder valuations.[12] While heterogeneous shareholder beliefs do not invalidate market efficiency, they do highlight a gap between market prices and a dissenter's pro rata interest. Heterogeneity in shareholder valuations also emphasizes—contrary to some academic work—that control premiums cannot be entirely written off as an "element of value arising from the accomplishment or expectation of the merger."[13] In the presence of shareholder heterogeneity, resorting to market prices will fail to provide a dissenting shareholder its pro rata interest in a firm's going concern value.

M. Miller, *Risk, Uncertainty and Divergence of Opinion*, 32 J. of Fin. 1151-68 (1977).

[12]Evidence of heterogeneity in shareholder valuations is well established on both the demand-side and the supply-side. For illustrative examples see Laurie Bagwell, *Dutch Auction Repurchases: An Analysis of Shareholder Heterogeneity*, 47 J. Fin. 71-105 (1992); Robert Comment & Gregg A. Jarrell, *The Relative Signalling Power of Dutch-Auction and Fixed-Price Self-Tender Offers and Open-Market Share Repurchase*, 46 J. of Fin. 1243-71 (1991); Malcolm Baker, Joshua Coval, and Jeremy C. Stein, *Corporate Financing Decisions when Investors Take the Path of Least Resistance*, 84 J. of Fin. Econ. 266-98 (2007); Laurie Hodrick, *Does Stock Price Elasticity Affect Corporate Financial Decisions?*, 52 J. of Fin. Econ. 225-56 (1999).

[13] DGCL § 262. *See supra* Hamermesh & Wachter, *The Short and Puzzling Life of the 'Implicit Minority Discount' in Delaware Appraisal Law*, 156 U. Pa. L. Rev. at 34 -37 (arguing that if acquirer is willing to pay a control premium because it can reduce agency costs at the target firm, this should be considered an element of value arising from the accomplishment of the deal). Heterogeneity in shareholder valuations suggests that a control premium will need to be paid even absent agency costs.

II. Setting Appraisal Valuation at the Unaffected Market Price Would be Harmful to Stockholders of Delaware Corporations

In response to appraisal arbitrage, some commentators have expressed concern that appraisal suits are frivolous, or, more troubling, that heightened risk of appraisal could cause bidders to pay less up front so they can afford to pay off dissenting shareholders ex post.[14] Yet, empirical research investigating such claims has found a very different story.

Several studies, for example, show that transactions where there is more reason to doubt the adequacy of the deal price are more likely to be changed. Illustrative of this, Kalodimos and Lundberg note that:

> Deals petitioned for appraisal tend to have substantially lower premia than a matched sample. Moreover, the acquiring firms of petitioned targets have substantially higher cumulative abnormal returns around the merger announcement relative to a matched sample.[15]

Similar results with respect to target premiums were also found by Charles R. Korsmo & Minor Myers, *Appraisal Abritrage and the Future of Public Company M&A*, 92 Wash. U.L. Rev. 1551 (2015) and Wei Jiang, et al., *Appraisal: Shareholder Remedy or Litigation Arbitrage?*, 29 J. Law & Econ. 697-729 (2016).

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[14] *See* for example Liz Hoffman, *Wall Street Law Firms Challenge Hedge-Fund Deal Tactic*, Wall St. J., Apr. 6, 2015.

[15] *See* Jonathan Kalodimos & Clark Lundberg, *Shareholder Rights in Mergers and Acquisitions: Are Appraisal Rights Being Abused?*, 22 Fin. Res. Letters 53, 57 (2017).

Kormso and Myers (2015) also find that conflict of interest transactions are more likely to receive an appraisal challenge.

Perhaps more important, there is no evidence that threat of appraisal causes bidders to offer a lower upfront price so they can afford to pay dissenting shareholders ex post. Two recent studies—Callahan, Palia, & Talley (2018) (hereafter CPT) and Boone, Broughman, and Macias (2018) (hereafter "BBM")—investigate this claim, exploring the impact of changes in the appraisal remedy on *ex ante* deal terms.[16] Using different time periods and a different sample of deals, both studies, nonetheless, find that events which increase the strength of the appraisal remedy are associated with a statistically significant increase in deal premia and abnormal returns for target shareholders in subsequent acquisitions.[17]

[16] *See* Scott Callahan, Darius Palia, & Eric L. Talley, *Appraisal Arbitrage and Shareholder Value*, 3 J. of Law, Fin. & Acct. 147-88 (2018) and Audra L. Boone, Brian J. Broughman & Antonia J. Macias, *Merger Negotiations in the Shadow of Judicial Appraisal*, Indiana Legal Studies Research Paper No. 381 (2018), *available at*, https://ssrn.com/abstract=3039040.

[17] BBM look at events – Delaware judicial decisions and amendments to DGCL § 262 staggered over a 13-year period (2004 to 2017) – that impact the strength of the appraisal remedy in Delaware, but do not apply to target firms incorporated elsewhere. BBM compare the impact such events have on deals involving a Delaware-incorporated target relative to a control group of acquisitions involving target firms incorporated outside Delaware, and finds that "shareholders of Delaware targets receive higher abnormal returns and acquisition premiums following events that strengthen the appraisal remedy, as compared to deals involving non-Delaware targets over the same period". By contrast, CPT limit their analysis to deals involving a target firm incorporated in Delaware, and then compare appraisal-eligible deals to control group of ineligible deals, but

These findings suggest that a robust appraisal regime provides a credible "reserve price" below which a sale cannot occur, and that shareholders benefit from this protection. As noted by CPT, "target-company shareholders likely benefited *ex ante* from liberalized appraisal, regardless of whether they subsequently sought appraisal or not."

Moreover, threat of appraisal does not appear to limit takeover activity or impact method of payment. Put simply, there is no evidence that appraisal arbitrage is causing Delaware to lose deal-flow or causing deal planners to avoid doing cash deals.[18] Finally, BBM explore the impact of appraisal arbitrage on governance terms and deal process:

> our analysis suggests that bidders protect themselves against threat of appraisal, not through contractual terms that would allow the bidder to walk away from the deal (e.g. appraisal out clause), but rather by increasing their upfront bid and improving the price-setting process (e.g. formal auctions).[19]

This last point is particularly important, as it suggests that the threat of appraisal has desirable *ex ante* effects on how acquisitions are negotiated and ultimately allows target firms to obtain a better price. Appraisal can serve as an important

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nonetheless find similar results to BBM. For appraisal-eligible deals, acquisition premiums increased following *Transkaryotic* and the 2007 amendments to DGCL 262 (both in summer 2007). *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007).

[18] *See supra* n.16, Boone, Broughman & Macias at 3.

[19] *See supra* n.16, Boone, Broughman & Macias at 4.

check in settings where executives of the target firm may have financial incentives (e.g. golden parachutes, and related M&A side-payment) to sell the firm, potentially undermining the executive's bargaining power to negotiate on behalf of shareholders.[20]

To be sure, appraisal is a rapidly evolving area. The research discussed above does not imply that a stronger appraisal regime will *always* be beneficial. Further changes in appraisal arbitrage may encourage deal planners to include new contractual protections or adjust in unexpected ways. Nonetheless, current research in this area strongly suggests that appraisal provides an important protection for minority shareholders.

CONCLUSION

For at least the foregoing reasons, *Amici* respectfully submit that the Court should reverse the decision of the Court of Chancery.

[20] Consistent with this concern, Jay C. Hartzell, Eli Ofek & David Yermack, *What's In It for Me? CEOs Whose Firms Are Acquired*, 17 Rev. of Fin. Studies 37-61 (2004), show that the CEO of the target firm will sometimes sacrifice acquisition premia so that he can receive additional side-payments.

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CERTIFICATE OF SERVICE

I hereby certify that on October 3, 2018, a copy of the Corrected Brief of *Amici Curiae* Professors Audra Boone, Brian Broughman, Albert Choi, Jesse Fried, Mira Ganor, Antonio Macias, and Noah Stoffman in Support of Appellant and Reversal was electronically served via *File & ServeXpress* on the following counsel of record:

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