DELAWARE VALUATION CASE LAW UPDATES

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This presentation will review recent corporate valuation decisions in Delaware

- A majority of U.S. public corporations are incorporated in Delaware
- Delaware has by far the most extensive body of case law

- First, we will review valuation methods used by the Delaware courts
  - We will then discuss Delaware Supreme Court valuation cases in the past 4 years
    - Next, we will discuss 2019 and 2020 Court of Chancery valuation case
      - The concluding comments on will address how Delaware case law impacts expert testimony in valuation cases

VALUATION METHODS

IN DELAWARE

VALUATION METHODS ACCEPTED BY DELAWARE COURTS

The principal valuation methodologies that are now generally accepted by Delaware courts in appraisals and other valuations:

- Primarily, discounted cash flow
- Less frequently, comparable companies
  - The Court of Chancery commonly uses "comparable" rather than "guideline"

In the past few years, several opinions have relied on the deal price *in arm's-length transactions* (often with adjustments to exclude synergies)

A recent decision used the unaffected market price

THE MARKET APPROACH

The Court of Chancery has seldom used the market approach in the past 15 years

- Comparable companies and comparable transactions are almost always used by investment bankers in fairness opinions

- The comparable company method has been accepted in a limited number of cases where the court is satisfied as to comparability of the selected companies
- Comparable transactions are usually rejected because of the lack of transactions that the Court of Chancery would accept as comparable and because the acquisition prices include synergies

VALUATION METHODS GENERALLY REJECTED IN DELAWARE

Rules of thumb are almost always rejected

Liquidation value cannot be used for a going concern

Asset value is generally barred for valuations of going concerns, but it is permitted in limited circumstances:

- Net asset value is permissible as a factor in valuing financial institutions, investment companies, and real estate companies
- Asset value cannot be the sole basis for valuation in an appraisal

Ng v. Heng Sang Realty Corp., 2004 Del. Ch. LEXIS 69 (Apr. 22, 2004) at *28; *aff'd*, 2005 Del. LEXIS 45 (Del. Jan. 27, 2005)

DELAWARE COURTS FAVOR DCF

The preferred method is DCF

DCF is rejected if projections are inadequate or unreliable

> *Because I have little confidence in the reliability of [the projections], I conclude that a DCF analysis is not the appropriate method of valuation in this case.*

Huff Fund Investment P'ship v. CKx, Inc., 2013 Del. Ch. LEXIS 269 (Nov. 1, 2013) at *35; *aff'd*, 2015 Del. LEXIS 77 (Del. Feb. 12, 2015)


DILBERT By Scott Adams
HOW RELIABLE ARE YOUR TEN-YEAR FINANCIAL PROJECTIONS?
THEY ARE AS RELIABLE AS ALL OTHER TEN-YEAR FINANCIAL PREDICTIONS.
OKAY, GOOD.
WHY DO I FEEL GUILTY EVERY TIME I TALK AT WORK?
DILBERT.COM @SCOTTADAMSSAYS
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Valuation Methods Used in Delaware Appraisal Decisions

	Number of Valuations	DCF or similar	Comparable Companies	Comparable Transactions	Asset Value	Transaction Price	Unaffected Market Price
	Arm's-Length Transactions						
1998-2005	2	2	0	0	0	1	0
2006-2013	4	3	1	0	0	2	0
2014-3Q20	16	7	2	1	0	13	1*
Total	22	12	3	1	0	16	1
	* Excludes reversed decision						
	Related Party Transactions						
1998-2005	21	11	10	4	2	1	0
2006-2013	7	7	1	1	1	0	0
2014-3Q20	11	11	0	0	1	0	0
Total	39	29	11	5	4	1	0

NORMALIZATION

Income and cash flow should be normalized to exclude nonrecurring items

- Normalizing adjustments include not only items classed as "extraordinary" by auditors, but also other nonrecurrent items

The Court of Chancery has faulted an expert for failure to normalize income data:

> *The earnings figures used to derive the earnings base should be adjusted to eliminate non-recurring gains and losses.*
>
> *Reis v. Hazelett Strip-Casting Corp.*, 28 A. 3d 442, 470 (Del. Ch. 2011)

RECENT DELAWARE SUPREME COURT DECISIONS

Recent Supreme Court Decisions

In the past four years, the Supreme Court has reversed three valuation decisions and affirmed five

- Reversed:
  - *Dell* (2017)
  - *DFC Global* (2017)
  - *Aruba Networks* (2019)
- Affirmed:
  - *ISN Software* (2017)
  - *SWS Group* (2018)
  - *ACP Master v. Sprint* (2018) [appraising Clearwire Corporation]
  - *PLX Technology* (2018)
  - *Jarden* (2020)

THE FIRST REVERSAL:

DFC GLOBAL CORP.

DFC Global – The Trial Court Decisions

Chancellor Andre Bouchard gave only 1/3 weight to the deal price because the purchaser was a financial buyer that was focusing on achieving a certain IRR

He valued the company, a payday lender, 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)

- After reargument, he made an adjustment to working capital that reduced his valuation and then changed the perpetual growth rate from 3.1% to 4.0%

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)

DFC Global – The Supreme Court Decision

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

- It rejected the concept that an LBO buyer's winning bid in a contested deal was negatively impacted by its target IRR
- It rejected the trial court's weighting of the valuation methods
- It rejected the higher growth rate used in the revised opinion
  - The case settled shortly after the Supreme Court's decision
  - Terms were not announced

DFC Global – Comparable Companies

The Supreme Court endorsed the use of the comparable company method that had been used by both experts:

> *The comparable companies analysis used by the Chancellor was supported by the record; 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.*
>
> 172 A.3d 346 at 351

DFC GLOBAL – IRR

The Supreme Court concluded that a financial buyer's target IRR did not negatively impact the relevance of its winning bid in determining fair value

> *[A]ll disciplined buyers, both strategic and financial, have internal rates of return that they expect in exchange for taking on the large risk of a merger, or for that matter, any sizeable investment of its capital. That a buyer focuses on hitting its internal rate of return has no rational connection to whether the price it pays as a result of a competitive process is a fair one.*
>
> *Id.* at 375

DFC Global – Weighting

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.*
>
> *Id*. at 388

DFC Global – The Growth Rate

The Supreme Court faulted the 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.*
>
> *Id.* at 350

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

> *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 its $13.33]*
>
> *Id.* at 361

THE SECOND REVERSAL:

DELL INC.

DELL – THE LOWER COURT DECISION

Vice Chancellor J. Travis Laster valued Dell at 27% above the deal price, solely using DCF

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)

He gave no weight to the deal price for several reasons:

1. 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
2. Deal prices in management buyouts (MBOs) are unreliable as measures of fair value
3. The price that leveraged buyout (LBO) sponsors would pay is limited by the need to achieve IRRs of 20%+, and by limits on financial leverage
4. The shopping process was inadequate
5. Financial sponsors are concerned about a "winner's curse"

DELL – EFFICIENT MARKET

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

1. 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.*
>
> 177 A.3d 1, 24

Dell – Not a Management Buyout

2. 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. He pledged his voting power would go to any higher bidder, voting in proportion to other shares.*
>
> *Id.* at 30

> *[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.*
>
> *Id.* at 32

DELL – LBO SPONSORS' IRR TARGETS ARE IRRELEVANT

3. 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.*
>
> Id. at 27

DELL – THE SHOPPING PROCESS

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.*
>
> *Id.* at 28

> *[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.*
>
> *Id.* at 29

DELL – THE "WINNER'S CURSE"

5. The Special Committee had addressed the of 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.*
>
> *Id.* at 32

DELL – THE TRANSACTION PRICE

The Supreme Court concluded that the transaction price should be the dominant factor in determining Dell's fair value

> *Overall, the weight of evidence shows that Dell's deal price has heavy, if not overriding, probative value. ... [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.*
>
> *Id*. at 30

DELL –TAX RATE IN DCF CALCULATION

The respondent argued that the Vice Chancellor's DCF analysis applied the wrong tax rate in calculating terminal value

- The Court used the 21% effective tax rate
- Respondent argued for the marginal tax rate of 35.8%

The Supreme Court concurred with the Court of Chancery's conclusion that the effective tax rate (rather than the marginal rate) should be applied

Id. at 39

DELL – SUPREME COURT COMMENTS ON DCF

[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.

Id. at 35

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.

Id. at *74

THE THIRD REVERSAL:

ARUBA NETWORKS, INC.

Aruba – The Lower Court Decision

Vice Chancellor Laster valued Aruba at "unaffected market price" (the average price during the 30 days prior to a news article that leaked the pending transaction)

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")

- The Court's appraised value was 69.4% of the deal price
- Neither side had addressed unaffected market price at trial

ARUBA – FLAW IN THE LOWER COURT DECISION

The Court of Chancery 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.*
>
> *Aruba* I at *63

Nonetheless, it 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.*
>
> *Aruba* I at *66

THE SUPREME COURT DISCUSSES THE FLAW

The Supreme Court reaches the appropriate conclusion:

> *[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.*
>
> *Aruba* II at 139

THE SUPREME COURT REJECTS UNAFFECTED MARKET PRICE AS ARUBA'S FAIR VALUE

The Supreme Court strongly criticized the Court of Chancery decision

> *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.*
>
> *Aruba* II at 140

THE VALUATION DATE IS THE EFFECTIVE DATE OF THE TRANSACTION

The Supreme Court pointed out that the Delaware appraisal statute requires that the company be valued at the closing date:

> *Although §262 requires the Court of Chancery to assess Aruba's fair value as of "the effective date of the merger," the Court of Chancery arrived at the unaffected market price by averaging the trading price of Aruba's stock during the thirty days before news of the merger leaked,* ***which was three to four months prior to closing*** [emphasis added].
>
> *Aruba* II at 132

Aruba – Fair Value Was Transaction Price Less Substantial Synergies

The Supreme Court awarded petitioners $19.10 per share

This number was Aruba's estimate of the deal price ($24.67) minus synergies

> *Aruba's estimate of $19.10 ...was corroborated by ... Aruba's [expert's] DCF, comparable companies, and comparable transactions analyses.*
>
> *Aruba* II at 142

DECISIONS THAT WERE AFFIRMED

ISN SOFTWARE

Vice Chancellor Sam Glasscock III appraised ISN Software, a private company, using only DCF, even though all three experts also used comparable companies

- He valued the shares at a 158% premium over the transaction price
- The Supreme Court affirmed

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)

SWS GROUP

The Supreme Court affirmed the Vice Chancellor Glasscock 's appraisal of SWS Group at 92% of the deal price based on DCF

- The Court of Chancery determined that a broker-dealer's excess regulatory capital was not a non-operating asset that was additive to value

  The 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

  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)

- It 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"

  Id. at *38

ACP Master v. Sprint (Clearwire)

Dissenting shareholders of Clearwire objected to the $5.00 transaction price and sought appraisal

- Their expert valued Clearwire at $16.08

Vice Chancellor Laster relied on DCF and awarded the dissenters $2.13 per share – only 43% of the transaction price – and the Supreme Court affirmed

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

- No previous Delaware appraisal had awarded dissenters less than 80% of transaction price

Background of Sprint/Clearwire Merger

1. Clearwire, a telecom company, owned a large block of 2.5 GHz spectrum
2. Sprint owned 51% of Clearwire but did not have voting control
3. In connection with Softbank's proposed acquisition of 70% of Sprint, Softbank wanted Sprint to have control of Clearwire
4. Unaffected market for Clearview was ~ $1.30
5. When news of potential Softbank/Sprint deal leaked, shares rose to $2.22
6. Sprint bought out a 5% holder at $2.97 to obtain 50.4% of the vote
7. Clearwire's Special Committee approved a merger with Sprint at $2.97
8. After minority shareholder opposition, Sprint raised its price to $3.40
9. DISH made a hostile tender offer at $4.40
10. Sprint topped at $5.00 and bought the rest of Clearwire

SYNERGIES WERE SUBSTANTIAL

Vice Chancellor 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* [emphasis added].
>
> 2017 Del. Ch. LEXIS 125 at *75

> *The deal price also provided an exaggerated picture of Clearwire's value because* ***the transaction generated considerable synergies*** [emphasis added].
>
> *Id.* at *79

COURT'S DCF USED MANAGEMENT'S PROJECTIONS, NOT PARENT'S

Laster relied on Clearwire management's projections, not Sprint's

> *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.*
>
> *Id.* at *87

In his determination of Clearview's value based on DCF, he included the value of Clearwire's unused spectrum, a non-operating asset

Id. at *93

PLX TECHNOLOGY

In *PLX Technology,* the Supreme Court affirmed the Vice Chancellor Laster's decision that that a hedge fund investor had aided and abetted breaches of the Board's duties to shareholders

However, it was a Pyhrric victory for plaintiffs because they "were unable to prove that the breaches resulted in damages"

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)

Plaintiff's DCF Valuation Rejected

Laster criticized projections used by plaintiff's expert that included "a new line of business involving a new set of customers with a new set of requirements"

Id. at *52

Also, he faulted expert's beta because it was based on daily returns, rather than weekly or monthly returns

> *"[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."*

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

JARDEN RELIED SOLELY ON UNAFFECTED MARKET PRICE

Vice Chancellor Joseph Slights III appraised Jarden, a consumer products company acquired by an unrelated third-party, based solely on the unaffected market price prior to rumors of the transaction; the Supreme Court affirmed

In re Appraisal of Jarden Corp., 2019 WL 3244085 (Del. Ch. July 19, 2019); *modified,* 2019 WL 4464636 (Del. Ch. Sept. 16, 2019); *aff'd, Fir Tree Value Master Fund, LP v. Jarden Corp.*,__ A.3d __, 2020 WL 3885166 (Del. 2020)

- Slights relied on "expert testimony ... including an event study that analyzed the market's response to earnings and other material announcements"

  2019 WL 4464636 at *2

- Importantly, he concluded that the unaffected market price was not "stale" on the closing date

  Id. at *29

JARDEN USED DCF AS CONFIRMATORY

The Vice Chancellor noted that his valuation (48.31 per share) was confirmed by his DCF calculation ($48.13) and by "the most reasonable estimate" of "the Merger price less synergies" ($46.21)

Id. at *50

- In his DCF calculation, he used the midpoint of the experts' inflation and GDP growth estimates as the perpetual growth rate

Id. at *32

He rejected a "conglomerate discount", noting that "it is not clear that this notion is accepted within the academy or among valuation professionals"

Id. at *31

Motion for Reargument

Petitioners moved for reargument, claiming that the Court's "DCF analysis does not corroborate [its] fair value determination because of ... certain structural and mathematical flaws," and that the corrected valuation (about $63 per share) was not corroborative of the Court's conclusion

2019 WL 4464636 at *1

The Vice Chancellor agreed with some of the petitioners' adjustments, but also revised his earlier terminal value calculation, arriving at a DCF value of $48.23

Id. at *4

THE SUPREME COURT AFFIRMS *JARDEN*

The Supreme Court concluded that the Court of Chancery was within its discretion in finding that "the market did not lack material nonpublic information about Jarden's financial prospects" and in relying unaffected market price to determine fair value

2020 WL 3885166 at *11

After noting that the lower court did not rely on its DCF model to find fair value, it ruled that that it was not an abuse of discretion to change its calculation of terminal value after reargument

Id. at *18

2019 COURT OF CHANCERY VALUATION DECISIONS

TRUSSWAY HOLDINGS

In February 2019, a shareholder who was squeezed out of Trussway, a private company, was awarded an amount 5% higher than the merger value

Vice Chancellor Glasscock relied solely on DCF, using two projection periods

> *I have blended two DCF values, one derived from the nine-year Project Point Projections, and a second derived from the same management forecasts, with a terminal period beginning after a more standard five years. I have assigned 50% weight to each.*
>
> *Hoyd v. Trussway Holdings, LLC,* 2019 WL 994048 (Del Ch. Feb. 28, 2019) at *7

- The Court's DCF valuation based on the five-year period was 15% lower than the valuation based on the nine-year period
- A five-year DCF calculation gives far greater weight to the final year of the projections than a nine-year calculation
  - Did the Court's decision to give 50% weight to a five-year period cause it to undervalue Trussway?

COLUMBIA PIPELINE

An August 2019 decision based appraisal value in a third-party transaction solely on the deal price

In re Appraisal of Columbia Pipeline Group, Inc., 2019 WL 3778370 (Del. Ch. Aug. 12, 2019) at *43

- Vice Chancellor Laster did not reduce the deal price for synergies

  > *TransCanada* [the buyer] *did not meet its burden of proof. TransCanada likely could have justified a smaller synergy deduction, but it claimed a larger and unpersuasive one. This decision therefore declines to make any downward adjustment to the deal price.*

  Id. at *45

- He rejected petitioners' claim that the company's value had increased between signing and closing

  Id.

DCF Rejected in *Columbia Pipeline*

Petitioners' DCF valuation was 24% over the deal price and 57% over unaffected market

Laster rejected their DCF analysis as contrary to contemporaneous market evidence

> *[Expert]'s opinion that the value of Columbia materially exceeded the deal price conflicts with the market behavior of other potential strategic acquirers who had shown interest in Columbia, and who did not step forward to top TransCanada's price.*
>
> *Id.* at *50

THE COURT QUESTIONED HIGH TERMINAL VALUE

Laster also expressed concern about petitioners' high terminal value

> *In [petitioners' expert]'s calculation, the terminal value represented 125% of his valuation of Columbia. ... This court has questioned the utility of a DCF in a case where the terminal value represented 97% of the result, finding that "[t]his back-loading highlights the very real risks" presented by using that methodology and "undermin[ing] the reliability of applying the DCF technique."*
>
> *Id.* at *51, quoting *Union Ill. 1995 Investment LP v. Union Finl. Group, Ltd.*, 847 A.2d 340, 361 (Del. Ch. 2003)

STILLWATER MINING

Another August 2019 decision by Laster based his appraisal value in a third-party transaction solely on the deal price

In re Appraisal of Stillwater Mining Co., 2019 WL 3943851 (Del. Ch. Aug. 21, 2019) at *50

- He rejected trading price, given the availability of "a market-tested indicator like the deal price"

  Id. at *59

- He did not rely on DCF

  The legitimate debates over [contested] inputs and the large swings in value they create undercut the reliability of the DCF model as a valuation indicator.

  Id. at *61

Inadequate Disclosure Impacted Usefulness of Market Prices

Laster wrote that SEC limitations on disclosure of reserves that did not rise to the "probable" level affected the viability of trading price as a valuation indicator

> *[The SEC did] not permit a mining company to disclose information about inferred resources, which are mineral deposits where the quantity, grade, and quality "can be estimated" based on "geological evidence," "limited sampling," and "reasonably assumed, but not verified, geological and grade continuity."*

Id. at *58, quoting the SEC's *Industry Guide 7*

Note: *Industry Guide 7* was rescinded on Oct. 31, 2018

No Adjustment for Change in Value Prior to Closing

Stillwater is the only U.S. source of palladium and platinum

> *Between signing and closing, the prices of palladium and platinum increased materially, with a direct effect on Stillwater's value.*
>
> *Id.* at *48

Laster did not adjust his appraisal for this fact because petitioners did not argue for it or quantify its effect on value

> *[W]hether to adjust the deal price for an increase in value between signing and closing presents numerous difficult questions. In this case, the petitioners did not argue for an adjustment to the deal price, and so the parties did not have the opportunity to address these interesting issues. ... The petitioners accordingly failed to prove that the deal price should be adjusted upward to reflect a change in value between signing and closing.*
>
> *Id.* at *50

2020 COURT OF CHANCERY VALUATION DECISIONS

UIP Companies

Delaware courts have seldom accepted company-specific premiums in determining cost of capital.

However, in January 2020, Vice Chancellor Kathaleen McCormick ruled in a shareholder dispute that special circumstance merited the application of this factor to reduce the value of a small private real estate management company:

> *Given UIP's unique circumstances as almost wholly dependent on the SPEs [special purposes real estate entities] and [UIP's two principals] for its revenue, the Court finds that Defendants have met their burden of showing that a specific-company risk premium is necessary in this case.*

Coster v. UIP Cos., Inc., 2020 WL 429906 (Del. Ch. Jan. 28, 2000) at *25.

SOURCEHOV HOLDINGS

In this January 2020 appraisal of a process outsourcing and financial technology company, both experts agreed that the income approach was the only appropriate valuation method

Petitioners' expert used both DCF and Capital Cash Flow (CCF)

> *CCF is a variation of DCF that is better suited to value future cash flows where a company's capital structure is expected to change. Ultimately, a traditional DCF and CCF are "algebraically equivalent."*
>
> *Manichaean Capital, LLC v. SourceHOV Holdings, Inc.*, 2020 WL 496606 (Del. Ch. Jan. 30, 2020) at *12

Respondent's expert used an adjusted present value DCF model that the Court said was "functionally the same as [the] CCF model."

Id. at *14

Novel Beta Calculation Rejected

The principal differences between the two analyses of SourceHOV were

(i) the calculation of beta,
(ii) the small company premium,
(iii) debt load projections, and
(iv) the projection on which the analysis was based (not material)

Petitioners' expert determined beta using publicly traded guideline companies

Respondent's expert calculated beta based on the yield on SourceHOV's debt

Vice Chancellor Slights rejected the beta based on the company's debt, describing it as "methodologically novel" and unsupported by academic literature.

Id. at *21.

SMALL COMPANY PREMIUM

Petitioners' expert based his small stock premium of 2.08% on the 8th decile in Duff & Phelps' 2017 Valuation Handbook

Respondent's expert used the 9th decile's 2.68%.

Both cited the market price of shares of the surviving company, but the latter argued that this price included synergies.

The Court was "persuaded the 2.68% size premium is more accurate on this record."

Id. at *27.

COURT REJECTS MOST OF RESPONDENT'S REPORT

The Court rejected respondent's expert's premise that SourceHOV would have retired all its debt when it matured in 2020,

- This premise would have reduced value by lowering tax savings from interest deductions.

The expert's valuations were $5,079 per share and $2,817 per share, respectively

The Court accepted all of the petitioners' report other than the small stock premium and appraised Source HOV at $4,591 per share

Depreciation Cannot Exceed Capex in Growth Model

The Court commented favorably on an adjustment by petitioners that favored the respondent, whose forecast included depreciation substantially in excess of capex:

> *[Respondent's] forecast led to "depreciating and amortizing more asset value than [SourceHOV] even ha[d] on the books." If [petitioners' expert] had accepted this high level of depreciation and amortization ..., the result would have been to increase SourceHOV's value in a DCF analysis. Instead, to account for his concern that depreciation and amortization forecasts were too high, [he] made a Respondent-friendly adjustment to provide a more accurate calculation.*
>
> *Id*. at *25

- In the past, the Court of Chancery has sometimes erred by accepting terminal value calculations in which depreciation materially exceeded capex

  E.g., In re Emerging Communications, Inc. Sh'h's Litig., 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) at *57, n. 56; *Lane v. Cancer Treatment Centers of America, Inc*., 2004 Del. Ch. LEXIS 108 (Del. Ch. July 30, 2004) at *111.

PANERA BREAD

Vice Chancellor Morgan Zurn rejected both experts' comparable transaction analyses because "neither sample size is reliable enough to afford it weight."

In re Appraisal of Panera Bread Co., 2020 WL 506684 (Del. Ch. Jan. 31, 2020) at *43

He criticized the comparable companies selected by each expert and stated:

> *Neither expert presents a reliable empirical analysis to show a suitable peer group; both sets have material weaknesses. For that reason, I do not find comparable companies as a fair measure of value. Instead, I view both parties' comparable companies analyses as an attempt to corroborate their preferred valuation.*
>
> *Id.* at *42.

Appraisal Value = Deal Price Less Synergies

The Court pointed out several flaws in petitioners' expert's DCF analysis but did not criticize respondent's expert's DCF.

Id. at *40-*41

The Court appraised Panera at $303.44, accepting the testimony of respondent's expert that the deal price of $315 per share included synergies of $11.56 per share.

Id. at *40.

- The company had prepaid the full $315 to the dissenters in order to avoid paying interest on the award
- The Vice Chancellor ruled that Delaware law did not authorize him to order a refund of the difference.

Id. at *44.

Real Time Cloud Services

In a dispute between partners in of a small accounting services firm, plaintiff's expert used financial statements "recreated" for purposes of the litigation that were inconsistent with the company's records and the plaintiff's own tax returns

Zachman v. Real Time Cloud Services, LLC, 2020 WL 1522840 (Del. Ch. Mar. 31, 2020) at *16-*17

The Court based its valuation on the defendants' report, which used the company's internal financials, but it used the higher growth rate posited by the plaintiff

Id. at *17.

APPRAISAL OF *SYNAPSE WIRELESS*

Minority shareholders of Synapse Wireless, an unsuccessful IoT company, were bought out in 2019 at $0.42899 per share

Sole dissenter's expert valued shares at $4.1876 per share

Respondent's expert valued it at $0.06–$0.11 per share

Vice Chancellor Slights appraised the shares at $0.228 (53% of the transaction price), the 2nd largest discount ever in a Delaware appraisal

Kruse v. Synapse Wireless, Inc., 2020 WL 3969386 (Del. Ch. July 14, 2020)

EVIDENCE OF VALUE WAS UNRELIABLE

There is no reliable market evidence, the comparable transactions analyses both experts utilized—a dicey valuation method in the best of circumstances—have significant flaws and the management projections relied upon by both experts in their DCF valuations are difficult to reconcile with Synapse's operative reality.

In the typical litigation context, the lack of fully reliable evidence might lead the factfinder to conclude that ***neither party carried their burden of proof*** *and neither party, therefore, is entitled to a verdict.* ***But "no" is not an answer*** *in the unique world of statutory appraisal litigation.* [emphasis added]

Id. at *2

SYNAPSE'S PROJECTIONS WERE OVEROPTIMISTIC

McWane, Inc. had acquired control in 2012 at $4.997 per share

It bought more shares in 2014 to reach 80% in order to use Synapse's tax losses

- It was contractually obligated to pay $4.997

Id. at *4

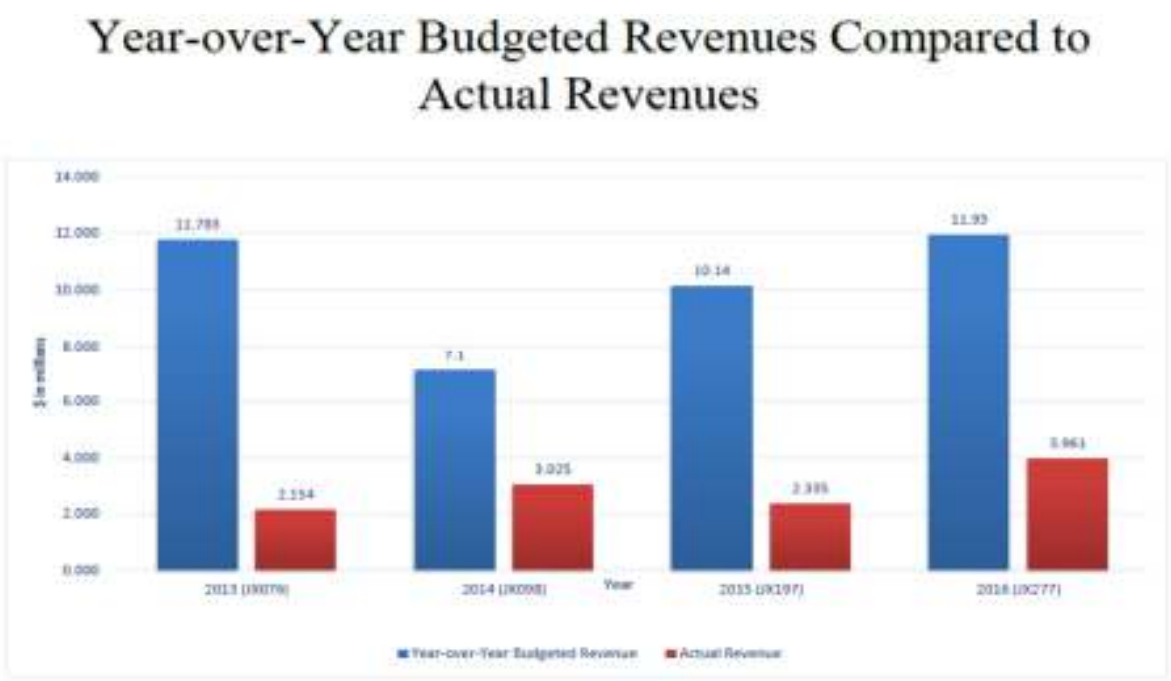
The 2012 revenue projections for 2015, the year preceding the squeezeout, were 84 times higher than actual results

> *I am satisfied that the 2012 Merger was either the product of Synapse's officers' misleading inflation of the company's value, or the product of McWane's failure to perform adequate due diligence.*

Id. at *9

. . . VERY OVEROPTIMISTIC

This chart (from the Delaware Court website) shows Synapse's inability to forecast:



COMPARABLE TRANSACTIONS REJECTED

I reject both [experts'] Comparable Transactions analyses. . . . Each expert was able to make well-considered, convincing objections to the other's model that were not effectively rebutted.

Id. at *11

I acknowledge I have some reservations about relying on Synapse's management's projections given the Company's serial inability to meet its financial targets. But, both experts rely on management projections in their analyses, and no alternate projections were offered for my consideration.

Id. at *13

COURT BASED ITS VALUATION ON DCF

The Court rejected the petitioner's expert's longer-term projections which assumed unrealistic profit margins

It accepted respondent's expert's 12% discount rate based on WACC and rejected his alternative of a 40% venture capital discount rate

It said that terminal value based on an EBITDA multiple was "different, but also well-accepted," but rejected the multiple used by petitioner's expert because it implied a perpetual growth rate >10%

Id. at *18-*19

It accepted a terminal value based on a perpetual growth rate of 3.1% as "standard and accepted"

Id. at *18

HAPPY CHILD WORLD

A September 2020 decision in this 14-year litigation (re a day care center that had ceased operations) addressed entire fairness as well as appraisal

Both sides alleged breaches of fiduciary duty to the corporation by the other prior to a squeeze-out merger

This small but interesting case challenge the Court because of the paucity of evidence:

> *I am left with an evidentiary record that is disjointed, incomplete and wholly inadequate to enable thoughtful post-trial deliberations. But the matter is submitted for decision and the Court must render judgment.*

In re Happy Child World, Inc., 2020 WL 5793156 (Del. Ch. Sept. 29, 2020) at *1

PLAINTIFF'S VALUATION REJECTED

Vice Chancellor Slights "value[d] the competing derivative claims, incorporate[d] those values in the appraisal of the corporation and then adjust[ed] the petitioner's appraisal recovery to account for his liability to the corporation"

Id. at *2

- The Court's analysis of these claims is outside the scope of this presentation

The Vice Chancellor castigated plaintiffs' expert's valuation of the company, saying that he "solved for the wrong problems – fair market value (as opposed to fair value) as of 2008 (as opposed to as of the [2012] Merger Date)" and "conducted the real estate appraisal himself even though he admittedly lacks that expertise"

*Id. at *27, fn. 301, and *28*

Defendant's Real Estate Valuation

Defendant's valuation expert testified as to the valuation he had performed prior to the squeeze-out

- In that valuation, he relied upon the appraisal of the company's unoccupied real estate, its sole material asset
- The real estate expert used the sales comparison method and the income capitalization method and weighted them equally
- The valuation expert adopted that real estate valuation and deducted the company's liabilities to arrive at net asset value

DEFENDANT'S GOING-CONCERN VALUATION

Defendant's expert then used the capitalization of earnings method to determine the value of the company as a going concern

- The decision does not discuss any details of his calculation

- The expert gave equal weight to net asset value and going-concern value to value the company as of the date of the squeeze-out

The Court rejected the plaintiffs' challenges to the expert's cost of equity and cost of debt

The Court's Valuation

The Vice Chancellor adopted all aspects of the defendant's valuation – weighting, methodologies, amount of debt – with one material exception:

- The appraiser had been unaware that the defendant had been negotiating a lease while the appraisal was being prepared and had leased it two weeks after the report

The Court applied the income capitalization method to the lease rental

This change increased the valuation of the company – before the Court's adjustments for damages from breach of fiduciary duty – from $85,237 to $135,962

THE COURT'S CONCLUSION

The Vice Chancellor calculated amount due plaintiffs by:

- adding the total value of derivative claims against both parties
- valuing of plaintiffs' 45% interest, and
- deducting the derivative claim assessed against plaintiffs for their breaches of fiduciary duty.

Plaintiffs were awarded $36,018

The Decision Does Not Explain the Weighting

In this case, the Court accepted a 50% weight to asset value

- Net asset value was relevant because if the inactive status of the operating business
- The decision does not explain why the Court accepted the weighting

The decision did not explain how going-concern value was determined or why the Court deemed it appropriate to give it 50% weight

CLOSING COMMENTS

Most States Have Different Standards

This presentation has focused on Delaware

Other states have different standards and sometimes differ materially, *e.g.*:

- Several states define fair value as acquisition value, *e.g.*:

  > *As a going concern, the value of an enterprise ... is the price a knowledgeable buyer would pay for the entire corporation.*
  >
  > *Sarrouf* v. *New England Patriots Football Club, Inc.*, 492 N.E.2d 1122, 1125 (Mass. 1986)

- New York permits a discount for lack of marketability
- Ohio awards dissenters in public companies the market price prior to announcement

EXPERT TESTIMONY

When professionals undertake a valuation for litigation purposes, they should consult with counsel as to the appropriate valuation standard and how it is applied in the relevant jurisdiction

Using the appropriate standard, expert witnesses should apply customary valuation techniques generally accepted by the business valuation profession and the investment community

THE IMPORTANCE OF EXPERT TESTIMONY

An argument may carry the day in a particular case if counsel advance it skillfully and present persuasive evidence to support it. The same argument may not prevail in another case if the proponents fail to generate a similarly persuasive level of probative evidence or if the opponents respond effectively.

Merion Capital L.P. v. Lender Processing Services, L.P., 2016 WL 7324170 (Del. Ch. Dec. 16, 2016) at *16

[T]he approach that an expert espouses may have met "the approval of this court on prior occasions," but may be rejected in a later case if not presented persuasively or if "the relevant professional community has mined additional data and pondered the reliability of past practice and come, by a healthy weight of reasoned opinion, to believe that a different practice should become the norm."

Columbia Pipeline at *16, quoting *Global GT LP v. Golden Telecom, Inc.,* 993 A 2d. 497, *aff'd*, 11 A.3d. 214 (Del. 2010).

Your questions, thoughts and comments are welcome

You may also email questions and comments to me at gil@suttersf.com

BIOGRAPHY

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Mr. Matthews has 60 years of experience in investment banking, having worked with a wide variety of clients in mergers, acquisitions and divestitures, friendly and unfriendly tender offers, public and private offerings of securities, recapitalizations, bankruptcy and other financial restructurings, and international transactions.

Mr. Matthews joined Sutter Securities in San Francisco as a Senior Managing Director in December 1995 and was Chairman from December 1997 to March 2019. From 1960 through 1995, he was with Bear Stearns in New York. He was a Senior Managing Director of Bear, Stearns & Co. Inc. and was a general partner of its predecessor partnership. From 1970 through 1995, he was Chairman of Bear Stearns' Valuation Committee, which was responsible for all opinions and valuations issued by the firm.

Mr. Matthews has testified as an expert witness with respect to investment banking practice, corporate valuation, fairness, and other issues in numerous Federal and state courts and before regulatory agencies. He has written several book chapters and articles on fairness opinions, corporate valuations, and litigation relating to valuations and appraisals, and has spoken on fairness opinions, valuations, and related matters before numerous professional groups. Mr. Matthews received an A.B. from Harvard in 1951 and an M.B.A. from Columbia in 1953.