Duff & Phelps

Selected Summaries of 2010 Decisions

Delaware Court of Chancery, Selected Business Valuation Case Summaries

Introduction

The Delaware Court of Chancery is widely recognized as one of the nation's leading business courts in terms of volume of business related cases and as a result has developed significant case law in this area. In 2010 alone there were 2,492 estate filings, 931 civil filings, and 761 various other filings for a total of 4,184 filings, a five-year high.

The high volume of business cases results in the Court issuing numerous opinions, many of which address valuation and damages. In this publication we focus on nine opinions from 2010 to highlight how certain valuation and damages analysis topics are viewed by the Court. We chose these nine opinions based on the valuation themes they represent and depth of analysis contained in the Court's opinions. In our review we have attempted to summarize the salient points related to valuation and damages only. The opinions we reviewed were diverse, ranging from cases where the Court deferred to contemporaneous actions to other cases where the Court overturned contemporaneous actions when it deemed there was a valid reason to do so. We recommend that interested readers obtain the full Court opinions to get a complete understanding of all the issues addressed and each judge's position. We have included the URL for your convenience: http://www.courts.delaware.gov

Case Summaries

In Re Sunbelt Beverage Corp. Shareholder Litigation, Consol. C.A. No. 16089-CC (Del. Ch., Jan. 5, 2010)

Click here to view the opinion.

In the Sunbelt decision Chancellor Chandler focuses on the appropriate valuation of Sunbelt shares related to the cash-out of a minority shareholder ("Plaintiff"). Ultimately the Court relied solely on the discounted cash flow approach, applying Sunbelt's projections and Plaintiff's discount rate in arriving at a per share value of $114.04.

The matter arose after the Plaintiff was offered a price for their shares based on a pricing formula that had been used during the buyout of a majority shareholder in 1994 ("1994 Formula"). Based on the 1994 Formula, the share price in 1997 was $45.83/share. This price was offered to the Plaintiff who rejected the offer as too low and filed suit seeking the fair value of the shares. Chancellor Chandler both accepted and rejected various valuation methodologies from both the Defendants and Plaintiffs in his finding of a per share fair value of $114.04.

Defendant's expert applied three valuation methodologies to determine fair market value: the Discounted Cash Flow ("DCF") method, the 1994 Formula and an asset-based approach. Plaintiff's expert applied two valuation methodologies in his analysis: the DCF method and the Guideline Transaction Method.

Regarding the Defendant's expert, the Court found that the valuation based on the Formula was irrelevant. The methodology did not take into account contemporaneous information and was created to complete a buyout of the majority shareholders based on facts available in 1994. The Court also found that the Formula consistently priced companies at one-third of their market capitalizations and was therefore unreliable. The Court also rejected Defendant's expert's asset-based approach as it relied too heavily on the book value of Sunbelt. Chancellor Chandler found that unlike an industry that relies heavily on physical assets (e.g., mining), Sunbelt's business did not, and therefore an asset-based approach was not appropriate.

The Court dismissed Plaintiff's expert's Guideline Transaction Method as it found that Plaintiff did not provide sufficient evidence to prove that the companies were in fact comparable. The Court expressed concern about the size of the comparable companies used, as well as the differences in their product offerings, geography, and the fact that each transaction used in the analysis was a private transaction. Furthermore, the Court disagreed with Plaintiff's expert's application of a median market multiple to resolve known deficiencies in his methodology.

Both sides applied a small stock premium in their discounted cash flow analyses, but disagreed on the appropriate premium as published by Ibbotsons (Ibbotson produces multiple premiums by size according to market capitalization). Chancellor Chandler points out that while the DCF determines a company's value and thus the appropriate premium to use, it also relies on the premium to determine the value of the company. The Court resolved this circularity by using the Plaintiff's small-firm risk premium that accounted for the possibility that the company was on either side of the divide between two premiums. Moreover, Chancellor Chandler denied Defendant's expert's application of a company-specific risk premium as he failed to provide enough evidence to support the premium. The Court found that none of the justifications were credible enough to underscore why they were unique to Sunbelt and not applicable to any other company in the same industry. Further, Defendants failed to offer sufficient quantitative support to justify the premium. Lastly, the Court denied both sides' application of a premium to account for the conversion of Sunbelt from a C-corp to an S-corp, which occurred after the events surrounding the current litigation. Chancellor Chandler found that Plaintiff should only be rewarded for the value of the shares of the company as it was structured as of the time of the disagreement. In the end, the Court relied solely on the discounted cash flow approach, applying Sunbelt's projections and Plaintiff's discount rate in arriving at a per share value of $114.04.

Case Summaries

Julian v. Julian, C.A. No. 1892-VCP (Del. Ch. March 22, 2010)

Click here to view the opinion.

The Court was asked to interpret provisions of a stockholder agreement governing valuation of stock in a privately held company held by the Plaintiff and Defendant. The subject company was one of three separate, but related, companies owned and operated by three brothers. There are two valuation-related issues addressed in the Court's opinion that we review below

First, the Court chose not to invalidate an appraisal conducted as part of a dispute resolution process provided for in the stockholder agreement. Therefore, the appraisal could be used as an indication of value in the matter. One of the parties later disagreed with the method(s) used in the appraisal, and sought to invalidate the appraisal. The Court viewed that the dispute resolution mechanism was analogous to arbitration and held that it would only modify or invalidate appraisals shown to be the product of fraud, bad faith, partiality, or deception. Since neither of the parties showed this to be true for any of the appraisals at issue, the Court ruled that the appraisals were valid.

Second, the Court determined that the Plaintiff was not required to submit into the record an appraisal that he requested to be performed on one of the real estate parcels at issue. Plaintiff was initially concerned that Defendant's appraisal was too high, and subsequently engaged another appraiser. However, the second appraiser returned with an estimate of value higher than the Defendant's appraisal. The Court ruled that because the Plaintiff had not formally submitted the appraisal under the stock valuation procedure outlined in the stockholder agreement, the Plaintiff was not bound to use it.

Global GT LP v. Golden Telecom, Inc., C.A. No. 3698-VCS (Del. Ch. Apr. 23, 2010)

Click here to view the opinion.

Vice Chancellor Strine concluded that the value per share for Golden Telecom as of February 2008 was $125.49, which was different than a deal price of $105 per share, and different than both valuation experts' estimates of value. The Court also rejected the argument that the deal price was reflective of a market price, given that Golden's two largest stockholders were also the acquirer's largest stockholders, and therefore focused on obtaining the best deal for the acquirer (i.e., the lowest price) rather than a fair market price.

The Court agreed with both experts' reliance on the DCF method, but found flaws in the assumptions of both parties, specifically in the (i) terminal growth rate, (ii) tax rate, (iii) equity risk premium ("ERP") and (iv) beta.

First, the Court rejected the Defendant's inflationary terminal growth rate as "unduly pessimistic," adopting the Plaintiff's mid-point between GDP and inflation, arguing that the Defendant's assumption for terminal growth rate did not take into account the high growth rates of the telecom industry.

Second, in determining the appropriate tax rate, the Court adopted the Defendant's tax rate based on analysis of historical tax rates and management's projections, rejecting the Plaintiffs' reliance on the tax rate used in a Fairness Opinion without explaining why it was reasonable.

Third, in calculating the cost of capital, the Court adopted the Plaintiffs' equity risk premium of 6% over the Defendant's use of Ibbotson's historical ERP of 7%. The Plaintiff's ERP relied on academic and empirical literature, as well as Ibbotson's supply side ERP. While the Court acknowledged that a historical ERP has been accepted by the Court in the past and may be acceptable in the future, additional relevant academic and professional data should be considered, if available.

Case Summaries

Finally, the Court rejected the Plaintiff's use of predictive Barra betas, arguing that there is limited transparency and supportive literature, and that the expert's use is inconsistent with prior DCF valuations he submitted to the Court. The expert claimed that his opinions had changed since the prior case, but gave no rationale for this change. Given the expert's inconsistency and lack of supporting literature, the Court did not, however, reject Barra betas for use in later cases. In calculating the cost of capital, the Court used a blended beta, giving predominant weight to the Bloomberg historical beta for Golden (which was publicly-traded), with "some substantial weight" to the industry beta.

Golden appealed the decision, Global cross-appealed, and the Delaware Supreme Court affirmed. The Court found no basis for requiring the Court of Chancery to defer to the merger price in appraisal proceedings, claiming that such reliance would "inappropriately shift" the responsibility of determining "fair value" from the Court to the private parties. The Court also declined to rule that a company is bound to rely only on company-specific data sent to stockholders in determining value, arguing that a "fair price" in an acquisition may differ from a "fair value as a going concern," given synergies and other transactional factors.

Berger v. Pubco Corp., et al.,
C. A. No. 3414-CC (May 10, 2010)

Click here to view the opinion.

In the opinion Chancellor Chandler provided his review of the treatment of capital gains tax and control premium impacts on the determination of equity value. The matter involved the valuation of Defendant's equity shares.

The Court ruled that the capital gains tax effect should not have been considered as part of the valuation. Although it was possible that the underlying assets, in this instance the company's securities portfolio, could be sold, there was nothing in the record indicating that any specific securities were to be sold or that a schedule existed to dispose of the securities portfolio. The Court concluded that since it is assumed that the valuation was to be performed to provide a fair value of the company as a "going concern" instead of as a liquidation, the reduction of the asset value based on possible future tax considerations would be speculative and therefore not permitted.

In addition, the Court addressed the use of a control premium as part of the valuation analysis. Experts for both the Plaintiff and Defendant used the DCF and Book Value methodologies. The Court ruled that the control premium could not be applied to either experts' analyses based on previous Court decisions and authoritative sources that discuss the application of a control premium to a DCF methodology. Neither expert used the Guideline Company Methodology, where the use of a control premium is acceptable under Delaware law.

Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc., C.A. No. 5402-VCS (Del. Ch. May 13, 2010)

Click here to view the opinion.

Plaintiff sought a preliminary injunction against a proposed merger for $5.60 per share, arguing that the Defendant breached fiduciary duty by failing to seek the highest price available. Vice Chancellor Strine granted the injunction, concluding that the Proxy Statement required additional disclosures related to three items in order to allow the Defendant's stockholders "adequate opportunity to digest them before a final merger vote." The three items outlined by Vice Chancellor Strine were as follows.

First, the conclusion of a weighted average cost of capital ("WACC") range between 23 percent to 27 percent, as presented to the Special Committee, did not match the two WACCs calculated by the advising investment bank's fairness opinion. The WACC estimates

Case Summaries

calculated by the investment bank were 22.6% and 22.5%, based on the Capital Asset Pricing Model and comparable company analyses. Both concluded values were below the low end of the range (23 percent) disclosed in the proxy statement.

Second, the Court determined that selective projections were included in the Proxy Statement. The Court wrote that the Proxy Statement "for some inexplicable reason" did not include the financial projections provided by the seller's management to the investment bank that prepared the fairness opinion.

Third, the Court expressed concern that the Proxy Statement created the materially misleading impression that management was given no expectations regarding the treatment they could receive from buyer. The Court found that while specific terms were not negotiated, typical incentive packages offered by the buyer and the likelihood of management being retained were discussed between the buyer and seller, and therefore additional disclosures were required in the Proxy Statement.

The Proxy Statement was revised accordingly, and the merger ultimately closed for $5.60 per share on May 25, 2010.

WaveDivision Holdings, LLC v. Millennium Digital Media Systems, L.L.C., C.A. No. 2993-VCS (Del. Ch. Sept. 17, 2010)

Click here to view the opinion.

Vice Chancellor Strine concluded that Defendant had breached sale agreements it had signed with Plaintiff, that the Plaintiff is entitled to damages, and that the damages calculations submitted by the valuation experts of both the Plaintiff and the Defendant contained flaws. In determining damages, the Court applied a market multiple analysis using information from financial projections provided to a lender. The Court also found that the Defendant's actions of consciously facilitating a refinancing transaction violated the no-solicitation and reasonable best efforts clauses of the sale agreements.

In assessing the damages to be paid to the Plaintiff, the Plaintiff initially used a guideline transaction method (which was later updated to include a guideline company method). However, the Court found that the Plaintiff's expert unreasonably extrapolated the success from a small sample of the Plaintiff's prior acquisitions to the value of the target assets. Plaintiff had applied growth rates from prior acquisitions in forecasting results for the target assets. In addition, the Court found that the Plaintiff's expert improperly omitted corporate overhead from forecasted operating profit. The Defendant used a DCF method based on financial projections provided by the Plaintiff to a lender for purposes of financing the purchase of the target assets. The Defendant then made downward adjustments to the projections based on industry expectations and incorporated an allocation for corporate overhead costs. The Court found these industry expectations adjustments inappropriate. Moreover, the Court found the Defendant's expert denied the Plaintiff the benefit it expected from the purchase by applying downward adjustments instead of focusing on what the Plaintiff would reasonably be able to accomplish with those assets.

In determining the damages, the Court applied a guideline company method using the market multiple introduced by the Plaintiff. The Court chose the guideline company method over a DCF in part because the Plaintiff "based its expectations" on this approach, and there was "ample evidence in the record" that other cable companies were using this approach to value cable systems.

For purposes of financial information on which to apply the market multiple, the Court used financial information for the target based on the financial projections provided to a lender (and

Case Summaries

not the Plaintiff's extrapolation). The Court also adjusted the Lender Projections to include an allocation for corporate overhead based on certain lending documents. The Court viewed the Lender Projections (adjusted to include corporate overhead) as the fairest representation available to the Court of the Plaintiff's expected results of the target assets if it was able to control them. The Court acknowledged that the Plaintiff may have had an incentive to be conservative in the projections it provided to its lender, but that in the absence of another set of projections prepared at the time of the deal by the Plaintiff, the Court must rely on the projections provided to the lender.

SV Investment Partners, LLC v. Thoughtworks, Inc., C.A. No. 2724-VCL (Del. Ch. Nov. 10, 2010)

Click here to view the opinion.

The decision addresses the issue of whether a company should be required to redeem preferred shares when doing so would render the company insolvent. On this issue the Court finds that "an unbroken line of decisional authority dating back to the late nineteenth century prohibits a corporation from redeeming shares when the payment would render the corporation insolvent."

The Plaintiff had invested in preferred equity offered by the Defendant, containing redemption rights after five years, subject to the legal availability of funds. If legally available funds were insufficient to fund the redemption, funds available were to be used for a pro-rata redemption until the requirements were fully discharged. A valuation provision required the company's assets to be valued at the maximum of fair market value or liquidation value. Defendant made several attempts to raise capital for the redemption, but was unable to secure more than $25 million (the redemption would require $43 million). For each quarter over several years, the Defendant's Board of Directors followed a process, which included engaging legal and financial experts, to determine if it had "funds legally available" to redeem any of the preferred equity. The process resulted in the redemption of a total of $4.1 million in preferred stock.

The Plaintiff's valuation expert valued the Defendant's net assets using a DCF, Guideline Company Method and Guideline Transaction Method. She concluded that the value of the equity was greater than the redemption amount, and therefore the business had a surplus in excess of the amount necessary to redeem the preferred shares.

The Court took issue with the Plaintiff's "fallacy" of equating funds legally available with surplus. "Legally available" meant, among other things, that the company was precluded from rendering the company insolvent through the transaction. The Court ruled that the valuation expert did not consider what the effect of the redemption would have on the Defendant's ability to operate as a going concern, or how the funds would actually be raised. The Court ruled that the Plaintiff's analysis did not represent "real economic value" or reflect what the company could borrow. The analysis did not demonstrate that the Plaintiff had acted in bad faith, or used unreliable methods in reaching its determination. The Court found that the "most credible evidence" of the funds available to the Defendant was through the efforts it made to raise debt in the market, resulting in a $23 million term sheet that could only be used in conjunction with other funds to satisfy the entire redemption.

Case Summaries

In Re Dollar Thrifty Shareholder Litigation, C.A. No. 5458 (Del. Ch., Sept. 8, 2010)

Click here to view the opinion.

Plaintiff sought a preliminary injunction preventing the consummation of a proposed merger. Plaintiff alleged that seller Management had not actively sought to create a bidding war between buyers that would have driven up the transaction price. At the time of filing there was a higher bid from a different prospective buyer than under the proposed merger. The material difference between the bids was that the higher bid did not include a reverse termination fee that would have compensated the seller for the risk of non-consummation. Vice Chancellor Strine found that Management rejected the higher bid because it was afraid the bidder would not have consummated the transaction at that price.

The seller's Board examined both offers and determined that the lower bid was superior due to the reverse termination fee included in the offer. The Board advised the higher bidder that it would consider the higher bid superior if a reverse termination fee was included in the proposal.

There were several valuations presented during the course of the proceedings. An investment advisor to the seller had performed a DCF valuation. The Plaintiff's expert also provided a DCF valuation analyses. The Court concluded that the valuation conducted by the Plaintiff's expert was not "sound" because it included synergies that might occur as a result of the merger. Once those synergies had been removed from the analysis, the Plaintiff and Defendant analyses were "not fundamentally different."

Vice Chancellor Strine ultimately concluded that the risks of an injunction outweighed the benefits to the shareholders, and denied the motion for preliminary injunction.

In re Hanover Direct, Inc. S'holders Litig. Consol. C.A. No. 1969-CC; Fackelmayer, et al. & Cede & Co. v. Hanover Direct, Inc., Civil Action No. 3047-CC; and Fackelmayer, et al. v. Feldman, et al., C. A. No. 3291-CC, (Del. Ch., Sept. 24, 2010)

Click here to view the opinion.

Chancellor Chandler concluded that the $0.25 per-share offer to the public stockholders holding common stock shares of the seller was "entirely fair." The Court found that the company had been struggling financially and that there was no credible evidence that the process surrounding the transaction indicated any improper motives that would have suggested that the process was "manipulated, timed or tainted". The Court noted that the valuation issue in question evolved into a "battle of the experts" regarding the proper valuation of the common stock shares.

The Court found for the Defendant based on its assessment that the Plaintiff's expert did not effectively provide valuation methodologies and testimony that were reliable and supportable. The main concerns with the testimony of the Plaintiff's valuation expert centered on six areas: testimony changes on the witness stand, the expert's demeanor in explaining her use of approaches and methodologies, valuation changes submitted via the post-trial answering brief, the use of data containing apparent outliers without adjustments, and the use of a single valuation methodology – guideline company analysis.

The Court recognized that there may be situations in which a single methodology is appropriate to use for valuation. However, the information used by Plaintiff's expert was not compelling and needed additional evidence to support the conclusions of the Plaintiff's expert, which multiple methodologies could have provided. The Court also found the data used by the Plaintiff's expert to be unreliable given the presence of unexplained outlier data.

In contrast, the Defendant's expert utilized reliable data and three generally accepted valuation methodologies which supported one another – DCF, Guideline Company Method, and Guideline Transaction Method.

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Dispute Consulting Contacts

Global Business Unit Leader
Gregory Higgins
+1 312 697 4748

Managing Directors
Atlanta
Mark Gallagher
+1 678 916 2581

Boston
Paul Marcus
+1 617 378 9470

Chicago
Roger Grabowski
+1 312 697 4600

Dallas
Daniel Beaulne
+1 469 547 3900

Houston
Chris Bakewell
+1 713 237 5336

Los Angeles
Erik Laykin
+1 213 270 2370

Morristown
Allen Pfeiffer
+1 973 775 8260

New York
Michael Braverman
+1 212.871.7000

Toronto, Canada
A. Scott Davidson
+1 416 364 9700

Washington, DC
Bruce Dubinsky
+1 202 649 1200

Contributors
Jaime d'Almeida
Terence Rodgers
Seth Fliegler
William Hrycay
Zain Saeed
Rebecca Levy
Vivek Thaker
Lisa Li

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