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Selected 2012 Business Valuation Proceedings

"[W]hen an expert throws out his sample and simply chooses his own multiple in a directional variation from the median and mean that serves his client's cause, he is not using the comparables method in any reliable way that accords with my understanding of its proper deployment."

"As a law-trained judge who has to come up with a valuation deploying the learning of the field of corporate finance, I choose to deploy one accepted method as well as I am able, given the record before me and my own abilities. Even if one were to conclude that there are multiple ways to come up with a discount rate, that does not mean that one should use them all at one time and then blend them together."

Chancellor Strine, In re Appraisal of the Orchard Enterprises, Inc.

"I share the plaintiffs' frustration that the traditional tools of equity may not provide the kind of fine instrument that enables optimal protection of stockholders in this context. The kind of troubling behavior exemplified here can result in substantial wealth shifts from stockholders to insiders that are hard for the litigation system to police if stockholders continue to display a reluctance to ever turn down a premium-generating deal when that is presented. The negotiation process and deal dance present ample opportunities for insiders to forge deals that, while 'good' for stockholders, are not 'as good' as they could have been, and then to put the stockholders to a Hobson's choice."

Chancellor Strine, In re El Paso Corporation Shareholder Litigation

"An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. Moreover, an omitted fact that otherwise might not be material may become material where the omission renders the partially disclosed information materially misleading. . . . Once defendants travel down the road of partial disclosure, they have an obligation to provide stockholders with an accurate, full, and fair characterization of whatever they disclose. . . . [However], Delaware law does not require the disclosure of inherently unreliable or speculative information which would tend to confuse stockholders or inundate them with an overload of information."

Vice Chancellor Parsons, Dent v. Ramtron Int'l Corp.

INTRODUCTION

The Delaware Court of Chancery ("Court") has a longstanding tradition as one of the nation's leading venues of jurisprudence for the resolution of business disputes. Drawing on the expansive base of public companies that are incorporated in Delaware, the Court has developed unparalleled expertise in issues of valuation and appraisal rights of shareholders in firms that experience corporate actions – i.e., activities in the market for corporate control. As a result, the Court has established general guidelines regarding acceptable valuation methods and practices over time, and its opinions provide a wealth of insight about the Court's thinking on such issues. A good understanding of the Court's opinions can be invaluable to legal counsel dealing with valuation related matters to be litigated before the Court.

In this publication, we focus on several issues that have prominently featured in recent valuation decisions by the Court. In particular, we summarize below four selected decisions issued by the Court during 2012, all of which involve disputes regarding the fair value of an enterprise that had been targeted for acquisition or merger. For each opinion, we highlight and provide commentary regarding the essential topics considered by the Court concerning

valuation. Chief among these are the following:

- Estimation of the "fair value" of an enterprise by application of the discounted cash flow ("DCF") model and other methods (including valuation multiples and comparable companies or transactions);
- Conflicts of interest among officers, directors, and/or outside financial advisors;
- Reliance on and materiality of financial projections made by management;
- An alleged fiduciary duty of "candor" to disclose information;
- Estimation of a firm's cost of equity under the Capital Asset Pricing Model ("CAPM") and other methods;
- Application of a small company size premium adjustment to a firm's cost of equity;
- Alternative approaches to the estimation of an equity risk premium in the CAPM; and
- Selection of an appropriate discount rate.

We recommend that interested readers obtain the full opinions of the Court to obtain a complete understanding of both the contested issues in each of the selected proceedings and the detailed explanations provided by each of the judges to support the Court's conclusions.

Opinions of the Delaware Court of Chancery are available at: http://www.courts.delaware.gov.

IN RE EL PASO CORPORATION SHAREHOLDER LITIGATION, C.A. NO. 6949-CS (DEL. CH. FEB. 29, 2012)

Opinion: Chancellor Strine
Issues: Breach of fiduciary duty; Conflict of interest; Valuation multiples in mergers
Court ruling: *In re El Paso Corporation Shareholder Litigation*

In this much discussed proceeding, shareholders of El Paso Corporation ("El Paso") had sought to halt the company's proposed merger with Kinder Morgan, Inc. ("Kinder Morgan"), alleging that various conflicts of interest between the involved parties resulted in a final offer price for El Paso that was lower than what a fair valuation of the company would have produced. Plaintiffs alleged, among other things, that the merger was the product of breaches of fiduciary duty by the Board of Directors of El Paso, aided and abetted by Kinder Morgan and by El Paso's financial advisor, Goldman Sachs.

Writing for the Court, Chancellor Strine expressed a belief that plaintiffs "have a reasonable likelihood of success in proving that the Merger was tainted by disloyalty," yet he "reluctantly" decided to deny the plaintiffs' motion for a preliminary injunction. In reaching its decision, the Court pointed out that there was "no rival bid for El Paso" and that the "price being offered by Kinder Morgan is one that reasonable El Paso stockholders might find very attractive." The Court further stated that "the El Paso stockholders should not be deprived of the chance to decide for themselves about the Merger, despite the disturbing nature of some of the behavior leading to its terms." Despite allowing the acquisition to continue, the Court nonetheless observed that plaintiffs might have been able to seek monetary damages arising from the alleged conduct at a future point in time.[1]

Prior to the merger proceedings, El Paso was a public independent energy company with two main lines of business: (i) a natural gas pipeline business operating in the United States and (ii) an exploration and production ("E&P") business that focused on opportunities to extract and produce natural gas and oil. On May 24, 2011, El Paso announced that it

[1] El Paso shareholders eventually agreed on a settlement amount of $110 million in cash, which was approved by the Court on December 3, 2012.

would spin off its E&P business. Goldman Sachs was retained as an exclusive advisor to El Paso to assist with the divestiture.

Approximately three months later, in late August of 2011, Kinder Morgan approached El Paso's Board with an initial, unsolicited offer of $25.50 per share in cash and stock for the entire company. The initial bid, received after the announcement of El Paso's intent to spin off the E&P business but prior to the actual divestiture, was rejected by El Paso's Board. According to the Court, the intent behind the offer may have been an effort on the part of Kinder Morgan to preclude competition for El Paso's soon-to-be-remaining standalone pipeline business. Citing internal company documents, the Court reported that "El Paso understood that Kinder Morgan was trying to preempt any competition by other bidders for what would be the separate pipeline business . . . by making a bid before El Paso divided into two companies." In response to the rejection of its initial bid by the El Paso directors, Kinder Morgan hardened its stance and threatened to go public with a hostile offer. This provided an impetus to the El Paso Board to enter into negotiations regarding the offer price, and – by September 18, 2011 – the two companies had reached preliminary agreement on an offer of $27.55 per share in cash and stock. Within a few days, however, Kinder Morgan reversed itself and abandoned the bid, prompting a new round of negotiations. Ultimately, the parties again reached agreement, and the El Paso Board on October 16, 2011 approved the transaction at a final, lower price of $26.87 per share in cash, stock, and warrants. Apparently, at no time during this process did the El Paso Board or its financial advisor solicit other bids or seek to determine a fair market price for the business to be acquired.

As alleged by plaintiffs in the subsequent shareholder litigation, the emergence of Kinder Morgan as the eventual sole bidder for El Paso generated certain conflicts of interest that were not properly addressed. As a preliminary matter, Goldman Sachs owned approximately 19 percent of Kinder Morgan and controlled two seats on Kinder Morgan's board. Its ownership precluded Goldman Sachs from serving as El Paso's advisor in the proposed merger transaction, yet it remained involved as an exclusive advisor to El Paso with respect to the contemplated E&P divestiture. El Paso retained Morgan Stanley to advise the firm with regard to the proposed merger transaction; furthermore, El Paso also asked Morgan Stanley to independently evaluate the spin-off transaction and to compare it, from the perspective of El Paso's shareholders, against the consideration being offered in the merger transaction. El Paso's board continued to rely on both advisors – Goldman Sachs and Morgan Stanley – in deliberating its final decision.

As the Court highlighted in its opinion, one problem with this situation was that Goldman Sachs' exclusive role as an advisor for the spin-off transaction "tainted the cleansing effect of Morgan Stanley." In particular, Morgan Stanley faced the following dilemma: either (i) advise that the spin-off would be a better transaction for El Paso's stockholders and receive no fees, since the Kinder Morgan merger transaction would then likely not have occurred, or (ii) advise that the merger would be a better choice for El Paso's stockholders and receive $35 million in fees for services relating to that merger. In addition, the Court found that the continued involvement of Goldman Sachs as the lead advisor on the spin-off transaction put the investment bank in a "position to continue to exert influence over the Merger," despite the apparent conflict of interest. Separately, but also of concern, was the fact that Goldman Sachs' lead banker advising El Paso with respect to the E&P divestiture did not disclose that he personally owned approximately $340,000 of stock in Kinder Morgan. Although certain measures were ostensibly taken to "cabin" Goldman Sachs' conflicts of interest, Chancellor Strine shared the plaintiffs' skepticism regarding the effectiveness of these measures to correct for or mitigate the conflicts.

As alleged, El Paso CEO Douglas L. Foshee had been appointed by the Board to lead the negotiations with Kinder Morgan on behalf of El Paso shareholders, but instead operated under additional, undisclosed conflicts of interest. In particular, Mr. Foshee did not disclose to El Paso's Board his interest and apparent intent to bid for the company's E&P assets from Kinder Morgan upon completion of the proposed merger. According to plaintiffs, this personal interest directly conflicted with the mandate assigned to the CEO by the Board to negotiate for the best deal on behalf of El Paso's shareholders. As explained by the Court, Mr. Foshee then undertook a "velvet glove negotiating strategy – which involved proffering counter-offers at levels below the level he was authorized by the Board to advance." Chancellor Strine concluded that this behavior on the part of the El Paso CEO "can now be viewed as having been

influenced by an improper motive" and was perhaps the "most troubling" element of the alleged conduct. It did not escape the Court's notice that an aggressive negotiation between Mr. Foshee and Kinder Morgan, in which the CEO sought the highest possible offer price for the shareholders of El Paso in the merger, might have resulted in a "bloodied Kinder unreceptive to a [subsequent] bid from Foshee" for the E&P assets.

The El Paso CEO eventually accepted a final offer price of $25.91 per share in cash and stock components ($26.87 including the value of warrants). Notably, this was less than the minimum share price of $26.50 in cash and stock that had previously been authorized by El Paso's Board. It was considerably less than the offer of $27.55 per share preliminarily agreed upon by El Paso and Kinder Morgan on September 18, 2011 (and from which Kinder Morgan had been allowed to back away during negotiations).

In its opinion, the Court commented on a number of valuation-related issues that had arisen over the course of the events surrounding the transaction. To begin with, the Court took note of an initial valuation of El Paso's E&P business by Goldman Sachs that the latter had performed as part of its advisory role following the May 2011 announcement by El Paso of its intent to divest itself of the business. The Court compared this work with similar valuations performed by Goldman Sachs after the merger offer by Kinder Morgan had emerged, and it took issue with the method employed by Goldman Sachs to value El Paso's E&P business. In particular, the Court found Goldman Sachs' use of comparable companies analysis to be "questionable." The method followed by Goldman Sachs sought to estimate the market value of El Paso's E&P business by applying trading multiples, observed among El Paso's peers, of the ratio of enterprise value ("EV") to earnings before interest, taxes, depreciation, and amortization ("EBITDA"). The results of this analysis implied that El Paso's E&P business had experienced a reduction in value of approximately $2 billion between May and October of 2011.

Chancellor Strine was unconvinced of the ability of the comparables valuation approach to assess the value of El Paso's E&P business accurately, and he highlighted a particular deficiency apparent in the method employed by Goldman Sachs. For instance, Chancellor Strine observed that "these market multiples [used by Goldman Sachs] were at depressed levels due to short-term volatility in commodity prices, and were not meant to provide a long-term indicator of the E&P business's value."

Such observations were particularly important to the case before the Court, for it involved substantial concerns regarding alleged conflicts of interest. The Court found a lower valuation of El Paso's E&P business "suspicious," not only "in light of Goldman's huge financial interest in Kinder Morgan," but also because it had the potential to encourage the Board towards accepting the merger offer by Kinder Morgan instead of going through the spin-off transaction. In addition, the Court noted that "solely looking to market multiples to generate a hypothetical trading value fails to take into account the control premium that could be achieved upon a sale of the E&P business."

The Court also found the involvement of Morgan Stanley as an advisor to El Paso to be of questionable value, as Morgan Stanley "only got paid if El Paso adopted the strategic option of selling to Kinder Morgan." In other words, the situation presented the investment bank with a biased set of incentives, and the direction of the bias was in favor of the merger transaction. This defeated the purpose of bringing an unconflicted investment bank to advise El Paso with regard to its strategic alternatives.

The Court further questioned the reliability of Morgan Stanley's valuation advice to El Paso. Specifically, Chancellor Strine observed that the record in the proceeding "includes evidence that supports a plausible argument that Morgan Stanley's analysis undervalued El Paso's stock and overvalued Kinder Morgan's stock." Morgan Stanley had used a discounted cash flow ("DCF") model to value El Paso's pipeline business, and such models typically project cash flows over some limited future period. However, if the business is assumed to continue as a going concern beyond the end of the forecast period, some "terminal" estimate of the value represented by the operation of the business beyond that point is needed. In the approach taken by Morgan Stanley, terminal value was estimated based on a multiple of EV/EBITDA. The Court was skeptical of this and suggested that a perpetual growth model of valuation might have been a better choice. Regardless, the Court concluded that Morgan Stanley's particular choice of 10× as the EV/EBITDA terminal multiple for the pipeline business was "unreasonably low." Not only that, but the 10× EV/EBITDA multiple used by Morgan Stanley implied a perpetual growth rate of

0.7 percent for El Paso's pipeline business, which the Court found to be contradicted by other evidence in the record. As Chancellor Strine wrote, Morgan Stanley effectively

> *calculated that the pipeline business would grow only 0.7% from 2016 into perpetuity – a rate less than half of the estimated rate of inflation (2%) – an implication which is inconsistent with Foshee's testimony that the pipeline business had strong growth prospects . . . and with the projections prepared by El Paso's management and used by Morgan Stanley, which included both maintenance and growth capital expenditures.*

The "unreasonably low" multiple served to reduce the overall estimate of the value of El Paso's stock, all else equal, which the Court again believed could potentially tilt the Board towards accepting the merger offer by Kinder Morgan in lieu of conducting the spin-off transaction.

Finally, the Court also criticized Morgan Stanley's use of Kinder Morgan's cost of equity in its DCF analyses, which appeared to be applied inconsistently and selectively depending on the context. The Court observed, for example, that Morgan Stanley made use of "a higher cost of equity (11.8%) when benchmarking El Paso's cost of equity, but a lower number (7.5%) when valuing Kinder Morgan directly." Chancellor Strine recognized that such an approach overvalued Kinder Morgan's stock relative to that of El Paso. Since the Kinder Morgan stock was to be used as currency for the merger, however, the result of the overvaluation was again to favor the merger as an alternative to the divestiture of the E&P business.

TULL N. GEARREALD, JR. ET AL. V. JUST CARE, INC., C.A. NO. 5233-VCP (DEL. CH. APR. 30, 2012)

Opinion: Vice Chancellor Parsons
Issues: Fair value of shares in connection with a merger; use of management projections; appropriate discount rate
Court Ruling: Gearreald et. al v. Just Care, Inc.

In the *Gearreald et. al v. Just Care* decision, the Delaware Court of Chancery addressed a number of issues regarding the determination of the fair value of common shares of Just Care, Inc. ("Just Care") as part of an acquisition of that firm by GEO Care, Inc. ("GEO").[2] While Respondent Just Care maintained that the fair value of the firm was $33.6 million, the Petitioners in this matter, a group of major shareholders of Just Care, claimed that the fair value of the company's shares was considerably greater – i.e., $55.2 million. In considering the dispute, the Court focused on certain elements of the parties' appraisal methods; in particular, the Court examined (i) the use of management projections that were not formally approved by Just Care's Board of Directions (the "Board") and (ii) the different inputs and assumptions used by the valuation experts separately engaged by the Petitioners and the Respondents. The Court ultimately concluded that, as of the merger date, the fair value of Just Care's common shares was approximately $34.2 million.

On November 21, 2008, GEO and Maxor National Pharmacy Services Corp. ("Maxor") entered into a confidentiality agreement regarding a potential acquisition of Just Care.[3] No agreement with respect to the transaction itself was reached at that time, however, and merger discussions ended soon thereafter without the Just Care Board having been informed of the overture by GEO. Reportedly, Maxor had expressed concerns regarding the due diligence process. The following April, GEO again approached Maxor, this time with a nonbinding letter of interest to purchase Just Care for cash consideration of between $30 and $35 million, but this offer was rejected by Maxor. GEO subsequently increased its target range to between $35 and $40 million, but this new proposal was also rejected by Maxor. On May 6, 2009, GEO offered a price of approximately $40 million for Just Care, an amount that represented approximately 5.9 times the company's earnings before interest, taxes, depreciation, and amortization ("EBITDA"). At this point in the proceedings, the Just Care Board was informed of GEO's offer by Jerry Hodge, who was both an employee of Maxor and a director of Just Care, and who had been involved with the prior discussions with GEO. For the first time aware of GEO's interest in an acquisition, the full

[2] Just Care, Inc. is a privately held prison healthcare services company that operates a single facility, the Columbia Regional Care Center in Columbia, South Carolina. GEO, a non-party in the suit, provides management services for correctional, detention, mental health, and residential treatment facilities.

[3] Maxor National Pharmacy Services Corp. was the majority shareholder of Just Care, Inc.

Board of Just Care approved further negotiations regarding a potential sale of the company. A few days later, on July 6, 2009, an unsolicited and competing bid for the purchase of Just Care was received from Brookstone Partners ("Brookstone"), a private equity firm. The Brookstone offer anticipated a purchase amount of between $38.3 million and $40.3 million.

To evaluate the proposed merger, Just Care's Board hired Harris Williams & Co., LLC ("Harris Williams") to act as its financial advisor. As part of its review, Harris Williams requested the preparation of financial projections through 2013 by the Just Care management (hereinafter, the "management projections"). These were subsequently produced and presented to Harris Williams by Just Care's principal founder and former CEO and by its CFO (both of whom were individually named Petitioners in this matter). The management projections forecasted the performance of Just Care under three scenarios that differed primarily with regard to the number and location of facilities operated by the firm:

i. Base Scenario. Assumes that Just Care would continue operating at close to full capacity, without further expansion of its facilities;
ii. Second Scenario. Adopts the base scenario but assumes also an expansion of Just Care's existing Columbia Regional Care Center facility in South Carolina ("Columbia Center") for the purposes of constructing a new building; and
iii. Third Scenario. Adopts the second scenario but further assumes new expansion into the State of Georgia.

Historically, Just Care did not prepare projections beyond the current fiscal year in its ordinary course of business. As a result, the management projections prepared for Harris Williams in the deliberation of the merger offers had not previously been formally approved or reviewed by the Board. Nevertheless, Harris Williams relied upon the management projections to support its fairness opinion.

Following the receipt of advice from Harris Williams that the GEO offer was superior to the Brookstone proposal, the Just Care Board approved an agreement and plan of merger with GEO in August of 2009.[4] Pursuant to the merger agreement, Just Care was to have been acquired "as a wholly owned subsidiary for $40 million in cash."[5] The Just Care shareholders voted to approve the merger the next month, and the transaction closed by the end of September.

In the matter before the Court, Petitioners contended that the fair value of Just Care was $55.2 million; this was well above the estimate of fair value offered by the Respondent (at $33.6 million). To support its estimate of fair value, each party to the dispute relied on an independent valuation expert. While the two valuation experts followed the same general method to calculate an estimate of the fair vale of Just Care, they differed with regard to the application of specific assumptions and inputs. The Court identified several areas of dispute between the opposing experts, but two were primarily responsible for the substantial difference in their final valuation estimates: (i) whether the fair value of Just Care should be determined considering all three scenarios forecasted by the management projections (and, if not, which scenarios should be considered) and (ii) whether it was appropriate to add a premium to Just Care's cost of equity to reflect the relatively small size of the company.

Both experts made use of the base case scenario in their analyses. However, whereas the Petitioners' valuation expert determined that both the second and third scenarios (both of which assumed the expansion of Just Care's business) should be included as part of the projected cash flows, the Respondent's valuation expert decided to exclude the third scenario (regarding new entry of Just Care's business into Georgia), deeming it as too speculative. In addition, the Respondent's expert performed alternative versions of his fair value analysis that both included and excluded the projections of the second scenario (regarding the addition of a new facility at the Columbia Center in South Carolina).

The Court agreed with the Respondent's valuation expert that the third scenario "was too speculative to be included in the valuation of the Company as of the merger date." In support of this conclusion, the Court observed that an expansion into Georgia was outside Just Care's normal business operations. Noting that, in an appraisal proceeding,

[4] Reportedly, Brookstone proved unable to secure firm financing to support its proposed offer for Just Care.

[5] Of the $40 million, $6 million was to be held in escrow to pay for certain claims against Just Care.

"the corporation must be valued as a going concern based upon the 'operative reality' of the company as of the time of the merger," the Court stated that it should consider "all factors known or knowable as of the Merger Date that relate to the future prospects" of the combined firm but also that it "should avoid including speculative costs or revenues." In rejecting the use of the third scenario from the management projections, the Court determined that Just Care's "business model was not predicated on maintaining multiple facilities" and that the firm "had no prior experience with expanding its business outside of the Columbia Center."

With regard to the second scenario, the Court recognized that the forecasted addition of a new building in the Columbia Center facility involved "substantial uncertainty" and "a high degree of risk," but it nevertheless concluded that "the evidence presented provides a sufficient basis to include the [second scenario] to at least some extent in the determination of the Company's value on the merger date." The Court expressed its belief that the scenario regarding an extension of Just Care's existing business in South Carolina was "significantly more credible" than the expansion of the Just Care business model and geographic presence forecasted under the third scenario, particularly since Just Care had already (in 2007) demonstrated its ability to expand its Columbia Center operations successfully. The Court further stated that the second scenario "represented a relatively small expansion, at the same location, in the same state, for the purpose of adding additional business for patients similar to those already being treated by Just Care." That being said, the Court also allowed that there was uncertainty regarding not only whether the contemplated facility would in fact move forward, but also whether Just Care would win the request for proposal to build and operate the facility. To reflect this uncertainty, the Court ultimately ruled that that the second scenario could be included in the valuation estimate so long as the value contributed by the assumed facility addition be "probability weighted by 66.7%." In effect, the Court assigned a likelihood of two-thirds to the expected value to Just Care from the contemplated expansion of the Columbia Center under the second scenario.

Turning to the contested issue of the small size premium, the Court noted as an initial matter that both of the valuation experts used the capital asset pricing model ("CAPM") to determine Just Care's cost of equity. The CAPM is a well accepted method for estimating a company's cost of equity, and it relies on three inputs: (i) the expected return of a theoretically risk-free asset (the "risk-free rate"); (ii) a measure of the degree to which volatility in a firm's stock price is correlated with volatility in the broader market ("beta"); and (iii) the excess of the expected return of the market over the risk-free rate of return (the "equity risk premium"). As the Court noted, however, empirical research performed in recent years provides support for the use of an additional adjustment to CAPM in certain circumstances. Specifically, a "size premium" may be added to the cost of equity when valuing smaller companies to account for the higher rate of return typically demanded by investors to compensate for the greater risk associated with the equity of smaller companies relative to that of larger ones.

The two opposing valuation experts in the present matter both agreed that the appropriate risk-free rate at the time of the merger was 4.02 percent, but they offered different opinions as to the appropriateness of other CAPM inputs and adjustments – including the company beta, the equity risk premium, and the size premium.

In evaluating the appropriate beta, the Court for the most part adopted the method of the Petitioners' valuation expert, which "accounts for the possibility that price changes for small, thinly-traded stocks may lag the overall market." The Court found that the justification provided by Petitioners' expert for the use of this particular approach appeared "reasonable based on Just Care's size and the illiquidity of its stock." Adjusting the expert's calculation somewhat to adhere to its other conclusions regarding the capital structure of Just Care, the Court determined the relevant beta for the CAPM to be equal to 0.82.

The equity risk premium basically represents the compensation to investors for taking on the extra risk of an equity investment relative to risk-free bonds. It has traditionally been calculated by observing historical returns on common stocks and comparing them to the returns on risk-free bonds, but an alternative "supply side" approach has more recently been developed, which attempts to isolate and measure the component of equity risk premium that is explained by growth in the stock's expected earnings. In the present matter, the Court noted that the opposing valuation experts "dispute whether a historical or supply side equity risk premium should apply." As with the discussion of beta above, the

Court again accepted the method supported by the Petitioners' expert, who had calculated a supply side equity risk premium that was lower than the historical equity risk premium applied by the Respondent's expert. The Court noted that "the academic community in recent years has gravitated toward greater support for utilizing the supply side equity risk premium," and it highlighted that Respondent's expert had offered no "substantive financial reason [as to] why a supply side equity risk premium would be inappropriate in this specific case." Consequently, the Court concluded that the supply side equity risk premium of 5.73 percent offered by the Petitioners' expert was the appropriate metric to be applied in valuing Just Care.

Finally, the Court addressed a disagreement between the valuation experts regarding the appropriate small company size premium to apply to Just Care's cost of equity. To judge just how small a "small company" is for the purposes of determining an appropriate size premium, it is not uncommon for valuation methods to make reference to a scale published by Ibbotson, a prominent third-party provider of financial research. Ranking companies into ten deciles based on market capitalization, Ibbotson assigns the smallest to Decile 10, which is subdivided further into 10a (relatively larger) and 10b (relatively smaller). Empirically estimated small company premiums are associated with each decile. As the Court has explained in this proceeding and elsewhere, the "*Ibbotson* size premium number reflects the empirical evidence that smaller firms have higher returns than larger firms."

Both valuation experts in the present matter agreed that Just Care's market capitalization, viewed alone, would imply that the company should fall within Ibbotson's Decile 10b; as such, both experts agreed it would be appropriate to add a small company size premium to the estimated cost of equity for the firm. The Respondent's valuation expert applied a size premium of 9.53 percent, which is consistent with Decile 10b. The Petitioners' valuation expert, however, asserted that a much lower size premium was warranted. Arguing that the size premium data for small cap stocks effectively reflects an "illiquidity premium" that essentially behaves like "a discount for lack of marketability or minority interest," Petitioners' expert maintained that the effective discount "must be eliminated in a fair value determination." Consequently, he applied a lower value of 4.11 percent as the small company size premium (which, despite his recognition of the Just Care market capitalization, is consistent with the larger companies of Decile 10a).

The Court agreed with the Petitioners' valuation expert that a liquidity discount, which relates to the marketability of the company's shares, generally cannot be applied in an appraisal proceeding, but it took issue with his characterization that such a liquidity discount was embedded within the size premium implied for Just Care by the Ibbotson scale. As the Court explained, the "liquidity effect in this case arises in relation to transactions between Just Care and its providers of capital and . . . is part of the Company's value as a going concern." According to the Court, this is different and distinct from the sort of liquidity effect described by the Petitioner's valuation expert, which relates instead "to transactions between a company's shareholders and other market participants" and is prohibited under appraisal law. While the Court rejected the size premium adjustment advocated by the Petitioner's valuation expert as a matter of law, it also highlighted that it found the specific adjustment applied by the expert to be unreliable. The Court thus concluded that the 4.11 percent size premium used by the Petitioner's valuation expert was not appropriate, and it ruled that the 9.53 percent size premium offered by the Respondents' expert (which was consistent with Decile 10b) should instead be used in the estimation of Just Care's cost of equity. In short, the Court declined "to reduce the Company's size premium to less than what is implied by its actual size."

Despite the fact that the Court largely followed the Petitioners' expert when deciding on the appropriateness of several inputs and adjustments to the calculation of Just Care's cost of equity, it agreed for the most part with the Respondent's expert when considering whether the various cash flow scenarios of the management projections should be included in the valuation of the firm. Of the two, the latter issue was most determinative of the Court's final decision with regard to the valuation of Just Care. The Court concluded that the fair value of Just Care as of September 30, 2009, was approximately $34.2 million – or much closer to the Respondent's estimate of $33.6 million than to the Petitioners' estimate of $55.2 million.

IN RE APPRAISAL OF THE ORCHARD ENTERPRISES, INC., C.A. NO. 5713-CS, 2012 WL 2923305 (DEL. CH. JULY 18, 2012)

Opinion: Chancellor Strine
Issues: Preferred stock; Discounted cash flow ("DCF") valuation; Comparable companies; Supply-side equity risk premium ("ERP"); Company-specific risk
Court ruling: In re: Appraisal of the Orchard Enterprises, Inc.

This case addresses several valuation issues that arise in determining the fair value of a business for Delaware appraisal purposes. The appraisal action considered by the Court in this matter arose "out of a merger in which the common stockholders of The Orchard Enterprises, Inc. were cashed out at a price of $2.05 per share by Orchard's controlling stockholder, Dimensional Associates, LLC." The Court determined its own fair value of Orchard's shares by applying the discounted cash flow ("DCF") method of valuation. As part of its opinion, the Court addressed several valuation issues that included the valuation treatment of Orchard's preferred stock, the selection of DCF as the sole method used for the appraisal, the treatment of management projections, and the selection of an appropriate discount rate.

Orchard's minority shareholders (the petitioners in this matter) argued that the cashed out valuation of $2.05 per Orchard share was too low. Relying on a DCF valuation, their expert offered an opinion that each common share was instead worth $5.42 as of the date of the merger that took the company private. This was contested by an expert testifying on behalf of the respondent, Orchard, who offered an opinion that the merger price was generous and that Orchard's common shares were actually worth only $1.53 as of the date of the merger. The Court ultimately determined that a fair value of the common shares was $4.67 per share, a figure in between the experts' valuations.

A major difference between the valuation approaches used by the two opposing experts was the treatment of Orchard's preferred stock. Each preferred stock share was convertible at any time to 3.33 common shares at the option of Orchard preferred stockholders.[6] In addition, Orchard's preferred stock enjoyed a liquidation preference value of $25 million under certain "Change of Control Event[s]," which essentially provided the preferred stockholders exclusive access to the first $25 million of proceeds upon a sale of all or substantially all of Orchard's assets to a third party. Orchard's expert argued that the $25 million liquidation preference value of the preferred stock should be deducted from the enterprise value of the Company in order to determine the value of Orchard's common stock. In essence, Orchard's expert proposed a valuation method in which the firm was treated as liquidated, instead of as a going concern, for the purpose of determining the effect of the preferred shares on the value of the enterprise. The Court, however, agreed with the minority shareholders that the $25 million liquidation preference value should not be deducted from Orchard's total equity value when determining the value of its common stock. The Court argued that Orchard's preferred stock should be valued on an as-converted basis since, "as of the date of the Merger, the liquidation preference had not been triggered, and the possibility that any of the triggering events would have occurred at all, much less in what specific time frame, was entirely a matter of speculation." The Court relied on "settled" Delaware law[7] that the minority shareholders were to receive their *pro rata* share of the value of Orchard as a going concern, not on a liquidated basis, and "without regard to post-merger events or other possible business combinations."

As discussed above, the Court arrived at a fair value of $4.67 per share by relying exclusively on the DCF method of valuation. In particular, the Court found the "comparable company" and "comparable transaction" methods of valuation insufficient in this matter. While the Court observed that the use of a comparable company method is "rooted in the same intuition as the DCF method," it nevertheless explained that the comparable company method draws inferences about the future expected cash flows based on the expectations of the market regarding comparable companies, "rather than directly estimating the future cash flows of the subject company and reducing them to present value." In this instance, the Court believed that no comparables existed because Orchard was a unique company pursuing a niche market, thereby making the comparables approaches less reliable.

[6] The preferred stockholders enjoyed typical anti-dilutive protections upon conversion that provided for adjustments for stock splits, combinations, and distributions.

[7] *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989).

Consequently, the Court found the comparables approach used by Orchard's expert to have failed due to the "lack of a good sample of actual comparables." The Court further concluded that Orchard's expert selected arbitrary valuation multiples to apply to Orchard, disregarding the mean and median multiples of the selected sample. In effect, wrote the Court, the Orchard expert herself had been "indicating that her comparables are in fact not at all very comparable." Chancellor Strine highlighted this flaw as fatal to the valuation approach of Orchard's expert, observing that, "when an expert throws out his sample and simply chooses his own multiple in a directional variation from the median and mean that serves his client's cause, he is not using the comparables method in any reliable way that accords with my understanding of its proper deployment."

Having decided to rely exclusively on the DCF approach, the Court turned to the DCF analyses performed by the experts. It found that there was little dispute between the experts regarding the core inputs to the DCF methodology, although it did note that the two experts did differ with regard to the treatment of the specific set of projections on which each expert relied upon. As the Court observed, one expert used outdated projections from the proxy statement despite the availability of more recent forecasts. The other expert used the same dated projections, but modified them to reflect additional inputs from management. In contrast, the Court adopted the most recent projections that were used in the fairness opinion associated with the merger, which reflected management's "then-current estimates and judgments." The two experts also treated net operating loss carryforwards ("NOLs") differently. The Court rejected the treatment used by both experts and relied instead on the NOLs provided in the fairness opinion.

The Court explained that the largest disagreement between the experts was over the discount rate to be used in the DCF method to bring the projected cash flows to present value. Between them, the opposing experts employed three different methods to calculate a discount rate. They considered two variations of the so-called "build-up" model as well as the Capital Asset Pricing Model ("CAPM").

The Court rejected both variations of the build-up model, stating that the model is "larded with subjectivity, and it incorporates elements that are not accepted by the mainstream of corporate finance scholars." In contrast, the Court considered the CAPM methodology because it "remains [to be] the accepted model for valuating [sic] corporations." In particular, the Court expressed its approval of the experts' use of "a modified CAPM method that takes into account academic acceptance that the size of a corporation affects the expected rate of return and should be factored into the calculation of a corporation's discount rate."

In his commentary, Chancellor Strine recognized the fact that the discount rate can be estimated in multiple ways, but he explicitly criticized the practice of simply "blending together" the various estimates to yield another, potentially different rate to be used in the actual DCF analysis. As he stated:

> *Even if one were to conclude that there are multiple ways to come up with a discount rate, that does not mean that one should use them all at one time and then blend them together. Marc Vetri, Mario Batali, and Lidia Bastianich all make a mean marinara sauce. Is the best way to serve a good meal to your guest to cook up each chef's recipe and then pour them into a single huge pot? Or is it to make the hard choice among the recipes and follow the chosen one as faithfully as a home cook can? This home cook will follow the one recipe approach and use the recipe endorsed by Brealey, Myers and Allen and the mainstream of corporate finance theory taught in our leading academic institutions, i.e., the CAPM method*.

The Court next addressed the specific inputs to the CAPM model to be used in the present matter. One important input to the CAPM is the equity risk premium ("ERP"), which has traditionally been measured using historical data as the difference between the equity rate of return and the risk-free rate of return. The ERP represents the compensation to investors for taking on the extra risk of an equity investment relative to bonds. As such, the ERP has traditionally been calculated by observing historical returns on common stocks and comparing them to the returns on risk-free bonds. Recently, however, an alternative approach to the ERP has calculated it from a "supply-side" perspective that attempts to isolate and measure the component of ERP explained by a

"stock's expected earnings growth."[8] The Court elected to use the supply-side approach to calculating ERP, observing that the use of the supply-side ERP "is supported by relevant professional and academic literature and prior decisions of this court in appraisal proceedings . . ." In this matter, the supply-side ERP was estimated at 5.2 percent, which, when compared to the historically estimated ERP rate of 6.7 percent, had the effect of reducing the expected discount rate. All else equal, reducing the rate at which the projected cash flows of the enterprise are to be discounted to present value results in a higher valuation.

In addition to using a supply-side ERP, the Court also expressed its belief that "a company-specific risk premium should [not] be used in a CAPM calculation of a discount rate." In his CAPM method, Orchard's expert had applied an additional 1 percent to the discount rate, ostensibly to reflect a company-specific risk adjustment, arguing that the addition of the incremental return would compensate investors for specific elements of risk unique to Orchard's business. The Court rejected his approach as being "inconsistent with the CAPM method." In particular, the Court took issue with the expert's choice to reflect company-specific risk by making an adjustment to the discount rate. To the extent such risk exists, the Court concluded that this is "a risk that should be reflected in the estimated cash flows, not heaped into a CAPM discount rate. It has no place there."

Both of the valuation experts in the matter incorporated into their analyses a premium (added to Orchard's cost of capital) to account for the fact that investors demand consideration for the extra risk that small companies tend to display relative to large companies. The Court agreed that a "size premium is a generally accepted addition to the CAPM formula in the valuation of smaller companies to account for the higher rate of return that investors demand as compensation for the greater risk associated with small company equity." However, it rejected the opinion of Orchard's expert regarding the specific premium to use in the matter at hand. Chancellor Strine explained that "Orchard has not persuaded me that simply because I use the supply-side equity risk premium, I should add more to the size premium," and he consequently sided with the petitioners by rejecting the upward adjustment to the size premium made by Orchard's expert. That being said, the Court acknowledged that a legitimate difference of opinions could apply to this, since "academic and practitioner thinking [in] this area seems to be in a period of active evolution."

[8] The supply-side ERP method attempts to account for what the underlying economy and individual companies can supply to the market in terms of expected returns.

After applying the supply-side ERP and removing the company specific adjustment (an approach that has been similarly recognized in other prior Delaware appraisal opinions), the Court calculated a discount rate of 15.3 percent under the CAPM method. Applying this discount rate to the projected cash flows resulted in a fair value of $4.67 per share for Orchard's common shares. As explained by the Court, this estimate of "fair value" indicates the "value of the company to the stockholder as a going concern, rather than its value to a third party as an acquisition."

DENT V. RAMTRON INT'L CORP., C.A. NO. 7950-VCP (DEL. CH., NOV. 19, 2012)

Opinion: Vice Chancellor Parsons, Jr.
Issues: Disclosure of financial projections
Court ruling: *Dent v. Ramtron Int'l Corp.*

In the *Dent v. Ramtron* decision, the Delaware Court of Chancery addressed whether an alleged failure to disclose management-prepared financial projections to shareholders was sufficient cause to enjoin the shareholder vote on a merger between Ramtron International Corp. ("Ramtron") and Cypress Semiconductor Corp. ("Cypress"). The Plaintiff, representing a class of Ramtron shareholders, had basically alleged that the failure to disclose the particular projections at issue was both material to the merger decision and constituted a breach of the fiduciary duty of the Ramtron Board of Directors, and therefore sought a motion for a preliminary injunction to enjoin the shareholder vote. In considering the matter, the Court focused on two leading questions: (i) whether the proxy statement associated with the proposed merger was false and misleading as a result of Ramtron's failure to disclose the management projections and (ii) whether this lack of disclosure resulted in the stockholders not being able to make an informed decision when seeking an appraisal of, or voting to approve, the merger.

On March 8, 2011, Cypress made an unsolicited proposal to acquire Ramtron for $3.01 per share

(which represented a 37 percent premium over Ramtron's closing stock price that day). The Ramtron Board of Directors declined the offer, and no further activity towards an acquisition appeared to have been pursued at that time. More than a year later, however, Cypress returned with a new overture towards the firm. On June 12, 2012, Cypress again proposed to acquire Ramtron, but this time it publicly announced its offer of $2.48 per share. Following the rejection of this bid as well, Cypress revised its offer several days later, increasing it to $2.68 per share. On August 27, 2012, Cypress increased its bid again, announcing an offer of $2.88 per share, which was not conditioned on financing. Approximately two weeks later, Ramtron countered with its own proposal of $3.50 per share, but was shortly rejected by Cypress. Negotiations continued, however, and the parties ultimately entered into a merger agreement in which Cypress was to make a tender offer of $3.10 for each outstanding share of Ramtron's common stock.

Ramtron engaged Needham & Company ("Needham") as a financial advisor to the firm in the matter of the proposed acquisition. Needham prepared an opinion in support of the merger offer, concluding that, "from a financial point of view, . . . the $3.10 per share of common stock consideration to be paid to holders of shares" was fair. Consequently, Needham recommended that the firm's stockholders accept the offer and tender their shares.

Under Delaware law, an acquirer is allowed to complete the transaction through a comparatively simple, short-form merger process once it succeeds in acquiring at least 90 percent of the ownership interest of the target. Consequently, merger agreements occasionally incorporate what is known as a "top-up option," which basically grants the acquirer the right to purchase newly issued shares of the target firm to increase its ownership percentage (thereby facilitating a short-form merger process), if it succeeds in meeting some minimum set of conditions specified in the merger agreement. As part of the offer agreement between Cypress and Ramtron, a top-up option was provided in the event that Cypress was able to secure more than 86 percent of Ramtron's outstanding stock. In practice, however, Cypress was only able to acquire a 78 percent interest in the target. As a result, Cypress was prevented from exercising the top-up option and was unable to pursue an expedited, short-form acquisition. In the alternative, Cypress decided to pursue a long-form merger (pursuant to Section 251 of the Delaware General Corporation Law), with a formal vote of the Ramtron stockholders scheduled to occur on November 20, 2012.

Prior to the vote, Plaintiff Paul Dent (filing on behalf of himself as a Ramtron shareholder and on behalf of all others similarly situated) sought a preliminary injunction against the proposed acquisition, alleging a breach of fiduciary duty by Ramtron's directors and aiding and abetting a breach of fiduciary duties against Cypress. Chief among Plaintiff's complaints was "that defendants breached the fiduciary duty of candor by failing to disclose Ramtron's management's financial projections that covered the second half of 2012 and the years 2013 through 2016." Implicit in this allegation is the apparent belief that, had these projections been disclosed and factored into shareholders' deliberations regarding the proposed merger, they would have been material to the decision regarding whether or not to support a sale at the price agreed.

Defendants responded that management's projections were neither accurate nor reliable and that Ramtron had shared these management projections with its financial advisor consulting on the merger. Defendants further sought to highlight the projections' lack of material relevance to the merger deliberations, arguing that: (i) Cypress did not have access to the financial projections when it decided to enter into the merger agreement; (ii) approximately 75 percent of Ramtron's shareholders tendered their shares without relying on the financial projections; (iii) the financial analysis conducted by Needham, which relied in part on management projections, had already been disclosed to shareholders and showed, based on a discounted cash flow ("DCF") valuation estimate, that Ramtron likely had an equity value between $3.57 and $5.01 per share (as compared to the $3.10 per share merger consideration); and (iv) the Plaintiff himself had admitted that he did not require the financial projections at issue to determine that the merger consideration was too low.

In examining whether or not the Board breached an alleged "duty of candor" by failing to include in the proxy disclosures the financial projections prepared by management, the Court noted that "Delaware law does not require the disclosure of inherently unreliable or speculative information which would tend to confuse shareholders or inundate them with an overload of information." The Court further

specified that “[t]here is no per se duty to disclose financial projections furnished to and relied upon by an investment banker.” Rather, in order for such forecasts to be “a subject of mandated disclosure,” the Court confirmed that “the projections must be material” to the proposed decision. With regard to the present matter, the Court concluded that the available evidence failed to support a finding that the financial projections were in fact material. As the Court explained, “notwithstanding management’s relatively bullish forecasts, the other metrics that were studied by the investment advisor” suggested that the management forecasts were likely overstated and thus potentially unreliable as a basis upon which to value Ramtron. Specifically, the Court found that one “reasonable inference” from the data and other information disclosed as part of the merger deliberations “is that management’s projections are relatively optimistic.”

As confirmed by the disclosed proxy statement, Ramtron’s financial advisor performed several different analyses, employing several different methods, to estimate the fair value of the Ramtron shares in the acquisition transaction with Cypress. In addition to the discounted cash flow valuation approach mentioned above, Needham also performed a selected company analysis, a selected transaction analysis, and a stock price premium analysis. These three additional methods together suggested that the price range calculated by the DCF valuation (i.e., between $3.57 and $5.01 per share), which had been based on the management-prepared financial projections, was perhaps overly optimistic. In particular, the three additional analyses together estimated a lower range of reasonable prices for the merger, a range that included the $3.10 per share that had previously been negotiated by Ramtron and Cypress.

The Court noted that certain other evidence produced in the record also suggested that the management projections at issue were optimistic. For example, the Court heard evidence that Ramtron had repeatedly failed to achieve the public earnings guidance issued by its management; similarly, the firm’s performance had repeatedly fallen short of its own internal projections. Collectively, these observations served to cast doubt on the accuracy and reliability of projections issued by Ramtron’s management. This deficiency had apparently been recognized by Ramtron itself, as the firm had publicly announced that it experienced “limited near-term visibility” and that it would no longer provide annual earnings guidance. Indeed, by the second quarter of 2012, not a single analyst provided earnings guidance with regard to Ramtron or reported projections of the firm’s future results. Based on all this, the Court found that the lack of disclosure of the particular set of financial projections that were the subject of Plaintiff’s complaint in this matter was not likely to have been material to the merger decision. As the Court concluded, “it is unlikely that a reasonable stockholder would find the projections to be important as opposed to merely helpful in deciding how to vote on the merger or whether to seek appraisal.”

In explaining its ruling, the Court did express its preference to have potential disclosure deficiencies addressed before a stockholder vote. That being said, the Court also concluded that, if it were to enjoin the vote in the present matter, Defendants would face several potential problems. The Court pointed out that no other interested buyer for Ramtron had emerged, for example, and that the Cypress offer represented a 71.3 percent premium over the June 11, 2012 closing price (“the last trading day before the first public announcement of Cypress’s offer to acquire Ramtron”). The Court also observed that Cypress had already established *de jure* – but not *de facto* – control over the company as a result of its acquisition of Ramtron stock to date, which meant that enjoining the vote would simply “delay Cypress’s ability to exercise control over Ramtron’s business and operations at a time when the company is performing below expectations and may face some level of distress.” Primarily for these reasons, the Court denied the motion and allowed the shareholder vote to proceed.

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