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Highlights of 2020 Delaware Valuation Decisions

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Although several valuation decisions were rendered in Delaware during 2020, none were as impactful as the Supreme Court's reversals of *DFC Global* and *Dell* in 2017 or its 2019 *Aruba* decision, which reversed the first appraisal decision based on unaffected market price. This article will discuss two 2020 Supreme Court decisions and eight decisions by the Court of Chancery.

The Supreme Court affirmed two 2019 decisions: *Jarden* was the first approval of an appraisal using unaffected market price, and *Stillwater Mining* affirmed the Court of Chancery's denial of petitioners' post-trial request for an upward adjustment for a favorable event because they failed to present appropriate testimony at trial. The Court of Chancery rendered six valuation opinions, each of which is summarized here. Only one, *Panera Bread,* involved a large public company, but each case has aspects that may be informative to potential expert witnesses.

Jarden

A 2019 decision appraised the company, a consumer products company, at its closing price on the day before the first published rumor of the deal, which Vice Chancellor Joseph Slights III deemed to be its unaffected market price.[1] His calculated DCF was quite close to unaffected market price, and he viewed it as confirmatory of his appraisal valuation.[2] He accepted the use of the terminal investment rate (TIR), also called the plowback rate, as a factor in calculating terminal value.[3]

After reargument, the vice chancellor agreed with some of petitioners' adjustments that increased DCF value, but he corrected his determination of TIR.[4] The combined effect of these changes left the court's calculated DCF virtually unchanged.

The Supreme Court concluded in 2020 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 on the unaffected market price to determine fair value.[5] It also ruled that it was not an abuse of discretion for the lower court to have relied on the event study by respondent's expert.[6]

The Supreme Court observed that the lower court did not rely on its DCF model to find fair value.[7] It also ruled that that it was not an abuse

1 See "Highlights of 2019 Delaware Valuation Decisions," *Business Valuation Update,* November 2019, pp. 6-7.

2 *In re Appraisal of Jarden Corp.*, 2019 WL 3244085 (Del. Ch. July 19, 2019) at *50.

3 Id. at *41.

4 *In re Appraisal of Jarden Corp.,* 2019 WL 4464636 (Del. Ch. Sept. 16, 2019) at *3.

5 *Fir Tree Value Master Fund, LP v. Jarden Corp.*, 236 A.3d 313 (Del. 2020) at 326.

6 Id. at 327.

7 Id. at 323.

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of discretion to change its TIR when calculating DCF after reargument.

> [A]s best we can tell, the petitioners' argument that the McKinsey formula undervalued Jarden because it was in a certain class of companies lacks support from the experts.... [W]hile the petitioners cite McKinsey's concerns about undervaluing certain companies, they do not provide support for readopting the court's original solution to split the difference.
>
> On reargument, the court stated that it had "improperly depart[ed]" from the McKinsey formula.... Based on the record before the court, the court did not abuse its discretion by applying the McKinsey formula in its post-trial opinion or correcting what it believed was an erroneous application of the formula on reargument.[8]

Stillwater Mining

Vice Chancellor Travis Laster determined in 2019 that appraisal value in this arm's-length transaction was the deal price.[9] Although the prices of palladium and platinum, Stillwater's principal products, increased materially between the date the deal was announced and the closing date, he did not adjust the appraisal because petitioners did not argue for it or quantify its effect on value at trial.[10]

The Supreme Court affirmed in 2020, agreeing that "the deal price was a reliable indicator of Stillwater's fair value."[11] It also upheld the lower court's decision to reject petitioners' post-trial request to adjust the appraisal value upward to reflect the material increases in palladium and platinum prices, noting that the respondent did

8 Id. at 335.

9 *See* "Highlights of 2019 Delaware Valuation Decisions," *Business Valuation Update*, November 2019, pp. 7-8.

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

11 *Brigade Leveraged Capital Structures Fund, Ltd. v. Stillwater Mining Co.*, 240 A.3d 3, 17 (Del. 2020).

not have the opportunity to address the issue at trial.[12]

UIP Companies

A 50% owner of a small real estate management company challenged the sale of tie-breaking shares to an associate of the defendant as a breach of fiduciary duty. Vice Chancellor Kathaleen McCormick ruled that the transaction was subject to the "entire fairness" standard. She determined that the process was unfair and that it was necessary to examine whether the newly issued stock had been sold at a fair price.

Defendant's expert's valuation analysis used the capitalized cash flow (CCF) method, which the decision described as a "near-cousin of a discounted cash flow analysis."[13] The expert's capitalization rate included a company-specific risk premium.

Delaware courts have seldom accepted company-specific premiums in determining cost of capital. In 2006, Vice Chancellor Leo Strine Jr. (later chief justice) observed that "company-specific risk is highly subjective" and commented, "To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients' objectives, when other valuation inputs fail to do the trick."[14]

In *UIP*, however, the court accepted the company-specific premium. Because the company's revenues were almost wholly dependent on special-purpose real estate entities and on its two principals for its revenue, it found that "[d]efendants have met their burden of showing that a specific-company risk premium is necessary in this case."[15]

The court accepted the defendant's valuation and concluded that the price was fair. Therefore, there was no breach of fiduciary duty.[16]

SourceHOV Holdings

Minority shareholders in SourceHOV Holdings, a privately held process outsourcing and financial technology company, sought appraisal after a three-way merger. Experts for both sides concurred that the only appropriate valuation method was the income approach. Petitioners' expert used both DCF and CCF. Respondent's expert used an adjusted present value DCF model that Vice Chancellor Slights said was functionally the same as CCF.[17] He commented, "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.'"[18]

The principal differences between the two experts' DCF analyses of SourceHOV were projected debt, beta, and the small-company premium. Respondent's expert assumed that the company would pay off its debt at maturity and not incur additional debt, thereby reducing interest payments. His valuation was lowered by the reduced tax savings. The court rejected this argument, concluding that the company would replace the debt.[19]

Petitioners' expert determined beta in a customary manner based on guideline companies. Respondent's expert calculated beta using the yield on SourceHOV's debt; Vice Chancellor Slights rejected this "methodologically novel" approach,

12 Id.

13 *Coster v. UIP Cos., Inc.,* 2020 WL 429906 (Del. Ch. Jan. 28, 2020) at *21.

14 *Del. Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 339 (Del. Ch. 2006).

15 *Coster* at *25.

16 Id. at *28.

17 *Manichaean Capital, LLC v. SourceHOV Holdings*, Inc., 2020 WL 496606 (Del. Ch. Jan. 30, 2020) at *14. The Supreme Court heard the appeal in this case on Jan. 13, 2021.

18 Id. at *12.

19 Id. at *24.

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observing that it was not supported by academic literature.[20]

Petitioners' expert determined his small stock premium on the eighth decile in Duff & Phelps' *2017 Valuation Handbook,* while respondent's expert chose the ninth decile. Each based his selection on the post-merger market price of shares of the newly formed merged company, but the respondent's expert adjusted the market price for synergies. The court accepted this concept.[21] The court accepted the petitioners' calculations other than the small stock premium. It appraised SourceHOV at approximately 90% of the petitioner's valuation and 163% of the respondent's valuation.

In the past, the Court of Chancery has sometimes erroneously accepted terminal values with capital expenditures materially lower than depreciation,[22] a mathematical impossibility for a going concern.[23] In this case, Vice Chancellor Slights recognized the problem and commented favorably on petitioners' adjustment that benefited the respondent:

> [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.[24]

Panera Bread

Panera Bread was acquired for $315 per share (more than $7 billion) in cash in an arm's-length transaction. Shareholders (including several merger arbitrageurs) filed for appraisal of over 785,000 shares of common stock (about $250 million).

Panera operated "fast casual" restaurants across the U.S. through company-owned locations and franchisors. Although it should have been quite simple to create a list of appropriate comparable companies, both experts compiled flawed lists. Vice Chancellor Morgan Zurn sharply criticized the comparable companies each expert selected, stating, "I view both parties' comparable companies analyses as an attempt to corroborate their preferred valuation."[25] One expert "included McDonald's and Burger King, but excluded Wendy's; he included Domino's, but excluded Papa John's."[26] The other expert "selected comparable companies by reviewing equity analysts' reports in the year before the merger date and selecting the firms mentioned by three or more analysts at least once."[27] His list included full-service restaurants, which the court appropriately rejected as valid comparables.

He also rejected both experts' comparable transaction analyses because "neither sample size is reliable enough to afford it weight."[28]

Respondent's expert testified that he viewed his DCF calculation as corroborating his conclusion that fair value was the transaction price less synergies. The court rejected petitioners' expert's

20 Id. at *21.

21 Id. at *27.

22 *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.

23 Bradford Cornell and Richard Gerger, "Estimating Terminal Values With Inflation: The Inputs Matter—It Is Not a Formulaic Exercise," 36 *Business Valuation Review* 117, 118 (2017); Gilbert E. Matthews, "CapX = Depreciation Is Unrealistic Assumption for Most Terminal Values," *Business Valuation Update*, March 2002.

24 *SourceHOV* at *25.

25 *In re Appraisal of Panera Bread Co.*, 2020 WL 506684 (Del. Ch. Jan. 31, 2020) at *42.

26 Id.

27 Id.

28 Id. at *43.

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DCF analysis because it assumed an "outsized" growth rate and an investment rate that was far too low.[29]

The vice chancellor found that the sale process "bore several objective indicia of reliability, which were not undermined by flaws in that process" and concluded that Panera's appraisal value should be determined solely by reference to the deal price.[30] He 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.[31]

There was an unusual twist. Since the company had prepaid the full $315 to the dissenters so as to save paying interest on the award, it was barred from benefiting from the synergy adjustment. The court concluded that it was not authorized by Delaware law to order shareholders to return the $11.56 per share ($9 million).[32]

Real Time Cloud Services

The plaintiff had been squeezed out of his 50% interest in a small accounting services firm. His expert valued his interest at $1,682,000, using financial statements "recreated" for purposes of the litigation. However, these financials were inconsistent with the company's records and the plaintiff's own tax returns.[33]

Defendant's expert opined that the fair value of plaintiff's interest was $132,500. Vice Chancellor Glasscock based his valuation primarily on the defendants' report, which used the company's internal financials. The one input by the plaintiff the court used was a higher growth rate. Plaintiff was awarded $173,000,[34] only 10% of his claim.

Synapse Wireless

Minority shareholders of Synapse Wireless, an unsuccessful internet of things (IoT) company, were bought out in 2019 at $0.42899 per share. McWane Inc. had acquired control in 2012 at $4.997 per share. To reach the 80% ownership interest that enabled it to use Synapse's tax losses, it purchased more stock in 2014; it was contractually obligated to pay the same price it had paid in 2012.[35]

Synapse's revenue in 2015 (the year before the squeeze-out) were merely 1.2% of the revenues that had been projected in 2012.[36] Vice Chancellor Slights was "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."[37]

He rejected both sides' comparable transactions analyses, observing, "Each expert was able to make well-considered, convincing objections to the other's model that were not effectively rebutted."[38]

The court based its valuation on DCF but expressed its concerns about the company's projections, expressing reservations because of "the Company's serial inability to meet its financial targets" but "no alternate projections were offered."[39] Petitioner's expert's longer-term projections were rejected because the assumed profit margins were unrealistic.[40] Vice Chancellor Slights accepted respondent's expert's 12% discount rate based on WACC and rejected his alternative of a 40% venture capital discount rate.[41]

29 Id. at *41.

30 Id. at *1.

31 Id. at *40.

32 Id. at *44.

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

34 Id. at *17.; *aff'd,* 184 A.3d 1291 (Del. 2018).

35 Id. at *4.

36 Id. at *9.

37 Id.

38 Id. at *11.

39 Id. at *13.

40 Id.

41 Id.

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The court used a terminal value calculated with a "standard and accepted" perpetual growth rate of 3.1%.[42] It wrote that a terminal value based on an EBITDA multiple was "different, but also well-accepted," but it rejected the multiple petitioner's expert used because it implied a perpetual growth rate greater than 10%.[43] Experts in appraisal cases seldom use EBITDA multiples for terminal value. It has not been accepted in an appraisal case since 2005.[44]

The expert for the sole dissenter valued the company at $4.1876 per share, and respondent's expert valued it at $0.06 to $0.11 per share. Vice Chancellor Slights appraised the shares at $0.228 (53% of the transaction price), the second largest discount ever in a Delaware appraisal.[45] The petitioner's claim was more than 18 times the award.

Happy Child World

In this lengthy litigation,[46] Vice Chancellor Slights addressed both entire fairness and appraisal. The parties each alleged breaches of fiduciary duty to the corporation before a squeeze-out merger. This case was challenging for the court because of the paucity of evidence. The vice chancellor lamented, "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."[47]

42 Id. at *18.

43 Id. at *18-*19.

44 *In re U. S. Cellular Operating Co.*, 2005 Del. Ch. LEXIS 1 (Jan. 6, 2005) at *67.

45 *Kruse v. Synapse Wireless, Inc.*, 2020 WL 3969386 (Del. Ch. July 14, 2020). Clearwire Corp. was valued at 42.6% of the transaction price in *ACP Master, Ltd. v. Sprint Corp.,* 2017 Del. Ch. LEXIS 125 (Del. Ch. July 21, 2017); *aff'd,* 184 A.3d 1291 (Del. 2018).

46 Litigation between the parties commenced in 2007, the relevant transaction occurred in 2012, the trial was in 2019, and the final briefs were submitted in June 2020.

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

The vice chancellor castigated plaintiffs' expert's valuation of the company, a day care center that had ceased operations. The expert "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)"[48] and he "conducted the real estate appraisal himself even though he admittedly lacks that expertise."[49]

Defendant's valuation expert had valued the company prior to the squeeze-out. He relied on a real estate expert's appraisal of the company's unoccupied real estate, its sole material asset. He used two methods, income capitalization and sales comparisons, and gave equal weight to each method.[50]

The valuation expert deducted the company's net liabilities from the real estate valuation to arrive at its net asset value. He then used the capitalization of earnings method to determine the company's going-concern value. He gave equal weight to the two approaches to value the company as of the date of the squeeze-out.[51] The opinion does not discuss any details of his calculation, but the court rejected the plaintiffs' challenges to the cost of equity and cost of debt.[52]

The court 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 was negotiating a lease while the appraisal was being prepared and had leased the property two weeks after the report.[53] The court applied the income capitalization method based on the terms of the new lease. This single change increased the valuation of the company, before the

48 Id. at *27, fn. 301.

49 Id. at *28.

50 Id. at *27. The real estate appraiser also testified at trial.

51 Id. at *32.

52 Id. at *31.

53 Id. at *29.

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court's adjustments for damages from breach of fiduciary duty, from $85,237 to $135,962.

Vice Chancellor Slights valued the derivative claims, adjusted the appraisal to reflect these claims, and adjusted petitioner's recovery to account for his liability to the company.[54] He denied all but three of the numerous fiduciary duty claims. He valued two of the derivative claims against plaintiffs at $62,199 and one against the defendant at $20,199.[55]

Defendant owned 55% of the equity before the squeeze-out, and plaintiffs owned 45%. The vice chancellor added the value of the parties' derivative claims ($82,398) to the value of the company, calculated the value of plaintiffs' 45% interest, and deducted the amount assessed against them ($62,199) for their breaches of fiduciary duty. Thus, they were awarded $36,018.[56]

The Significance of Expert Testimony

A review of the 2020 Delaware cases again shows that the Delaware Court of Chancery's decisions are fact-specific and are influenced by expert testimony and legal argument.

The 2020 decisions provided numerous examples of inadequate or improper expert testimony. Neither expert in *Panera* compiled a reasonable selection of comparable companies. A witness in *Real Time Cloud Services* used financial statements that were inconsistent with the company's records. In *Happy Child World,* an expert used the wrong standard of value. An expert in *SourceHOV* assumed a debt structure that did not reflect the company's operative reality.

The Court of Chancery rejects not only expert testimony that is unpersuasive, but also testimony that is not supported in the valuation literature, such as a conglomerate discount in *Jarden* and the beta based on debt yield in *SourceHOV*. In contrast, an expert was able to persuade the court that it was appropriate to use a company-specific premium in the *UIP* case.

The absence of expert testimony on relevant valuation issues can be harmful. Because there was no testimony and argument as to the impact of increased palladium and platinum prices prior to closing in *Stillwater Mining*, the court was unable to quantify the impact of this change on the appraised value.

In the past, event studies were often used in other types of security cases but seldom in appraisals. The current focus on deal prices and historical market prices in arm's-length transactions has necessitated testimony on event studies in appraisal cases such as *Jarden* where the court relies on market factors rather than corporate valuations.

Recent cases demonstrate the importance of high-quality expert testimony in valuation litigation. Experts must be familiar with prior holdings and practice in the Court of Chancery and with its interpretation of fair value. Experts should be careful to utilize practices that are supported in the academic and valuation communities and should be aware of current developments in the profession.

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Editor's Note: Case digests and full opinions of the cases that are the focus of this article are available at BVLaw *at bvresources.com/products/bvlaw.*

54 Id. at *2.

55 Id. at *8. The court's analysis of these claims is outside the scope of this article.

56 Id. at *34.

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