Selected Summaries of 2013 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 complex business related cases. As a result, the Court issues a number of significant opinions and decisions and has become an authoritative voice on valuation-related matters.

As expert testifiers in this area, we closely monitor and often look to the Court's decisions for guidance on how it views certain issues. In our annual review, we have selected nine key opinions from 2013 to highlight and summarize. We selected these opinions based on the valuation themes and depth of analysis contained within the Court's opinions. We have also included one decision from the United States Bankruptcy Court for the District of Delaware because of the valuation issues contained therein.

The cases we have summarized include the following:

Edgewater Growth Capital Partners LP and Edgewater Private Equity Fund III LP, v. H.I.G. Capital, Inc. et al., C.A. No. 3601-CS (Del. Ch. February 28, 2013)
Chancellor Strine
Issues: commercially reasonable, DCF, correcting mistakes
Click here to view the opinion.

Brenda Koehler v NetSpend Holdings Inc., et al., C.A. No. 8373-VCG (Del. Ch., May 21, 2013)
Vice Chancellor Glasscock
Issues: weak fairness opinion, DCF, comparable companies, comparable transactions
Click here to view the opinion.

In Re MFW Shareholders Litigation, C.A. No. 6566-CS (Del. Ch., May 29, 2013).
Chancellor Strine
Issues: business judgment rule
Click here to view the opinion.

In re: SemCrude, L.P., Whyte v. C/R Energy Coinvestment II, L.P. et al., Whyte v. Cottonwood Partnership, LLP et al., Case No. 08-11525, Adv. No. 10-50840, Adv. No. 10-51808 (US Bankruptcy Court, Delaware, June 10, 2013)
Issues: solvency, unreasonably small capital, Asset Approach, contemporaneous analyses
Click here to view the opinion.

Towerview LLC, et al., v. Cox Radio, Inc., C.A. No. 4809-VCP (Del. Ch., June 28, 2013).
Vice Chancellor Parsons
Issues: DCF, projections
Click here to view the opinion.

Merion Capital, L.P., et al. v. 3M Cogent, Inc., C.A. No. 6247-VCP (Del. Ch., July 8, 2013)
Vice Chancellor Parsons
Issues: DCF, comparable companies, comparable transactions, beta
Click here to view the opinion.

Southeastern Pennsylvania Transportation Authority v. Ernst Volgenau, et al., C.A. No. 6354-VCN (Del. Ch., August 5, 2013)
Vice Chancellor Noble
Issues: business judgment rule
Click here to view the opinion.

In Re Trados Incorporated Shareholder Litigation, Consol. C.A. No. 1512-VCL (August 16, 2013)
Vice Chancellor Laster
Issues: liquidation preference, DCF, weights for approaches, comparable companies
Click here to view the opinion.

Huff Fund Investment Partnership d/b/a Musashi II Ltd, and Bryan E. Bloom v. CKx, Inc., C.A. No. 6844-VCG (Del. Ch., November 1, 2013)
Vice Chancellor Glasscock
Issues: merger price, DCF, comparable companies, comparable transactions
Click here to view the opinion.

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Edgewater Growth Capital Partners LP and Edgewater Private Equity Fund III LP, v. H.I.G. Capital, Inc. et al., C.A. No. 3601-CS (Del. Ch. February 28, 2013)

Click here to view the opinion.

This case involves the commercial reasonableness of an auction. Edgewater, a private equity firm, held a controlling investment in Pendum, a company that provided services to clients operating automated teller machines. However, due to its poor financial situation, Pendum became distressed and had difficulty complying with the covenants agreed upon with the debtors. Eventually HIG Capital, a private investment firm, purchased the majority of senior debt and refused to allow Edgewater to remain in control unless it refinanced its debt. Edgewater did not refinance the debt, so its directors resigned, and Edgewater seated four new directors from a restructuring firm identified by senior creditors.

Subsequently, HIG Capital negotiated a foreclosure sale agreement for Pendum to hold an auction for its assets. However, an affiliate of HIG Capital made the only bid for the assets at the auction. Edgewater filed a complaint arguing that the auction was commercially unreasonable. Edgewater also claimed that even if the foreclosure sale process was commercially reasonable, the price paid for Pendum's assets did not represent the appropriate value of the company. The Court found that Edgewater's motivation in bringing the case was principally to avoid paying on a guarantee of roughly $4 million that it had made to Pendum's lenders.

The Court upheld the sale as commercially reasonable in part because: (i) Edgewater itself did not bid on the assets, (ii) contemporaneous evidence indicated that Edgewater did not believe Pendum had a value above what was paid, (iii) another major creditor of Pendum was given every chance to make a bid but never did, (iv) the board engaged a qualified investment bank to market the company aggressively, and obtained financing for the marketing period, (v) the banker contacted numerous possible buyers, (vi) none of the parties contacted expressed a serious interest in the company, and (vii) all of the possible buyers were invited to the auction and none made a bid.

Edgewater also offered a valuation expert that valued Pendum at $110 million. Chancellor Strine found the expert's valuation unreliable for several reasons. First, the Court found that the expert utilized optimistic cash flow projections prepared by Pendum. These cash flows were based on a capital restructuring plan that was never implemented. Chancellor Strine called the cash flow projections "stale" and "unrealistic." Second, the Court found that when preparing a guideline company method, the expert used comparable companies that they were not comparable to Pendum, predominantly because the other companies were not in distress. Third, when the expert faced certain significant mistakes in his report, he corrected those material changes in his report, yet there was no commensurate change in the expert's overall concluded value as Court had expected. Chancellor Strine noted "[t]o my mind, this makes no sense." Chancellor Strine found the valuation was unreliable.

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Brenda Koehler v NetSpend Holdings Inc., et al., C.A. No. 8373-VCG (Del. Ch., May 21, 2013)

Click here to view the opinion.

On May 21, 2013, Vice Chancellor Glasscock denied a preliminary injunction by a dissenting shareholder to stop the acquisition of NetSpend Holdings Inc. ("NetSpend") by Total System Services, Inc. ("TSYS"). The Plaintiff claimed that the sale process was not designed to maximize shareholder value. The Court agreed that "a reasonable likelihood exists that the sales process undertaken by the NetSpend Board…was not designed to produce the best price for the stockholders." However, the Court denied the injunction because the Plaintiff "failed to demonstrate that the equities of the matter favor injunctive relief," given that the requested injunction would present a possibility that the stockholders could lose the substantial premium over market price offered by TSYS.

The Court acknowledged that the sale process was unfair, noting that the Board relied on a "weak fairness opinion." While the Court determined that the Board's decision to conduct a single-bidder process was "not unreasonable per se," the relative weakness of the fairness opinion "is a poor substitute for a market check." The fairness opinion was prepared at the request of NetSpend's Board to confirm the $16 per share merger price and was based on several valuations of NetSpend. Two of the valuations were based on NetSpend's stock price, which the Court noted NetSpend's Board itself had acknowledged was not a good indicator of NetSpend's value. Other valuations were based on the comparable companies and comparable transactions analyses. The Court found that the companies used in the comparable companies analysis were dissimilar to NetSpend, as acknowledged by the fairness opinion provider's lead banker on the deal. Similarly, as noted by the Board, the transactions in comparable transactions analysis were old, some predating the financial crisis, and the target companies were "not particularly similar" to NetSpend. Lastly, the Court found that the DCF analysis in the fairness opinion "indicates that the TSYS offer was grossly inadequate." The merger price of $16 per share was "20% below the *bottom* range of values implied by the DCF."

While the Court determined that the sale process was not designed to maximize the sale price, the injunction was denied due to the magnitude of impact. The Court found that the Plaintiff presented little evidence establishing the magnitude of the harm that stockholders faced as a result of the inadequate sales process that the directors had conducted. While not informing the Court's opinion, the Court noted that the Plaintiff only held "a couple hundred shares" out of over 69 million common shares outstanding, and "even if the relief sought could achieve *a 25 percent increase in price* (a result which nothing in the record indicates is possible), the return to the Plaintiff would be *$800.*" Conversely, the $16 merger price represented a 45% premium over NetSpend's share price one week prior to the deal.

Ultimately, the Court found that the "balance of the harms weighs against issuing an injunction in this case." The Court found little risk of irreparable harm and restated its established precedent disfavoring injunctions of premium deals in the absence of an alternative bidder.

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In Re MFW Shareholders Litigation, C.A. No. 6566-CS (Del. Ch., May 29, 2013)

Click here to view the opinion.

Chancellor Strine found that that "when a controlling stockholder merger has, from the time of the controller's first overture, been subject to (i) negotiation and approval by a special committee of independent directors fully empowered to say no, and (ii) approval by an uncoerced, fully informed vote of a majority of the minority investors, the business judgment rule standard of review applies." The Court noted that the question of what standard of review should be applied in this scenario had been debated for years, but had never previously been "put directly to [the Delaware Court of Chancery] or…to [the] Delaware Supreme Court."

In *Kahn v Lynch* (Del. 1994, *"Lynch"*), the Delaware Supreme Court held that "the approval by *either* a special committee or the majority of the noncontrolling stockholders of a merger with a buying controlling stockholder would shift the burden of proof under the entire fairness standard from the defendant to the plaintiff." This gave controlling stockholders a strong incentive to structure a merger to include at least one of these protections for minority investors. However, *Lynch* also suggested that a controlling stockholder who consented to both of these procedural protections for the minority would receive no additional benefit, and the merger would still be subject to the same entire fairness standard. Therefore, as the Court noted, controlling stockholders have had little incentive to structure transactions to satisfy both prongs.

The Court stated that there is little debate that a transactional structure that requires both approval of an independent special committee and a vote of a majority of the minority is highly beneficial to minority shareholders. Because both the special committee and the controlling shareholder know from the beginning that the deal will be subject to a vote of the minority, the Court noted that they have a strong incentive to structure a deal that will gain their approval. If, despite those incentives, the special committee approves a transaction that the minority investors do not like, they have the opportunity to vote it down themselves. The Court noted that the business judgment rule is only involved if: (i) the transaction requires both the approval of a special committee and a majority of minority stockholders, (ii) the special committee is independent, (iii) the special committee is empowered to freely select its own advisors and to say no to an offer definitely, (iv) the special committee meets its duty of care, (v) minority investors make an informed vote, and (vi) there is no coercion of the minority. The Court found that these conditions were all met in the instance case, noting that the special committee could and did hire qualified legal and financial advisors and did study a full range of financial information to inform itself.

In the Opinion, Chancellor Strine stated that this decision is consistent with the traditional approach of the Court of Chancery, "to defer to the disinterested decisions of directors, who are expert, and stockholders, whose money is at stake." He also noted that by giving controlling stockholders the opportunity to be reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to effectively protect their interests.

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In re: SemCrude, L.P., Whyte v. C/R Energy Coinvestment II, L.P. et al., Whyte v. Cottonwood Partnership, LLP et al., Case No. 08-11525, Adv. No. 10-50840, Adv. No. 10-51808 (US Bankruptcy Court, Delaware, June 10, 2013)

Click here to view the opinion.

SemGroup, L.P. ("SemGroup") filed for bankruptcy in July 2008. SemGroup was involved in midstream oil and gas services, buying and selling petroleum products and natural gas. The company also had a marketing business that included a trading operation in derivatives. The company's trading operations ultimately gave rise to a liquidity crisis that triggered bankruptcy.

The Trustee sought to recover as constructively fraudulent transfers over $29 million in distributions made in 2008 to equity investors prior to the bankruptcy. The Trustee argued that SemGroup was insolvent and had unreasonably small capital at the time of the distributions.

The Trustee had also raised concerns regarding distributions made in 2007, though the Defendants successfully won summary judgment regarding those distributions. Following discovery the Trustee had dropped the insolvency claim for the 2007 distributions, and only argued unreasonably small capital, claiming that there were circumstances unknown to the lenders that would have led the lenders to terminate the existing credit facility. The Court found that the Debtor had access to a significant credit facility provided by a syndicate of over 100 different lenders at the time and that was sufficient to meet the capital requirements in 2007. The Court did not accept the Trustee's argument regarding disclosure of information to lenders because there was no allegation of fraud or criminal conduct in the instant case.

As it relates to the 2008 distributions, the parties argued over the solvency of the debtor as of the date of the 2008 distributions, and did not argue over whether the Debtor was adequately capitalized or was able to pay its debts as they came due. Both sides offered valuation expert testimony addressing the value of the Debtor as of the distribution date.

The Trustee's expert utilized the Asset Approach while the Defendants' expert used both an Income Approach and Market Approach to value the company.

The Trustee's expert argued that the Asset Approach was necessary because it was the only approach that could adequately take into account the impact of: (i) speculative trading that had gone on at the company, as well as (ii) a relationship with another company (Westback) to which SemGroup allegedly funded millions of dollars in order for SemGroup's CEO to engage in commodities trading. The Asset Approach begins with the company's balance sheet and makes adjustments to line items in order to arrive at a concluded value. For example, the Trustee's expert valued the receivable from Westback at zero, arguing that an informed buyer would assign the receivable no value. Ultimately, the Trustee's expert concluded that the debtor was insolvent by at least $429 million.

The Defendants' expert argued that since the company was a going concern at the time of the distribution, an Income Approach or a Market Approach would be a more appropriate approach to estimate value. The Defendant's expert used a contemporaneous valuation prepared by Goldman Sachs for purposes of a securities offering, making adjustments to the Goldman analysis for: (1) the valuation date, (2) the purpose of the valuation, and (3) to account for the company's derivative trading operation. The Defendant's expert estimated a solvency cushion in the range of $670 million to $2.683 billion using the Income Approach.

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The Court found that the Defendant's expert's approach was more convincing given that the Debtor was a going concern as of the valuation date, and the preferred approach for valuing a going concern is the Income Approach. The Court also noted that Goldman's valuation was contemporaneously prepared in 2008 and thus, was not made in anticipation of litigation, referencing *In re Iridium Operating, LLC* and quoting that a "powerful indication of contemporary, informed opinion as to value comes from private investors."

The Court found that the Debtor was solvent on the date of the distributions in 2008.

Towerview LLC, et al., v. Cox Radio, Inc., C.A. No. 4809-VCP (Del. Ch., June 28, 2013).

Click here to view the opinion.

Cox Radio ("CXR") is a radio broadcasting company headquartered in Atlanta, Georgia. On May 29, 2009, Cox Enterprises, the parent company of CXR, acquired the publicly held Class A common stock of Cox Radio that it did not already own at $4.80 per share. The Petitioners maintained that $4.80 per share considerably undervalued their shares and chose to exercise their appraisal rights. Both parties to the case engaged valuation experts. The Petitioners' expert assessed the fair value of the shares at the time of the merger to be between $11.05 and $12.12 per share. The Respondent's expert estimated the fair value of the shares to be in a range of $3.40 to $5.29 per share, in line with the merger consideration price per share of $4.80.

Both experts agreed that a discounted cash flow analysis was the appropriate methodology to primarily rely upon to value CXR's common stock. The Respondents' expert initially attempted to use the market approach and perform a comparable company analysis. However, the expert concluded that this analysis was of limited value since the market values of debt were available for only one comparable company. Further, the book values of debt did not provide a good substitute for the market values as these values were skewed due to the recent economic recession.

The discrepancy in the experts' valuations mainly resulted from the divergent projections relied upon by each expert. In October 2008, CXR's management prepared long-term financial projections for the next five years 2009-2013 ("2009 LRP"). In the months leading up to the transaction, CXR's management recognized that the reliability of the 2009 LRP was challenged by the changes that were taking place in the radio industry and the economy. As such, CXR's management lowered considerably its financial projections for 2009 (management's projections for 2010-2013 as presented in the 2009 LRP remained unchanged).

Both experts agreed that the revised financial projections for 2009 were an appropriate starting point, but disagreed on forecasts beyond 2009. The Petitioner's expert assumed that the company's revenues would return to the projections of the 2009 LRP sometime between the end of 2010 and 2013. This assumption was based in part on Milton Friedman's "plucking theory," which states that, "a large contraction in output tends to be followed on the average by a large business expansion; a mild contraction, by a mild expansion." The Petitioner's expert argued that in the previous ten business cycles dating back to 1948, the economy recovered to pre-recession real GDP levels during the first three quarters of their recovery. However, the expert conceded that it would take longer for the economy to recover from the 2008/2009 recession given the unprecedented severe conditions compared to economic recessions in recent history.

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In contrast, the Respondent's expert did not forecast CXR's cash flows to return to the levels as projected in the 2009 LRP any time before 2013. The Respondent's expert's projections for 2010-2013 were based on historical growth in the years immediately following the 2000/2001 recession. The expert used a 9.28 percent growth rate for 2009 and 4.6 percent growth rate for the years 2010-2013. In support of these rates, CXR's growth rate in 2002, the first year following the 2000/2001 recession, was 9.28 percent and the average growth rate in the four years following the 2000/2001 recession was approximately 4.7 percent. The Respondent's expert also provided a second DCF model. To project 2009 and 2010 cash flow, the expert utilized a combination of consensus analyst estimates for CXR, and to project 2011-2013 cash flow, the expert used the actual growth rate CXR experienced in the three years following the 2000/2001 recession.

The experts virtually agreed on the appropriate discount rate (8.1 percent vs. 8.0 percent). However, there were differences regarding the appropriate terminal growth rate. The Petitioners' expert used a long term growth rate of 2.5 percent while the Respondent's expert used a rate of 1.25 percent. Both experts agreed that expected inflation was between 2 and 2.5 percent. The Plaintiffs' expert maintained that a rate of 2.5 percent was conservative based on an inflation rate of 2 percent, an assumed real long-term growth rate of 1.7 percent and productivity rate of about 1 percent. The Respondent's expert cited industry analysts and financial advisors who projected perpetuity growth rates between (1 percent) and 2 percent for the radio industry to support a selected terminal growth rate of 1.25 percent.

As an incremental addition to the results of the DCF, the Petitioners' expert argued that the value obtained from the DCF should be increased because management typically reduced projected revenues by $2 million and increased projected expenses by $2 million in the forecasts to manage the parent company's expectations. The Petitioners' expert termed this the "retained cushion." At the selected discount rate, this retained cushion represented an additional value of $0.62 per share.

The Court adopted the Respondent's expert's first DCF model, maintaining that it provided the best representation of cash flows in subsequent years given the economic conditions at that time. The Court rejected the Respondent's expert's second DCF model maintaining that the model relied upon the projections of only a few industry analysts. The Court found that the Respondent's expert's 9.28 percent growth rate in 2009 and 4.6 percent growth rate for 2010-2013 were appropriate as they were in line with the historical data and took into account the severity of the 2008/2009 recession compared to that of 2000/2001.

The Court used the Respondent's expert's discount rate of 8 percent as it also adopted his DCF model and the lower discount rate favored the Petitioners. The Court used a terminal growth rate of 2.25 percent, which is slightly higher than the expected inflation rate and lower than the Petitioners' expert's rate of 2.5 percent. In choosing this rate the Court questioned the reasonableness of the Petitioners' expert's apparent assumption that free cash flow would grow at twice the rate as revenue (as the Respondent's expert had questioned).

As it relates to the retained cushion, the Court was not persuaded by the testimony of management on this subject, finding that the Petitioners did not meet their burden of proof to support the $0.62 per share incremental value.

Based on all the analysis described above, and other analysis contained in the decision, the Court concluded on a fair value of $5.75 per share.

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Merion Capital, L.P., et al. v. 3M Cogent, Inc., C.A. No. 6247-VCP (Del. Ch., July 8, 2013)

Click here to view the opinion.

This was an appraisal action related to the sale of Cogent, Inc. ("Cogent") where the purchase price was $10.50 per share. The Petitioners argued that the shares were worth $16.26 per share, while the Respondent argued the shares were worth $10.12 per share. The Court found that the shares were worth $10.87 per share.

The Petitioners' expert performed a DCF analysis, a comparable companies analysis and a comparable transactions analysis, but ultimately relied solely upon the DCF analysis for a conclusion. The Respondent's experts performed a DCF analysis, a comparable companies analysis and a comparable transactions analysis, giving each analysis equal one-third weight. The Respondent replaced the initial expert with a second expert at trial.

The Court found the Respondent's experts' comparable companies analysis to be unreliable, noting that the Respondent's experts failed to provide sufficient evidence that the companies used were adequately comparable. The Court found that some of the inadequacies of the companies chosen included: 1) a majority of the companies had an enterprise value ("EV") significantly lower than Cogent's EV; 2) that same group of companies did not report a profit, demonstrating they were in an early-growth stage phase, whereas Cogent was a mature company and had reported positive profits from 1990-2005; 3) the companies were not in a comparable industry to Cogent; and 4) the Respondent's experts omitted a company the court identified as an obvious choice to include as a comparable for such analysis.

The Court also placed no weight on the Respondent's comparable transactions analysis. The Petitioner's expert criticized the Respondent's experts' comparable transactions analysis for using revenue multiples, contending that they are less reliable than EBITDA multiples when valuing a mature company in a growing industry. One of the Respondent's own experts rejected the use of revenue multiples in another matter stating that they have a "higher level of variance." Further, the Petitioner's expert contended that the LTM and forward EBITDA multiples were flawed since, after eliminating the top and bottom quartile, there remained less than eight meaningful multiples. The Petitioner's expert argued that this does not provide a sufficient foundation of data points upon which to rely. The Court agreed with the Petitioner's expert and did not place any weight on the comparable transactions analysis.

Both sides' experts performed DCF analyses, which is the only analysis the Court deemed appropriate. There were, however, a number of differences between the Petitioners' expert's DCF and the Respondent's expert's DCF.

The disagreement regarding cash flow projections related to management's projections for Cogent. The Petitioner's expert rejected management's projections and adopted two alternative scenarios: 1) "Industry Growth Scenario" – assuming an industry growth rate of 17 percent through 2015; and 2) "Cash Deployment Scenario" – assuming Cogent would spend a certain amount of its cash on acquisitions. In comparison, the Respondent urged the Court to rely on management's projections with only a few minor adjustments. The Court rejected the Petitioner's expert's scenarios and determined that management's projections were a reliable starting point for a DCF analysis, noting Delaware's long-standing preference for management projections. The Court noted that it "prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations," despite the fact that Cogent had "never prepared projections beyond the current fiscal year."

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In their respective DCF analyses, the Petitioner's and Respondent's experts made adjustments to the free cash flows. The Respondent's experts deducted share based compensation ("SBC") from projected cash flows, treating it as a cash expense, and excluded certain asset and liability accounts they considered long-term when calculating working capital. The Petitioner's expert did not deduct SBC from projected cash flows and considered the aforementioned asset and liability accounts as short-term, thereby including them in the calculation of working capital. The Court found that the Respondent's experts failed to sufficiently support their assertion that SBC will have any effect on the cash flows of Cogent and cited professional and academic valuation literature to support Petitioner's expert's contention to include the disputed asset and liability accounts in the calculation of working capital.

In determining the cost of equity, the main driver in the disparity between the experts' calculations was the selected beta value. Both experts used Cogent's own beta, but diverged regarding three main points: (1) whether to use a 1-year Bloomberg weekly raw beta or a 2-year Bloomberg weekly adjusted beta (i.e., smoothing the beta towards a market beta of 1); 2) the order of operations to determine the beta; and 3) whether to adjust the beta for all cash or only excess cash. The Court adopted the Petitioner's expert's 1-year Bloomberg raw beta, adjusted for cash, and lastly adjusted for the smoothing towards a market beta of 1. The Court found that the Respondent's experts provided no basis for their selection of a 2-year period, and noted that the Respondent's approach of adjusting for cash on a market adjusted beta was inappropriate, choosing instead to adjust cash on the raw beta, and then applying a market adjustment as discussed below. The Court declined to incorporate a beta based on comparable companies.

Both experts agreed that Cogent's beta needed to be adjusted for excess cash, applying the process for adjusting asset beta estimates as outlined by Shannon Pratt and Roger Grabowski in "Cost of Capital: Applications and Examples". Regarding the cash adjustment, the Petitioner's and Respondent's experts disagreed as to what constituted "excess cash." The Respondent's experts considered all of Cogent's cash to be excess and the Petitioner's expert asserted that all cash outside an amount set aside by the board to be used to execute a share buyback was excess cash. The Court cited Pratt and Grabowski who define surplus assets as, "[a]ssets that could be sold or distributed without impairing company operations." Applying this definition, the Court calculated an amount of excess cash that was roughly the midpoint of the values suggested by the experts. The Court then further "smoothed" the beta value by adjusting historical beta by a market beta of 1, using a one-third weighting factor for the market and a two-thirds weighting for the subject company's (Cogent's) beta. The Court arrived at a forward beta of 1.397 for purposes of determining Cogent's WACC.

The Court also opined on additional components of the cost of equity, including: (1) adopting the Respondent's experts' risk-free rate of the 10-year Treasury bond yield over the Petitioner's expert's 20-year Treasury bond yield, based on referenced literature and the maturity of Cogent; (2) adopting the Petitioner's expert's supply-side equity risk premium of 5.2% over the Respondent's experts' equity risk premium of 5.0%, derived from multiple sources, noting that the Petitioner's expert "demonstrated a stronger understanding of this subject and explained his methodology more convincingly"; and (3) adopting the Petitioner's expert's size premium of 1.73% based on the Ibbotson 2010 yearbook 7th decile over the Respondent's experts' size premium that adjusted the market capitalization for cash.

Lastly, in their calculation of the terminal value, the Petitioner's expert used a perpetual growth rate of 4.5 percent, based on historical GDP and inflation data, economic analysts' projections and the growth prospects of the biometrics industry. The Respondent's experts implicitly selected the midpoint of a suggested range of growth rates to arrive at a growth rate of 3.5

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percent. Because Petitioner's expert justified his conclusion while the Respondent's experts provided no analysis or explanation to support their selected value, the court adopted Petitioner's estimated growth rate of 4.5 percent.

The Court prepared its own calculations based on the findings above as well as other findings, determining that the fair value of Cogent was $10.87 per share.

Southeastern Pennsylvania Transportation Authority v. Ernst Volgenau, et al., C.A. No. 6354-VCN (Del. Ch., August 5, 2013)

Click here to view the opinion.

The matter involves the buyout of SRA International, Inc. ("SRA") by Providence Equity Partners LLC ("Providence"). SRA was founded in 1978 by Ernst Volgenau, who, despite owning just 21.8 percent of the outstanding equity of the company, held 71.8 percent of the voting power through his ownership of Class B shares. In the merger, minority shareholders received $31.25 per share in cash. Mr. Volgenau received $31.25 per share in cash for 59 percent of his shares, rolled over a portion of his equity into a minority interest in the merged entity, and received a non-recourse note related to the sale of two divisions of the company. The Defendants moved for summary judgment, arguing that robust procedural protections were used that entitled the merger to review under the business judgment rule instead of the entire fairness standard.

The Court noted as an initial matter that the Court's recent decision in *MFW* (reviewed above) illuminated many of the procedural protections at issue in this case. The Court noted, however, that unlike *MFW*, where a controlling stockholder was on both sides of the transaction, this case involved a merger between a third-party and a company with a controlling stockholder. The Court found that Mr. Volgenau does not stand on both sides of the transaction just because he rolled over a portion of his equity into the merged entity. In *Frank v. Elgamal,* the Court stated that "[w]hen a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders are cashed out, and the controlling stockholder receives a minority interest in the surviving company, the controlling stockholder does not 'stand on both sides' of the merger."

That Court noted that the procedural protections required for a third-party transaction involving a controlling stockholder to qualify for review under the business judgment rule are outlined in *Hammons*, and include: (i) recommendation by a disinterested and independent special committee, (ii) which has sufficient authority and opportunity to bargain on behalf of minority stockholders, including the ability to hire independent legal and financial advisors, (iii) approval by stockholders in a non-waivable majority of the minority vote, and (iv) approval by stockholders who are fully informed and free of coercion. The Court reviewed the transaction to determine if it satisfied these tests.

The Court found that the transaction satisfied the tests outlined to meet the business judgment rule standard, finding that the Special Committee was comprised of independent and disinterested directors, and that the stockholders were fully informed when they approved the merger in a non-waivable majority of the minority vote. The Court stated that this case, like *MFW*, "serves as an example of how the proper utilization of certain procedural devices can avoid judicial review under the entire fairness standard…" The Court also found that there was no issue of material fact as to whether the directors breached their fiduciary duties, noting that the Board's decisions "were rational (and reasonable) and made in good faith." The Court granted summary judgment to Defendants on all counts.

Case Summaries

In Re Trados Incorporated Shareholder Litigation, Consol. C.A. No. 1512-VCL (August 16, 2013)

Click here to view the opinion.

In July 2005, Trados, Inc. ("Trados") was acquired by SDL plc ("SDL") for $60 million (the "Merger"). Roughly $7.8 million of the Merger consideration went to management as part of an incentive plan, with the remaining $52.2 million going to the preferred shareholders to satisfy their liquidation preference of $57.9 million. The common stockholders received nothing.

The case combined both a breach of fiduciary duty claim and an appraisal proceeding. The Plaintiff argued that the Board should not have agreed to the Merger and had a duty to continue operating Trados on a standalone basis, in an attempt to generate value for the common stock. In this case, the Board lacked a majority of disinterested and independent directors, making entire fairness the applicable standard.

On the issue of fair price, both sides introduced expert testimony. The Defendant's expert argued that the $51.9 million valuation generated by a DCF represented "the best case scenario that the plaintiff claimed that the Board should have pursued." Vice Chancellor Laster sided with the Defendant's DCF analysis, stating that he "made reasonable and plaintiff-friendly assumptions, yet his valuation still did not generate any return for the common." The Defendant's expert's assumptions included:

1. 3-year compound annual revenue growth of 24% (compared to historical growth of 18%);
2. EBITDA margins in excess of 15% (compared to historical margins of 2% or less); and
3. a perpetuity growth rate of 7%. The Court recognized this as "generous to the plaintiff", stating that "Delaware decisions often use lower growth rates."

In contrast, Vice Chancellor Laster found a number of issues with the Plaintiff's expert's analysis. The Plaintiff's expert did not prepare a DCF analysis, and instead relied on a comparable company approach and two separate comparable transaction approaches. Criticisms of the Plaintiff's expert's methodologies included:

1. Inclusion of synergies: failing to back out synergies in the transaction approaches, skewing those values high;
2. "Gaming" the weights: filing a revised report that lowered valuations, but based on new weightings the concluded value remained high;
3. Lack of comparability: failing to demonstrate that the companies and transactions used were truly comparable to Trados; and
4. Inconsistency: using a different set of comparable companies to rebut the Defendant's expert's DCF analysis as compared to the companies used by the Plaintiff's own comparable companies analysis.

The Court also addressed Board minutes several months before the transaction that were cited by the Plaintiff. The minutes showed that the Board determined the fair market value of Trados's common stock was $0.10 per share for purposes of granting stock options. The directors testified that when the minutes show that they determined the fair market value of the common stock was $0.10 per share, they actually did not believe at the time that it was true. There did not appear to be any third party valuation analysis to support the price determined by the Board, and ultimately the Court accepted the Defendant's assertion that the Board minutes were false, and that the Board did not believe the common stock was worth $0.10 per share at the time.

Case Summaries

Vice Chancellor Laster ultimately decided that the Merger satisfied the test of fairness, stating that “[t]he common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before.”

Finally, the Court made it clear that the determination that no breach of duty occurred because the merger price was fair does not necessarily moot the companion appraisal proceeding. The Court noted that “[a] court could conclude that a price fell within the range of fairness and would not support fiduciary liability, yet still find that the point calculation demanded by the appraisal statute yields an award in excess of the Merger price.” The Court stated that this was not the case here, as the fair value of Trados‘s common stock for purposes of 8 Del. C. § 262 was zero. As the Court stated, “Trados had no realistic chance of growing fast enough to overcome the preferred stock’s existing liquidation preference and 8% cumulative dividend.”

Huff Fund Investment Partnership d/b/a Musashi II Ltd, and Bryan E. Bloom v. CKx, Inc., C.A. No. 6844-VCG (Del. Ch., November 1, 2013)

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On November 1, 2013, Vice Chancellor Glasscock ruled that the merger price in a transaction represented fair value for purposes of an appraisal under 8 Del. C. Section 262. The Vice Chancellor stated in the decision that the Court of Chancery has a statutory mandate to consider “all relevant factors” as part of the appraisal proceeding. However, as a result of “significant and atypical valuation challenges,” specifically the absence of comparable companies and transactions and the unreliability of cash flow projections, Vice Chancellor Glasscock relied solely on the merger price as the best and most reliable indication of value.

The case involves the acquisition of CKx, Inc. (“CKx”) by Apollo Global Management (“Apollo”). Prior to the merger, CKx was a publicly traded company that focused on acquiring the rights to iconic entertainment properties. Of its holdings, American Idol was the most valuable, accounting for between 60 and 75 percent of CKx’s cash flow. As part of the appraisal proceeding, the Petitioners and the Respondents each submitted expert valuations of CKx. The Petitioners’ expert utilized the DCF approach, the comparable companies approach, and the comparable transactions approach, valuing the company at $11.02 per share, more than twice the sales price of $5.50 per share. The Respondents’ expert used the DCF approach to conclude on a value of $4.41 per share.

The Court ultimately rejected the Petitioners’ expert’s comparable company and comparable transaction approaches due to the fact that the companies and transactions used were not sufficiently comparable to CKx. The Court also concluded that the DCF analyses of both experts were unreliable measures of CKx’s value. This was based primarily on the uncertainty surrounding the upcoming negotiation of American Idol’s contract with Fox. While acknowledging that all projections involve some level of uncertainty, the Court stated that “management believed that predicting the outcome of [the American Idol] negotiations would be little more than guesswork.” Because it lacked confidence in the reliability of the cash flow projections under the to-be-negotiated American Idol contract, the Court concluded that a DCF analysis was an inappropriate valuation method for this case. Because of the absence of comparable companies and transactions and the unreliability of the cash flow projections, the Court relied solely on the merger price as the best and most reliable indication of CKx’s value.

Case Summaries

Based in part on the Delaware Supreme Court's decision in *Golden Telecom*, the Petitioners' argued that merger price is irrelevant in an appraisal context and that the Court is required to give it no weight when determining fair value. In Golden Telecom, the Supreme Court was asked to reform Delaware appraisal law by imposing a presumption in favor of merger price as evidence of fair value. The Court declined to do so, stating that "Requiring the Court of Chancery to defer, conclusively or presumptively, to the merger price…would contravene the unambiguous language of the statute and the reasoned holdings of precedent." In his decision, Vice Chancellor Glasscock states that the Petitioners' argument- that the merger price of CKx should be ignored- is directly at odds with the rationale of *Golden Telecom*, which holds that the Court has the obligation to consider "all relevant factors."

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