Duff & Phelps

Selected Summaries of 2015 Decisions

The Delaware Court of Chancery Selected Business Valuation Case Summaries

Introduction

Duff & Phelps' experts testify on commercial and shareholder disputes across the country as well as in the Delaware Court of Chancery. However, 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 and as a result has developed significant case law in this area.

The high volume of business cases results in the Court issuing numerous opinions, many of which address business and security valuation and economic damages. In this Court Case Update we focus on eight opinions from 2015 to highlight how certain valuation and damages analysis topics are viewed by the Court. We chose these eight opinions based on the valuation themes they represent and depth of analysis contained in the Court's opinions.

In our review of the cases herein we have attempted to summarize the salient points related to valuation and damages only. We recommend that interested readers obtain the full Court opinions to gain a complete understanding of all the issues addressed and each judge's position. We have included a hyperlink to each decision below its case caption.

The cases we have summarized include the following:

In Re Appraisal of Ancestry.com, Consol., C.A. No. 8173-VCG (Del. Ch., January 30, 2015)
Vice Chancellor Glasscock
Issues: merger price, projections
Click here to view the opinion.

In re Dole Food Co., Inc. Stockholder Litigation, C.A. No. 8703-VCL (Del. Ch., February 27, 2015)
In re Appraisal of Dole Food Company, Inc., C.A. No. 9079-VCL (Del. Ch., August 27, 2015)
Vice Chancellor Laster
Issues: business judgement rule, synergies
Click here to view the February 27, 2015 opinion.
Click here to view the August 27, 2015 opinion

In re El Paso Pipeline Partners, L.P. Derivative Litigation, C.A. No. 7141-VCL (Del., April 20, 2015)
Vice Chancellor Laster
Issues: cost of capital, long-term agreements
Click here to view the opinion.

Merlin Partners LP v. AutoInfo, Inc., C.A. No. 8509-VCN (Del. Ch., April 30, 2015)
Vice Chancellor Noble
Issues: merger price, DCF, projections, comparability
Click here to view the opinion.

Nathan Owen v. Lynn Cannon, et. al., C.A. No. 8860-CB (Del. Ch., June 17, 2015)
Chancellor Bouchard
Issues: projections, S-corp tax rate
Click here to view the opinion.

Longpath Capital, LLC v. Ramtron International Corporation, C.A. No. 8094-VCP (Del. Ch., June 30, 2015)
Vice Chancellor Parsons
Issues: merger price, DCF, synergies
Click here to view the opinion.

Fox v. CDx Holdings, Inc., C.A. No. 8031-VCL (Del. Ch., July 28, 2015)
Vice Chancellor Laster
Issues: historical valuation analyses
Click here to view the opinion.

Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG (Del. Ch., October 21, 2015)
Vice Chancellor Glasscock
Issues: merger price, cost of capital, DCF, stock based compensation
Click here to view the opinion.

Case Summaries

In Re Appraisal of Ancestry.com, Consol., C.A. No. 8173-VCG (Del. Ch., January 30, 2015)

Click here to view the opinion.

On January 30, 2015 the Court of Chancery of the State of Delaware issued a decision regarding the fair value of Ancestry, Inc. (“Ancestry”), an internet-based company that provides family history information to its worldwide subscribers. Ancestry, which went public in 2009, was known for its sponsored television show, “Who Do You Think You Are?” where celebrities learned more about their own family histories, using research provided by Ancestry.

Three years after going public, in 2012 Ancestry’s board began exploring strategic options for the Company. Ultimately the Company agreed to sell itself to private equity firm Permira Advisors, LLC (“Permira”) for $32 per share, a 41 percent premium to the stock price prior to the auction process. The Petitioners filed to have their interest in Ancestry appraised by the Court rather than accept the $32 per share offer price, arguing that the fair value of Ancestry was at least $42.81 per share. The Respondent maintained that the fair value of Ancestry was $30.63 per share. The Court found that the merger price of $32 per share was the best indicator of Ancestry’s fair value as of the Merger Date, though not before performing a valuation analysis of its own that resulted in a value of $31.79 per share. The Court used the $31.79 per share value as a check on the merger price.

In this matter, the sales process in connection with the Permira transaction was the first time Ancestry had ever prepared long-term projections. Two sets of projections were prepared in connection with the sales process. First, an initial set of “optimistic, even aggressive” projections were prepared in May for the board (the “Initial May Projections”). The board encouraged management to be more aggressive in the projections, and management came up with new projections (the “May Sales Projections”, collectively with the Initial May Projections, the “May Projections”) that were approved by the board, and provided to interested parties during the sales process. The second set of projections (the “October Projections”) were prepared in response to: (i) bidder feedback that the May Projections were optimistic and aggressive, and (ii) feedback that Ancestry’s fairness opinion provider likely couldn’t render a fairness opinion based on the May Projections. The October Projections included two scenarios, A and B.

Both the Petitioners’ expert and the Respondent’s expert relied exclusively on a Discounted Cash Flow (“DCF”) analysis to estimate value, and ultimately the Court prepared its own DCF. For projections, the Petitioners’ expert appears to have used an equal blend of the “Initial May Projections” and the better of the two scenarios in the October Projections. The Petitioners’ expert did not rely on the May Projections provided to bidders in his analysis. He contended that the May Projections were so optimistic that potential investors lost confidence in management; thus he focused instead on a prior version of projections prepared in May and shared with the board (the “Initial May Projections”).

The Respondent’s expert used an equal weighting of the two scenarios in the October Projections.

The Court found both sets of projections to be imperfect, though ultimately found that an equal weighting of the scenarios in the October Projections were a better platform on which to base a DCF analysis. However, absent projections prepared in the ordinary course of business, in conjunction with other reasons, the Court ultimately found that estimating fair value based on a DCF was more appropriate to use as a benchmark, not as a concluding value.

Case Summaries

In Re Appraisal of Ancestry.com, Consol., C.A. No. 8173-VCG (Del. Ch., January 30, 2015)

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Click here to view the opinion.

Next, both expert witnesses were criticized in the Ancestry decision for different assumptions and calculations. Following is a list of valuation components addressed by the Vice Chancellor, and the Court's discussion of those components:

- In siding with the Respondent's expert's approach of normalizing long-term margins (by setting long-term margins based on an average of projected margins) the Court noted that "while criticizing [the Respondent's expert's] approach, the Petitioners offered little in the way of substantive support of [the Petitioners' expert's] approach, other than to characterize it as 'appropriate' given Ancestry's consistent trend of increasing margins."
- In stating that both experts' DCF analyses "appear to be result oriented riffs on the market price," the Court criticized both experts. While many valuation practitioners would consider "reconciliation" with another indication of value, in this case the market price, to be a positive activity, the Court stated that "reconciliation" by the Respondents' expert implied "tailoring" the analysis to fit the merger price. The Court also criticized the Petitioners' expert for testifying that he "tortur[ed] the numbers until they confess[ed]," with the Court noting that "it is well-known that the problem with relying on torture is the possibility of false confession."
- In siding with the Respondent's expert's approach to use the marginal tax rate in perpetuity, the Petitioners' expert's contention that few (if any) companies pay their marginal tax rates in perpetuity was not enough to convince the Vice Chancellor that it was not "overly speculative to apply the current tax rate in perpetuity."
- In choosing to estimate beta using a weekly observation period, the Court noted that "[the Respondent's expert] did not adequately explain why, specifically, a weekly input would be inappropriate here."
- In siding with the Respondent's expert's approach to reflect stock-based compensation by accounting for it in expenses, the Court noted that the Petitioners "dispute [the Respondent's expert's] approach, but do not offer a reliable alternative for my consideration."

In addition, the Court adopted the approach of using the Ibbotson 2013 Yearbook even though it was not published until after the valuation date. The Court also found that the S&P 500 was a more suitable market proxy than NASDAQ for estimating beta.

Case Summaries

In re Dole Food Co., Inc. Stockholder Litigation, C.A. No. 8703-VCL (Del. Ch., February 27, 2015)

In re Appraisal of Dole Food Company, Inc., C.A. No. 9079-VCL (Del. Ch., August 27, 2015)

Click here to view the February 27, 2015 opinion.
Click here to view the August 27, 2015 opinion

In a “take-private” transaction involving Dole Food Company, Inc. (“Dole”), the Court found two directors – one, the CEO and controlling shareholder, and the other, the president, chief operating officer and general counsel – personally liable to minority shareholders for $148 million in damages for withholding material information and intentionally driving down Dole’s share price prior to the transaction. In a separate opinion, the Court found that the Defendants could not name a corporation as an expert witness on valuation issues but instead must designate a specific individual to serve in that capacity.

From 2003 to 2009, Dole was owned and controlled by David Murdock (“Murdock”). In 2009, in the midst of the financial crisis and faced with significant debt, the company, in an IPO, sold 41 percent of its stock to raise capital. In 2013, Murdock sought to take the company private by reacquiring the outstanding stock. The Dole board appointed an independent committee to evaluate Murdock’s offer and consider other options. Additionally, approval of the deal required a majority vote of unaffiliated shareholders. While Dole argued that the transaction should be subject to the business judgment rule, in a post-trial opinion dated August 27, 2015, the Court found that Murdock and the president, C. Michael Carter (“Carter”), who was Murdock’s only direct report, subverted the independent committee process and breached fiduciary duties, warranting application of the less-deferential “entire fairness standard.” Carter’s complicity, the Court found, rose to the level of fraud.

The Court found that Murdock and Carter “sought to undermine the Committee from the start.” Carter, the Court found, failed to disclose to the committee certain material information, including anticipated cost savings from the sale of Dole’s Asian operations and the anticipated positive impact on earnings from a farm purchase program. The Court also found that Carter provided the committee with suppressed revenue projections that conflicted with more positive and accurate projections he had provided to Murdock’s advisers and lenders. Additionally, the Court found that Carter intentionally, and publicly, withdrew a board-approved share repurchase program in order to suppress share price prior to the take-private transaction, and that he did so without first consulting the board. The Court also found that, notwithstanding the committee’s admonishment not to do so, Carter provided Murdock’s advisers access to a data room that had been established solely for the committee’s advisers, that he and other Dole managers met secretly with Murdock’s advisers in violation of the committee’s protocols, and that Carter had counseled Murdock on a hostile takeover strategy in the event the take-private transaction failed. The Court found that these and other actions “were not innocent or inadvertent, but rather intentional and in bad faith,” and that, as a result, Murdock and Carter deprived the committee of the ability to negotiate on a fully informed basis.

Based upon the information it was provided, the committee’s financial adviser, using a discounted cash flow (“DCF”) analysis, valued Dole at between $11.40 and $14.08 per share, and the committee agreed to recommend a sale at $13.50 per share. The unaffiliated shareholders narrowly approved the transaction by a 50.9% majority.

In applying the “entire fairness standard,” the Court found that Murdock and Carter had violated the standard’s two basic principles – fair dealing and fair price. In calculating damages, the Court adjusted the DCF model used by the committee to account for the cost savings and farm purchase plan that Murdock and Carter failed to disclose. The high-end value of the model increased share price by $6.84, to $20.92 per share. However, the Court ultimately settled on a more modest valuation, stating that the cost-saving initiatives and revenues from the farm purchase plan were much more risky than Dole’s established businesses and therefore not guaranteed. This valuation added an additional $1.87 per share

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In re Dole Food Co., Inc. Stockholder Litigation, C.A. No. 8703-VCL (Del. Ch., February 27, 2015)

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for the cost-cutting benefits, based on Management's high case scenario of $14.8 million in total cost savings. The Court added $0.87 per share for the farm purchases, adopting the Plaintiffs' ask of $28.6 million in farm purchases, rather than the full $100 million incorporated by Carter. The Court determined that the Plaintiffs were entitled to the full incremental $2.74 per share above the transaction price, resulting in a fair value for Dole of $16.24.

Earlier, in a February 27, 2015, opinion, the Court was called upon to decide whether the Defendants could designate a corporation as a valuation expert rather than a specific individual. The Defendants were hoping to designate an advisory firm as a valuation expert. While noting that a corporation may qualify as a "person" under certain laws and circumstances, the Court, found that an expert witness must be able to testify from personal knowledge, take an oath or make an affirmation, have a memory that can be refreshed, hear the testimony of other witnesses, and perceive facts or data, none of which a corporation could do. The Court also ruled that a corporation cannot attempt to finesse these problems by testifying through an agent, noting that no one, including a biological person, can have another person testify on his behalf. The Court ruled that as long as the Defendants named a qualified employee of the corporation who adopted the valuation report, he could testify as an expert regarding the report's contents.

Prior to appeals, on December 7, 2015, Murdock and Dole reached an agreement to pay shareholders $101 million in damages and $12.5 million in interest, with the remainder of the judgment amount to be paid to the Plaintiffs in a separate appraisal action. Additionally, the Defendants gave up the right to appeal the Court's rulings and judgment. This case involved the sale of assets from El Paso Corporation ("Parent") to El Paso Pipeline Partners, L.P. ("El Paso MLP"), a pass-through entity controlled by Parent. In this 2015 decision, Vice Chancellor Laster found that the Conflicts Committee ("Committee") that approved the transaction "failed to form a subjective belief that the transaction was in the best interests of the El Paso MLP," therefore breaching the LP Agreement. Damages in the case were calculated as the difference between the amount paid by El Paso MLP in the transaction and the value of the assets transferred. At trial, the plaintiff's expert demonstrated that El Paso MLP paid at least $171 million more than it would have if not for the breach of the agreement. The Court adopted the plaintiff's expert's calculation without adjustment.

Case Summaries

In re El Paso Pipeline Partners, L.P. Derivative Litigation, C.A. No. 7141-VCL (Del., April 20, 2015)

Click here to view the opinion.

This case focused primarily on two transactions between Parent and El Paso MLP, involving interests in two natural gas assets. The first was a liquefied natural gas ("LNG") terminal on Elba Island, Georgia, and a related 190-mile pipeline ("Elba"). The second was Southern Natural Gas, L.L.C. ("Southern"), which operated a 7,600-mile natural gas pipeline. In March 2010, Parent sold El Paso MLP a 51 percent interest in Elba (the "March Transaction"). In November 2010, Parent sold El Paso MLP the remaining 49 percent interest in Elba, plus a 15 percent interest in Southern (the "November Transaction").

The plaintiff challenged both transactions. The Court granted the defendants' motion for summary judgment with respect to the March Transaction. However, the Court ultimately found that the Committee that approved the November Transaction breached the LP Agreement by failing to form a subjective belief that the transaction was in the best interests of the El Paso MLP. The Court stated that there were "numerous problems" with the November Transaction, including: (1) email evidence indicating that the Committee members believed that it was not in El Paso MLP's best interest to acquire more of Elba in 2010; (2) the Committee's fixation on accretion rather than overall value creation; and (3) the Committee's disregard for market evidence that indicated that El Paso MLP had overpaid for Elba in the March Transaction.

In addition, the Court found that the work product of the Committee's financial advisor "undermined any possible confidence in the Committee." The Court stated that the financial advisor "sought to make the price that Parent proposed look fair," and that "the firm did what it could to justify [the November Transaction], get to closing, and collect its contingent fee." The Court identified a number of specific issues. First, the Court noted that the methodology used in the precedent transaction analysis was changed between the March Transaction and the November Transaction, "without calling the change to the Committee's attention and explaining it." Second, the Court stated that the Discounted Cash Flow ("DCF") analysis incorrectly used the cost of capital of El Paso MLP, the acquirer, rather than Elba, the asset being valued. The Court described this error, explaining that the advisor "valued an LNG import terminal using a cost of capital that reflected the materially lower risks associated with a domestic pipeline business." Finally, the Court claimed that the financial advisor "manipulated its discount rate." When analyzing the November Transaction, the advisor "cut off the upper bound [of the discount rate range] at 12%," despite claiming to use the same inputs from a prior analysis that produced a range of up to 14.5%.

In the calculation of damages in the case, the Court stated that "[a]rriving at an accurate valuation of Elba…requires an assessment of the reliability of Elba's future cash flows." Elba's revenues came from long-term fixed fee contracts with subsidiaries of Royal Dutch Shell and British Gas, but only a portion of the revenues were guaranteed. The Court acknowledged that due to adverse market conditions, "there was substantial risk in the LNG import business generally and to Elba's cash flows specifically." The Court credited the plaintiff's expert for accounting for the risk of Elba's cash flows, which he incorporated by using different discount rates to estimate the present value of the guaranteed and non-guaranteed cash flow streams. The expert discounted the guaranteed cash flows using the yield to maturity of Shell's senior corporate bonds. For the non-guaranteed cash flows, the expert calculated the WACC for Cheniere Energy Partners, whose sole asset was "an optimal comparable [LNG] terminal."

Case Summaries

In re El Paso Pipeline Partners, L.P. Derivative Litigation, C.A. No. 7141-VCL (Del., April 20, 2015)

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Click here to view the opinion.

Like Elba, the Cheniere terminal was operated under a long-term agreement. However, the Court stated that because of the greater creditworthiness of the guarantees associated with the Cheniere terminal cash flows, the Cheniere WACC "understated the risk associated with Elba." The plaintiff's expert accounted for this additional risk using option theory, and the Court ultimately adopted the plaintiff's expert's calculations.

The plaintiff's expert calculated a terminal value using an EBITDA multiple, applying a multiple based on a prior comparable transaction and from Parent's own internal valuations. The terminal value was discounted using the WACC for the non-guaranteed cash flows. Based on this analysis, the plaintiff's expert calculated damages of $171 million from the November Transaction. The expert compared his calculation against other indications of value to cross-check his conclusion, using implied multiples from two other LNG transactions in 2010, and performing an event study based on the stock market reaction to the November Transaction. The Court found that these comparisons supported the expert's conclusion, and even indicated that the figure "was conservative." The Court adopted the damages calculation proposed by the plaintiff's expert without adjustment.

Case Summaries

Merlin Partners LP v. AutoInfo, Inc., C.A. No. 8509-VCN (Del. Ch., April 30, 2015)

Click here to view the opinion.

In early 2013, AutoInfo, Inc. ("AutoInfo") merged with Comvest Partners ("Comvest") with common shareholders of AutoInfo receiving $1.05 per share. Merlin Partners LP initiated a petition for appraisal on its shares in the company. On April 30, 2015, the Court found that the merger price of $1.05 per share represented the best indication of the fair value of AutoInfo for purposes of an appraisal.

The Petitioners' expert valued AutoInfo's shares at $2.60 per share, placing equal weight on three estimates of value: (i) a discounted cash flow ("DCF") analysis; (ii) a comparable company analysis using a historical based multiple; and (iii) a comparable company analysis using a forward multiple. The Defendants' expert valued AutoInfo's shares at $0.97 per share, placing no weight on the DCF analysis or on the comparable company analysis, arguing that the analysis could not be performed with available data. The Defendants' expert determined that the merger price less specific costs savings from the merger, was the best indication of fair value.

The Court criticized the Petitioners for failing to show that management projections were reliable and trustworthy, especially considering that this was management's first attempt at constructing projections. The Court stated that "[b]ecause Petitioners have failed to establish the credibility of a key component in their expert's DCF analysis, the Court gives that analysis no weight."

The Court also gave no weight to the Petitioners' expert's comparable companies analyses, stating that they "fail[ed] to meet their burden" of proving that their expert's "comparables are truly comparable." The Court noted that the Petitioners' expert failed to address the difference in size and business model between AutoInfo and the selected comparable companies.

The Defendants' expert, on the other hand, relied on the merger price, contending that there were no reliable comparable companies, comparable transactions, or cash flow projections. The Court notes that it would "give little weight to a merger price unless the record supports its reliability." The Petitioners argued that the merger price was unreliable for the following reasons: "(i) the Merger price is not a business valuation methodology, (ii) the Court cannot rely on the price if no business valuation methodology, e.g., a DCF analysis, was performed to corroborate the price, and (iii) even if the Merger price could be considered, AutoInfo's sales process was deficient."

The Court dismissed the Petitioners' first two contentions, noting that "[w]hen it is the best indicator of value, the Court may assign 100% weight to the negotiated price," and that "no particular valuation methodology must provide corroboration." The Court also dismissed the third contention, finding that the sales process showed no evidence of self-interest or disloyalty, rather it was negotiated at arm's length with adequate information.

To corroborate its reliance on the merger price, the Court conducted its own DCF analysis. Since the Court rejected the management projections used by the Petitioners' expert, the Court primarily adopted the DCF framework provided by the Defendants' expert for illustrative purposes in his rebuttal report, which relied on financial projections prepared by Comvest for internal use in evaluating the AutoInfo deal. However, the Court did not agree with the Defendant's expert's reduction in value based on removing annual merger cost savings of approximately $1.45 million. The Defendant's expert had removed these cost savings, resulting in a lower value than the merger price. These merger cost savings purportedly consisted of company costs associated with being a public company, and executive compensation costs that Comvest planned to eliminate. Based on its own DCF analysis the Court estimated a value of $0.93 per share. However, since the merger price appeared to be the best estimate of value, the Court placed full weight on the merger price.

Case Summaries

Nathan Owen v. Lynn Cannon, et. Al., C.A. No. 8860-CB (Del. Ch., June 17, 2015)

Click here to view the opinion.

In May 2013, Nathan Owen ("Owen"), the largest stockholder of Energy Services Group, Inc. ("ESG") at the time, was forcibly bought out by two other large stockholders within the company. Owen, the previous President of ESG and a director of the company, held 1,320,000 shares of stock at the time of the merger. The other three shareholders, including Lynn Cannon ("Cannon"), transferred their shares to ESG Acquisition Corp, merging ESG into the corporation and forcing Owen out of the company. Nathan Owen was offered $19.95 per share, or $26.33 million in total. While the Plaintiff accepted to have the valuation of ESG based on projections utilized to reach the offer price for his shares, he and his expert did not approve of the additional assumptions applied to arrive at the valuation. These included including tax affecting ESG as a Subchapter S corporation ("S-Corp"). Though the Defendants had initially accepted the 2013 projections at the time of the merger, they subsequently argued that the 2013 projections were unreliable. Instead, Defendants relied on a set of projections created by their expert. These two differences, the projections and the applied tax rate, generated the majority of the variation in estimated value.

Experts for both parties performed a discounted cash flow ("DCF") analysis, but disagreed in 5 respects: "(i) the source of the projections of the Company's future performance; (ii) whether ESG's earnings should be tax affected due to its status as a Subchapter S corporation; (iii) the terminal growth rate; (iv) the proper treatment of the cash on ESG's balance sheet as of the Merger; and (v) Nate's ownership percentage of the Company."

Plaintiff's expert utilized the 2013 projections, while the Defendants' expert argued that the 2013 projections were unreliable, utilizing his own set of projections. The Court agreed with the Plaintiff that "the 2013 Projections reflected management's best estimates of what was known or knowable about ESG's future performance as of the Merger," and gave no weight to the projections prepared by the Defendants' expert.

Next, as an S-Corp, ESG does not pay income taxes at the corporate level. The court calculated, under Kessler, a hypothetical corporate tax rate for ESG of 22.71%, based on the following: (i) effective state and federal tax rate of 43%; (ii) Owen's tax rate on distributions of 31.75% – the sum of the 20% federal dividend tax rate, the 3.8% Net Income Investment Tax ("NIIT") imposed by the Affordable Care Act, and the 7.95% Main state tax on dividends; and (iii) Owen's tax rate on distributions from an S-Corp of 47.25%, the sum of Nate's actual 35.5% federal income tax rate, the 3.8% NIIT, and the 7.95% Maine state tax rate.

Plaintiff's expert utilized a 5% terminal growth rate, based on a premium of 0.5% to the midpoint of three estimates of nominal U.S. GDP growth of 4.5%. Defendants' expert utilized a rate of 3%, based on a premium of 1% to the Federal Reserve's projected inflation rate of 2%. The Court found the Plaintiff's expert's 5% growth rate "too high for a company like ESG, which, as of the Merger, had matured into a company that was facing increasing competitive pressures and flatter growth." The court adopted a 3% terminal growth rate.

The Court determined that ESG's "excess" cash on hand as of the merger date was $12.984 million, calculated as cash on the balance sheet less a Texas sales and use tax liability and working capital.

Regarding the ownership percentage, the two sides disputed whether the fully diluted shares should include certain "performance units" (phantom stock) offered to other employees. The Court decided to remove most of the "performance units" from the calculation.

Applying all of these changes, the Court found Owen's equity interest to be $42,165,920 and found that the initial merger price was not the result of fair dealing.

Case Summaries

Longpath Capital, LLC v. Ramtron International Corporation, C.A. No. 8094-VCP (Del. Ch., June 30, 2015)

Click here to view the opinion.

In this appraisal action, the Court determined that the most valid indicator of share price was the merger price less estimated synergies, rejecting a discounted cash flow ("DCF") analysis and comparable transaction analysis as both based upon flawed and insufficient data.

The action is related to the acquisition of Ramtron International Corporation ("Ramtron"), a semiconductor manufacturer, by Cypress Semiconductor Corporation ("Cypress"). After initially offering $2.48 per share, which Ramtron's board rejected, Cypress initiated a hostile tender offer, increased its offer five times, and ultimately acquired Ramtron for $3.10 per share, a 71-percent premium over the unaffected share price of $1.81. During this process, Ramtron's board actively marketed the company for sale but received no competing bids. The Petitioner, LongPath Capital, LLC ("LongPath"), acquired its shares after the merger announcement but prior to closing. In the appraisal action, LongPath's expert, relying on a weighted combination of a DCF analysis based upon certain management projections and a comparable transactions analysis based upon two transactions, contended the shares were worth $4.96 per share, while Ramtron, relying on actual merger price less estimated synergies of $0.34 per share, argued for a fair value of $2.76 per share. The Court agreed with Ramtron that the merger price less synergies was the most valid indicator of share price but disagreed on the value of the estimated synergies, resulting in a $3.07 valuation.

In rejecting LongPath's DCF analysis, the Court, while recognizing that Delaware courts tend to favor the DCF methodology in appraisal actions, noted that the procedure had diminished utility where key inputs were not reliable, stating, "[t]he utility of a DCF ceases when its inputs are unreliable; and, in this instance…the management projections that provide the key inputs to the Petitioner's DCF analysis are not reliable." While LongPath's expert used Management's projections without any adjustments, the Court found Management's projections to be flawed in part because they were prepared by an inexperienced management team using a new methodology and they also were prepared in order to shop the company and in anticipation of potential future plaintiff-side disputes. The Court noted a number of specific issues with the projections including: (i) they relied on inflated base year numbers that resulted from anomalous customer allocation issues and associated channel stuffing; (ii) they predicted growth inconsistent with historical results; (iii) they projected future results for a longer period of time than previous forecasts prepared in the ordinary course of business; and (iv) they were based on an overly optimistic timeframe involved in transitioning to a new semiconductor foundry that, in turn, overestimated cost savings to the company. In addition, the Court found that the company had provided less-optimistic projections to its banks, which the CFO had testified were more accurate.

Experts for both sides agreed there were no companies comparable to Ramtron to enable a comparable companies analysis, and the Court rejected a comparable transactions approach proffered by LongPath's expert because it relied on only two transactions, which the Court deemed insufficient.

In accepting the transaction price as the best evidence of fair value, the Court recognized the Delaware Supreme Court's admonition that courts should not simply defer to that methodology and noted instances in which it may not provide an accurate measure. However, where the evidence revealed an arms-length transaction process and where alternative appraisal methods were unavailing, the Court determined that the transaction price may be accorded full weight. Here, the Court found that Ramtron repeatedly rejected Cypress' increasing bids, which resulted in a 25-percent premium over the starting offer, and that the company simultaneously was marketed for sale to 23 other potential buyers, some of which, the Court determined, had indicated serious interest. Notwithstanding the fact that no

Case Summaries

Longpath Capital, LLC v. Ramtron International Corporation, C.A. No. 8094-VCP (Del. Ch., June 30, 2015)

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alternate bids ultimately were received, the Court found that "[t]his lengthy, publicized process was thorough" and that "if Ramtron could have commanded a higher value, it would have."

However, the Court did not agree with either Ramtron's or LongPath's expert in valuing synergies attributed to the merger price. The Court first rejected LongPath's expert's argument that synergies should be subtracted not from the merger price, but rather from the post-merger value that Cypress attributed to Ramtron as a division of Cypress, finding instead that the appropriate base for synergy adjustments was the actual purchase price. The Court next rejected Ramtron's argument, which relied on industry averaging, to yield over a 10-percent synergy value reduction, finding that the analysis was general and did not capture specific values associated with the transaction. Ramtron's analysis, the Court also found, relied solely on cost savings, or "positive synergies," without consideration of potential negative synergies, such as "negative revenue synergies and transaction costs." Here, the Court accepted negative synergy costs proffered by LongPath's expert, which when applied to positive synergies, yielded a net $0.03 reduction from the merger price, resulting in an appraisal value of $3.07 per share.

Case Summaries

Fox v. CDx Holdings, Inc., C.A. No. 8031-VCL (Del. Ch., July 28, 2015)

Click here to view the opinion..

In a class action lawsuit, the Court found that a group of affiliated companies were purposely undervalued as part of a sales transaction in order to avoid tax liabilities, which diminished the value of stock options and breached the terms of a stock option agreement.

Caris Life Sciences, Inc. ("Caris") operated three subsidiaries: Caris Diagnostics, TargetNow, and Carisome. Caris sold Caris Diagnostics to Miraca Holdings ("Miraca") through a "spin/merge" transaction in which it transferred ownership of TargetNow and Carisome to a new subsidiary, which was spun off to existing stockholders. Caris, now owning only Caris Diagnostics, was then merged into a subsidiary of Miraca. The alternative of selling Caris Diagnostics directly to Miraca would have resulted in double taxation, initially at the corporate level, with Caris taxed on the gain from the sale and then at the shareholder level, when proceeds were distributed. Through the merger alternative, proceeds from the transaction would only be taxed at the shareholder level. However, in spinning off TargetNow and Carisome, Caris would recognize a taxable gain as if it had sold the businesses, and it would owe tax on the difference between the fair market value of the businesses and their tax basis.

According to the terms of a 2007 Caris stock incentive plan, each option holder was entitled, upon a change of control, to receive the amount by which the fair market value of shares exceeded the exercise price. The plan stipulated that fair market value be determined by the Caris board of directors, and that the "Board's good faith determinations were conclusive unless arbitrary and capricious." The plan also required, in the event of a transaction such as the spinoff, that the option exercise price be proportionately adjusted to reflect any change in the number of issued shares or any change in the fair market value of the shares. Employee option holders, via a class representative, brought suit, claiming that, contrary to the plan, company management, not the board, determined valuation, and that management did not determine the fair market value of TargetNow and Carisome in good faith, but rather suppressed that value in order to avoid tax. The Court agreed and awarded more than $16 million in damages, plus pre- and post-judgment interest.

The Court found that company management, to achieve its tax-driven result in the transaction, relied on a "tax transfer valuation" of TargetNow and Carisome's intellectual property prepared by the company's tax adviser, rather than fair market valuation, in determining the consideration due to option holders. The Court also found that management had directed the adviser "where to come out" and supplied reduced projections to achieve the desired result. When Miraca questioned the report and insisted upon a second opinion, the company retained its stock option valuation adviser to prepare a report. The Court found that the adviser, contrary to its prior valuation techniques and results, essentially copied the tax adviser's analysis and reached a similarly diminished outcome.

The Court's decision was further supported by the fact that, both prior to and after the Miraca transaction, company management and its financial advisers had valued TargetNow and Carisome substantially higher than the companies were valued in the spinoff ($47 million and $15 million, respectively). For example, an adviser retained for valuing stock options for income tax and financial statement reporting previously had valued the company in one report at $104 million, using management projections and discounted cash flow and comparable company valuations. Additionally, the company's CFO previously had advised another financial adviser that the estimated value was between $150 million and $300 million. Thereafter, that adviser independently valued TargetNow at between $195 million to $300 million. Following the transaction, the same adviser advised management that TargetNow could sell for

Case Summaries

Fox v. CDx Holdings, Inc., C.A. No. 8031-VCL (Del. Ch., July 28, 2015)

Continued

Click here to view the opinion.

approximately $200 million. Additionally, during the marketing of Caris Diagnostics, multiple bidders had expressed interest in acquiring TargetNow, with the Court citing one example that yielded an implied value of $100 million to $175 million for the company. The court found similar discrepancies in the evidence with respect to Carisome, including prior valuation estimates provided by the stock option adviser in the ordinary course.

Given the foregoing, the Court found that the valuation was not made in good faith and that management had breached the option agreement. The Court then conducted its own valuation analysis, relying heavily on the stock option adviser's prior work as performed in the ordinary course for tax and financial statement reporting, and increased the $0.61 per-share transaction value assigned by management to TargetNow and Carisome to $2.10 per share. The Court increased the $5.07 per-share transaction value of Caris to $6.57. This value was multiplied by the number of cancelled option shares, yielding a total fair market value of cancelled option shares of $63,499,831,77. After subtracting the aggregate exercise price and proceeds received by the option holders, the Court concluded the damages suffered by the class to total $16,260,333.

Case Summaries

Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG (Del. Ch., October 21, 2015)

Click here to view the opinion.

This case was an appraisal action, involving the valuation of BMC Software, Inc. ("BMC" or the "Company"). BMC was one of the largest software companies in the world when it was taken private by a consortium of investment firms (the "Buyer Group") in September 2013 for $46.25 per share (the "Merger"). After performing his own Discounted Cash Flow ("DCF") analysis resulting in a valuation of $48.00 per share and reviewing the record regarding the sales process that generated the Merger, Vice Chancellor Glasscock found the merger price of $46.25 to be the best indicator of fair value of BMC as of the date of the Merger.

The Petitioners' expert relied exclusively on the DCF method and determined that the fair value of BMC was $67.08 per share. The Respondent's expert also relied on the DCF method, concluding that the fair value was $37.88 per share. The Court noted that "[a]lthough the difference between the experts' estimates is large, the contrasting prices are the result of a few different assumptions."

First, while both experts relied on the same set of management projections, the Respondent's expert concluded that the projections "were biased by 'overoptimism'" and reduced the projections by five percent based on his analysis that the Company had historically fallen short of its projected revenues. Despite the Court finding that the projections "harbored something of a bias towards optimism," it saw the five percent reduction as "too speculative to accurately account for that bias," and used the projections as provided by management. The Court also considered the "tuck-in" merger & acquisition ("M&A") activity that Management testified was integral to the Company's revenue growth, and which was expected to continue if it had remained a public company. The Court found that because growth from this "tuck-in" M&A activity was built into management's revenue projections, it was appropriate for management to build "tuck-in" M&A expenditures into the calculation of free cash flow as well.

Second, the experts disagreed on the appropriate equity risk premium ("ERP") to use in the discount rate, with the Petitioners' expert using a supply side ERP and the Respondent's expert using a historical ERP. As support for his selection of the supply side ERP, Vice Chancellor Glasscock referenced the Court's recent tendency to employ the supply side ERP approach, and found that nothing in [the Respondent's expert's] testimony convinced him "to depart from this Court's practice of the recent past." Vice Chancellor Glasscock did indicate, however, that "the testimony at trial showed [the ERP] to be a vigorously debated topic, not just between these two experts, but in the financial community at large," and that "scholarship may dictate other approaches in the future."

Third, the experts disagreed on the terminal growth rate. Citing inconclusive evidence regarding BMC's growth prospects, the Court ultimately found it most appropriate to follow the approach from Golden Telecom and apply a terminal growth rate equal to the midpoint of inflation and GDP. The Court was not convinced by the Respondent's expert's adoption of inflation, noting that "inflation is generally the 'floor' for a terminal value." Likewise, the Court rejected the "arbitrary" addition of 50 basis points to the midpoint of inflation and GDP, as proposed by the Petitioners' expert.

Fourth, the Respondent's expert made an adjustment to account for the expense associated with repatriating cash held abroad. Although the Company's 10-K stated that it intended to maintain cash balances overseas indefinitely, the Court found that an adjustment was warranted, stating that the funds "represent opportunity for the Company either in terms of investment or in repatriating those funds for use in the United States, which would likely trigger a taxable event."

Case Summaries

Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG (Del. Ch., October 21, 2015)

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Finally, regarding the issue of stock-based compensation, the Court adopted the Respondent's expert's methodology of treating estimated stock-based compensation as an expense. The Court said that because of the Company's history of buying back stock to prevent dilution, stock-based compensation "is clearly in line with a cash expense." The Petitioners "argued strenuously that this overstates the cost," but failed to provide an alternative that accounted for future stock-based compensation.

Utilizing the assumptions described above, the Court performed a DCF analysis resulting in a price per share of $48.00. As another indication of fair value, the Court then evaluated the merger price, ultimately concluding that "the Company conducted a robust, arm's-length sales process." The Court stated that BMC "conducted two auctions over roughly the course of a year, actively marketed itself for several months in each, as well as vigorously marketed itself in the 30-day Go Shop period." Despite several challenges by the Petitioners regarding the effectiveness of the sales process, the Court found that the process was "sufficiently structured to develop fair value of the Company, and thus, under Huff, the Merger price is a relevant factor [the Court] may consider in appraising the Company."

In determining the best indicator of fair value, Vice Chancellor Glasscock stated that although he believed his DCF analysis to rely on the most appropriate inputs, he was "reluctant to defer to that valuation in this appraisal." As reasons for this reluctance, the Court cited management projections that were "historically problematic," concern about the discount rate due to the "meaningful debate on the issue of using a supply side versus historical equity risk premium," and a lack of complete confidence regarding the use of the midpoint of inflation and GDP as the Company's expected growth rate. Due to these uncertainties in the DCF analysis, combined with a merger price that was the result of an arm's-length transaction, the Court found the merger price to be "the most persuasive indication of fair value available."

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