

BRATTLE'S VALUATION EXPERTISE

Valuation analysis is a substantial part of securities and financial markets litigation. The analysis used to value complex security instruments requires a thorough understanding of the facts and issues. To this end, The Brattle Group combines in-depth industry experience and rigorous analyses using sound economic and financial principles to help clients answer complex valuation and financial questions in litigation.

Valuation analysis is a common approach in disputes associated with bankruptcies, buyouts, divestitures, initial public offerings, going-private transactions, mergers and acquisitions, private placements, and reorganizations. Valuation analysis is also common in disputes that focus on debt, derivative securities, and intellectual property rights.

The Brattle Group's litigation experts have extensive experience with valuation analysis such as appraisal of fair value, estimation of cost of capital, and disputes associated with mergers and acquisitions. Our expertise is grounded in a thorough understanding of finance and economics, accounting, financial products, capital markets, regulation, and industry custom and practice.

In addition, we are frequently asked to present on valuation topics at law firms and conferences, during which we share a financial economists' perspective of valuation disputes and provide analysis of issues that arise in connection with recent trends in litigation.

The Delaware Court of Chancery (the "Court") addresses and resolves numerous merger disputes each year. While appraisal-rights actions are an available tactic for objecting stockholders, they have typically been utilized less commonly. Dissenting stockholders can petition for an independent "fair value" determination by the Court after rejecting the offered merger deal. Appraisal-rights actions have, however, recently attracted more attention. There are reasons to expect more appraisal-rights actions in the future. First, merger values during the financial crisis have been low. Although the Court has suggested that in appraisal-rights actions the stock market price is not a guide to determining the fair value of the subject shares, shareholders are perhaps still likely to perceive an unfair loss and pursue compensation. Second, appraisal-rights actions are becoming more predictable because the Court relies on generally accepted finance principles.

The recent opinions by the Court in *Towerview LLC v. Cox Radio, C.A. 4809-VCP* (June 28, 2013) and in *Merion Capital LP v. 3M Cogent, C.A. 6247-VCP* (July 8, 2013) show that the fair value is grounded in a discounted cash flow (DCF) method although other valuation methodologies are considered, such as the comparable transactions or comparable companies method. The Court's reliance on a DCF to determine the fair value may result in better estimates of the possible outcome than may have been possible in the past.

Nonetheless, the recent decisions reveal that an appraisal action is only as strong as the expert testimony. The Court expects that expert opinions are based on generally accepted finance principles. Moreover, the experts can substantiate, by detailed explanations, how an opinion was reached to validate the principles relied upon. In addition, experience or knowledge of the relevant industry is critical. Industry experience provides additional credibility when, for example, an expert substantiates expected future growth projections for a business entity that is being valued. Because valuation calculations express the opinion of the expert and not a definitive fact, experts must take care to justify their assumptions and particular pre-merger evidence utilized.

The Court has also recently addressed a "quasi-appraisal" action in *re Rural Metro Corporation Shareholders Litigation, C.A. No. 6350-VCL* (Del. CH. April 29, 2013). Specifically, the Court discussed the reliance on post-merger evidence when

evaluating whether a valuation was reasonable at the time of the merger. The Court found that post-merger evidence was valuable in certain circumstances, but stressed that contemporaneous information should be the primary justification for pre-merger valuation assumptions. When performing an appraisal valuation, experts should, therefore, employ caution when relying on information that could introduce a hindsight bias.

Other appraisal-rights actions from the previous year include: *Tull N. Gearreald, Jr. et al. v. Just Care, Inc.*, C.A. No. 5233-VCP (DEL. CH. April 30, 2012), *re Appraisal of the Orchard Enterprises, Inc.*, C.A. No. 5713-CS, 2012 WL 2923305 (DEL. CH. July 18, 2012), and *re Synthes, Inc., Shareholder Litigation*, C.A. No. 6452 (DEL. CH. August 17, 2012). In these appraisal-rights actions, the Court addressed valuation analysis required to determine the fair value of subject shares. For example, the Court indicated that any “control premium” should be shared pro rata by all stockholders, even with the existence of a controlling majority stockholder. Another example where the Court addressed the valuation analysis was in *Golden Telecom, Inc., v. Global GT LP et al.*, C.A., No. 3698 (Del. CH. December 29, 2010) where the Supreme Court rejected the negotiated deal price as a “market-checked” fair value.

The recent appraisal opinions issued by the Court highlight the application of generally accepted finance principles, including valuation analysis topics such as the use of management-prepared projections, hindsight bias, and the estimation of the appropriate discount rate, which include assumptions about expected tax rate, the equity risk premium (supply-side equity premium), and beta. This summary of recent guidance presents selected Delaware cases and discusses the implication on valuation analysis.

I. Recent Cases

TOWERVIEW LLC v. COX RADIO, INC., C.A. No. 4809 (DEL. CH. JUNE 28, 2013)

Opinion: Vice Chancellor Donald F. Parsons, Jr.

Issues: Appraisal; Merger; Reliability of management projections; Hindsight bias

Court Ruling: [Towerview LLC v. Cox Radio, Inc.](#)

The appraisal action considered by the Court in this matter arose from the merger of Cox Radio (CXR), a partially owned subsidiary of Cox Enterprises, Inc., with its wholly owned subsidiary, Cox Media Group, on May 29, 2009. The petitioners, CXR minority stockholders, maintained that the tender offer of \$4.80 per share “substantially underestimated the value of their shares.” The petitioners dissented to the merger, filing a breach of fiduciary duty action against CXR management and seeking a fair value appraisal of their shares. Applying the discounted cash flow (DCF) method, the Court determined the fair value of the petitioners’ shares to be \$5.75 per share.

The Court’s appraisal of the fair value was based on a going concern as of the merger date. The petitioners alleged that CXR was undervalued due to the expected rebound in the radio industry from its low in early 2009. Respondents alleged that the radio industry would not recover to its previous high levels of revenues. However, the valuation experts for the petitioners and the respondents agreed that the DCF analysis was the most reliable method to address this issue. The experts also argued, and the Court agreed, that the comparable transactions and comparable companies’ methods were not suitable to assess the fair value due to CXR’s unique position within the radio industry and the economic conditions at the time. Nonetheless, the experts differed on how to utilize the long-run projections for 2009-2013 prepared by CXR’s management and approved by CXR’s board in December 2008 (Long Range Plan, or LRP).

The petitioners claimed that the radio industry and CXR, in particular, remained resilient and would recover quickly from the cyclical downturn in 2008 and 2009. Thus, experts predicated their analysis on the assumption that CXR's growth rate would return to the optimistic projections in the Long Range Plan within a period of 18 months. The respondents argued that fundamental changes occurred within the radio industry even before the recession and CXR's future growth had deviated substantially from the Long Range Plan. The Court rejected the projections put forward by the petitioners' experts as being overly optimistic and thus adopted the DCF analysis by the respondents' expert as a starting point.

To choose an appropriate operating cash flow input to the DCF model, the Court agreed with the respondent's view that CXR would not "recover to pre-recession expectations, i.e., to the 2009 LRP." The Court argued that "[p]re-merger management projections are an appropriate starting point from which to derive data in the appraisal context because they are not tainted by post-merger hindsight." The Court also stated that "[m]anagement also is in the best position to forecast the company's future before the merger. Nevertheless, 'if Management forecasts are prepared a significant period of time before the merger, it may be necessary to make minor changes to them reflecting actual results as of the merger date.'" Thus, lacking updated management projections beyond 2009, the expert for the respondent based his valuation on CXR's historical growth rates following the 2000/2001 recession. The Court agreed that "an appropriate recovery in this case would include a growth rate comparable to the rate of growth CXR experienced in the first year after the 2000/2001 recession with growth thereafter returning to the steady rate of 4.6%."

Using this framework, the Court used historical growth rates following the 2000/2001 recession but increased the expected growth rate for 2010 to account for the demonstrated optimism among management at the time of the merger and the prospect of greater growth in the first year coming out of a recession. The Court noted that "[i]n an appraisal case, this Court is charged with the difficult task of putting itself back in time to consider without the benefit of hindsight what the company's fair value was in light of its 'operative reality' at the time of the merger." Accordingly, the Court adjusted CXR's growth rate for 2010 to 9.8%.

Next, the Court addressed other DCF analysis inputs, including the employee long-term incentive plan (LTIP) payments, debt, retained cushion, deferred taxes, and number of outstanding shares. The Court adopted the approach of CXR's expert as to these inputs, but adopted the approach of the petitioners' expert with respect to value of debt. To assess the fair value, the Court found that, because the radio industry is a mature industry, CXR's terminal growth rate should be at least equal to the expected inflation rate. As such, the Court adopted a terminal rate of 2.25% that was slightly lower than the projected rate of 2.5% used by the petitioners' expert. The experts fundamentally agreed on the appropriate discount rate, and the Court adopted the 8.0% rate used by CXR's expert, a rate that was slightly more favorable to the petitioners than the 8.1% rate used by their expert.

For all of these reasons, the Court determined the fair value of the petitioners' shares to be \$5.75 per share.

MERION CAPITAL, L.P. et al., v. 3M COGENT, INC., C.A. No. 6247-VCP (DEL. CH. JULY 8, 2013)

Opinion: Vice Chancellor Donald F. Parsons, Jr.

Issues: Appraisal; Mergers; Expert Testimony; Comparable companies

Court Ruling: [*Merion Capital, L.P. et al., v. 3M Cogent, Inc.*](#)

This appraisal action stems from a merger between 3M Company (3M) and Cogent Inc. (Cogent). Former stockholders of Cogent (petitioners) acquired their shares after the announcement of the 3M merger with Cogent and rejected the offer of \$10.50 a share on December 1, 2010 (the “merger date”). Petitioners contended that the each share of Cogent was worth \$16.26 as of the merger date while the respondents claimed each share was worth \$10.12. After rejecting the use of comparable companies and comparable transaction analyses, the Court employed a DCF method to determine a fair value of petitioners’ shares of \$10.87.

The petitioners’ expert arrived at a fair value of \$16.26 after performing three valuation analyses (DCF, comparable companies and comparable transactions) but ultimately decided to rely only on the DCF valuation. The expert “believed there were no truly comparable companies or transactions to compare to Cogent” and that to “the extent there were any potentially comparable companies and transactions [they] lacked sufficient data from which to draw comparisons.” Respondents’ expert, however, applied equal weight to each of the three valuation procedures to arrive at a fair value. The Court noted that it generally prefers to rely on multiple approaches when determining the robustness of an estimated fair value.

Respondents attempted to have the Court rely on the merger price as evidence of the fair value of the subject shares. However, the Court rejected this on grounds that the respondents did not themselves use the merger price as a measurement of fair value in their own calculations and they did not adjust the merger price “to remove the speculative elements of value that may arise from the ‘accomplishment or expectation’ of the merger.”

The Court considered the comparable companies analysis from the respondents’ expert but ultimately chose to apply no weight to the analysis. The Court found that the expert’s analysis relied on companies that were not comparable and thus rendered the analysis unreliable. The Court argued that “six of the ten comparable companies [the expert] identified were significantly smaller than Cogent” and “not one of those same six ‘comparable’ companies had generated a profit.” The Court also found the expert failed to select companies that were competitors with or even in the same industry as Cogent. As such the Court applied no weight to the comparable analysis.

Similarly, the Court considered the comparable transactions analysis by the respondents’ expert. However, the Court again chose to apply no weight to the analysis, for largely similar reasons. The Court found that the expert’s use of revenue multiples was flawed given Cogent’s robust and profitable business and so chose only to consider EBITDA multiples. Moreover, the Court found that, once they removed revenue multiples from the analysis, there were too few data points and that the data points were too dispersed (“the mean of the forward EBITDA multiple was 25.4x” and “the standard deviation was 25.1x”) to be meaningful. As such the Court applied no weight to the comparable transactions.

Rejecting the other methods, the Court then considered the DCF analyses of the respondents and petitioners. “A primary dispute between the parties is whether the Court should rely on the Five-Year Projections prepared” by management or use alternative forecasts. While the respondents relied upon management projections, the petitioners rejected them and instead formulated two alternate scenarios: an industry growth scenario and a cash deployment scenario. The Court found that the petitioner’s industry growth scenario vastly overstated Cogent’s potential growth based on its historically underperforming industry growth. The Court also found that the cash deployment scenario was highly speculative in that it attempted to estimate a rate of return on a nonexistent acquisition. In addition, Cogent had previously considered more than twenty potential targets for acquisition but had found none suitable. Thus, in line with the respondents’ analysis, the Court chose to rely on the management projections.

Finally, the Court addressed disputes on other DCF input assumptions and adjustments. Of particular note was the Court's choice of beta. The Court found that "the experts' calculations of beta diverge in significant respects and are the largest driver of the price difference in their respective DCF calculations." To estimate beta the petitioners chose to use a one-year sample period to avoid the noise of the global financial crisis, whereas the respondents chose a two-year sample period but offered no explanation. Thus, the Court decided to rely on the petitioners' beta estimation. The Court then considered adjusting beta for Cogent's large cash position. The petitioners adjusted the Bloomberg raw beta, whereas the respondents adjusted the Bloomberg market adjusted beta. The Court found that it was "inappropriate to cash adjust a market-adjusted beta because it effectively cash adjusts the market." Moreover, the Court found that the petitioner's attempt to treat the surplus cash as an operational asset to violate a generally accepted finance principles.

After addressing the inputs and assumptions to the DCF analyses, the Court arrived at a fair value of \$10.87 per share.

IN RE RURAL METRO CORPORATION SHAREHOLDERS LITIGATION, C.A. No. 6350-VCL (DEL. CH. APRIL 29, 2013)

Opinion: Vice Chancellor J. Travis Laster

Issues: Hindsight bias; Quasi-appraisal

Court Ruling: [*In Re Rural Metro Corporation Shareholder Litigation*](#)

In its pre-trial hearing, the Court was to decide on a motion to exclude all evidence dated after the merger in March 2011 between Rural Metro Corporation (Rural/Metro) and Warburg Pincus. Plaintiffs sought damages for breach of fiduciary duty by alleging that the timing of the sale was not favorable, which subsequently resulted in damages of \$100 million to Rural/Metro shareholders. Further, in a "quasi-appraisal" claim, plaintiffs alleged that the financial advisors for RBC Capital Markets and Moelis & Co. made errors in their pre-merger valuations of Rural/Metro, which prevented shareholders from dissenting to the merger and seeking a fair value appraisal of their shares. The Court dismissed the motion and cautiously weighed the value of post-merger evidence versus its imposed risk of provoking hindsight bias.

The plaintiffs argued that the inclusion of post-merger evidence causes a hindsight bias and thus moved for contemporaneous information to be the only evidence used to demonstrate the state of mind of the Rural/Metro management at the time of the merger. In this case, the pre-merger valuation of Rural/Metro was based on a new and untested acquisition strategy. As such, allowing hindsight offered defendants the ability to show the failure of the acquisition strategy when actually implemented post-merger. Defendants argued that this demonstrated that Rural/Metro management did indeed make the best decision to sell at that time. The plaintiffs objected to using this after-the-fact information to influence the Court's judgment on what was perceived as the most reasonable and fair course of action at the time of the merger.

The Court, however, denied plaintiffs' motion to exclude post-merger evidence. It argued that post-merger evidence can "show what people actually were thinking and believed at the time [of the merger]." Yet, the Court cautioned that "the idea of hindsight bias is going to be something that I'm going to have to guard against... by discounting the probative value of evidence the further we get from the valuation date." The Court also argued that the post-merger evidence can help limit the effect of very inaccurate pre-merger projections, revealing that a valuation was, in fact, not reasonable at the time of the merger.

The Court also offered insight into how post-merger evidence is discounted relative to pre-merger evidence in order to limit the cognitive biases of incorporating hindsight into the judgment of a valuation. In order to determine what decisions were reasonable at the time of the merger, the Court stated:

I will tell you that I will give less credence to information the further it is from the merger date. I will give less credence to information that doesn't seem to actually reflect what people knew at the time of the merger and really reflects developments that happened based on the actual state of the world that occurred as opposed to the multiple different states of the world that could have occurred.

In sum, the Court sees certain value in post-merger evidence but emphasizes that contemporaneous information must be the primary justification for pre-merger valuation assumptions. As a result, experts should employ caution when introducing information based on hindsight in appraisal cases.

II. Notable Cases in 2012

In [*Tull N. Gearreald, et al, v. Just Care, Inc.*](#), C.A. No. 5233-VCP (DEL. CH. April 30, 2012), the petitioners sought appraisal of subject shares after the acquisition of Just Care, a prison healthcare detention company, by GEO Care, Inc. for \$40 million on September 30, 2009. Petitioners argued that the shares were worth \$55.2 million based on a DCF analysis that included three possible scenarios in their valuation: the base case, moderate expansion within existing facilities, and aggressive expansion to a new facility. These scenarios came from management projections not approved by the Just Care board. The respondent's expert claimed the appropriate value was \$33.6 million, based on a weighted average of results from a DCF analysis and a comparable companies analysis and excluding the aggressive expansion case that the expert deemed too speculative. The Court agreed with the respondent that the aggressive expansion case represented unprecedented growth by Just Care and was beyond its "operative reality" at the time of the merger given that the company had no history of expansion. Rejecting the comparable companies analysis because of Just Care's unique business model, the Court conducted only a DCF analysis that excluded the aggressive growth scenario and gave less weight to the moderate growth scenario. The Court ruled that the value of Just Care on September 30, 2009 was \$34.2 million.

In [*re: Appraisal of the Orchard Enterprises, Inc.*](#), C.A. No. 5713-CS, 2012 WL 2923305 (DEL. CH. July 18, 2012), the petitioners sought fair value appraisal after Orchard Enterprises merged with its controlling stockholder, Dimensional Associates, LLC, on March 15, 2010 to become a privately held company. Arguing that their shares had been undervalued at \$2.05 per share, experts for the petitioners calculated the fair value to be \$5.42 using a DCF method. The Court rejected the respondent's attempt to use comparable companies and comparable transactions methods, stating that there was no adequate means of comparison since Orchard was pursuing a niche market of independent music and video distribution and sales. Subsequently agreeing on a DCF model, the petitioners and the respondent disagreed over the appropriate discount rate. The Court rejected the "build-up" methods approach used by both experts, due to its lack of mainstream acceptance with corporate finance scholars. Further, the Court took issue with both experts' attempts to use multiple methods for determining the discount rate and then averaging the results together. After the Court decided to solely utilize the mainstream Capital Asset Pricing Model (CAPM), the petitioner and respondent agreed on a discount rate of 15.3%. Limiting the analysis to the DCF method using CAPM to determine the discount rate, the Court arrived at a fair value price of \$4.67 per share. In this ruling, the Court demonstrated a preference for experts to choose

one widely accepted method, justify the choice, comprehensively explain assumptions, and execute the method without unduly complicating and blending together results.

III. Summary

With the recent trend in appraisal-rights actions, the Court has begun to articulate a consistent way of evaluating expert valuations. In the actions outlined above, the Court has demonstrated a preference for DCF analysis in appraisal rulings. In conjunction, comparable transactions and comparable companies methods have been considered by the Court but have been rejected frequently with the Court citing such reasons as the Company was in a unique industry with a unique business plan or that comparisons chosen were systematically biased in some way, as in *Towerview LLC v. Cox Radio* and *Merion Capital LP v. 3M Cogent*, respectively. Similarly, the Court has shown a consistent willingness to reject valuations that rely on new methods that have not been widely accepted, as demonstrated in *re Appraisal of Orchard Enterprises, Inc.*, in which the Court refused to adopt the “build-up” method approaches. This emphasizes the importance of experts relying on tried and true methods such as DCF and CAPM.

Depending on the facts and circumstances of the action, the Court has addressed the validity of using multiple methods to arrive at one valuation of the subject shares. As described above in *Merion Capital, et al. v. 3M Cogent*, the Court expressed a preference for experts to use multiple approaches to demonstrate the robustness of their valuation. On the other hand, in *re Appraisal of Orchard Enterprises, Inc.*, the Court cautioned against using multiple approaches and applying some weights to blend all the valuations into one final answer that supports a specific conclusion. In either case, the Court emphasized that an expert’s choice of an approach must be thoroughly justified and methods must be executed properly and without bias.

Finally, the Court has stressed the concept of “operative reality” in a number of cases. Generally, the Court has given great weight to using management growth projections prepared before the merger as a basis for expert valuation. The cases wherein the projections were rejected by the Court all involved scenarios that were too speculative to be considered a reasonable option for the Company at the time of the merger. For instance, in *Merion Capital, et al. v. 3M Cogent* and *Gearreald, et al. v. Just Care, Inc.*, aggressive expansion scenarios based on unprecedented levels of growth were rejected by the Court because they deviated significantly from the historical performance of the Company. In a similar way, the Court has emphasized the importance of evaluating the reasonableness of valuations as of the merger date by avoiding hindsight bias. As a result, experts add credence to their valuation estimates by relying on information available at the time of the merger and limiting the use of any post-merger insight.

ABOUT BRATTLE

The Brattle Group provides consulting and expert testimony in economics, finance, securities, valuation, and regulation to corporations, law firms, and governments around the world. In addition to our extensive team of in-house experts, we maintain affiliations with leading international academics and highly credentialed industry specialists that serve as experts on many client engagements.

We advise clients and provide expert testimony in a range of matters involving alleged violations of state and federal securities laws. Our experience includes work in class actions, derivatives, executive compensation, stock options, asset-backed securities, ERISA actions, breach of fiduciary duty, valuation, and bankruptcy. Our expertise is grounded in a thorough understanding of finance and economic theory, accounting, financial products, capital markets, regulation, and industry custom and practice. The Brattle Group has been involved in a number of high profile cases arising from accounting fraud in the energy, telecommunications, banking, and insurance industries.

Members of our firm are internationally recognized experts in financial economics, corporate finance, accounting, and other functional areas that provide the expertise required for complex securities cases and contractual disputes. Our staff and affiliates include a Nobel Prize winning economist, former chief economists at the U.S. Securities and Exchange Commission, and the authors of the leading graduate-level textbook on corporate finance.

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