PENN STATE LAW REVIEW

Judge and Banker—Valuation Analyses in the Delaware Courts

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I. INTRODUCTION

Litigation challenging public company merger and acquisition transactions is on the increase. Whereas, not too long ago, only transactions involving director conflicts of interest or other potentially troubling facts would bring forth the plaintiffs' lawyers, today, lawsuits can be expected challenging even those transactions in which a board of directors has, by all readily apparent views, pursued a reasonable process in fulfillment of its fiduciary duties, garnering a significant premium for its shareholders.[2] In such merger and acquisition litigation, the financial advisor to the board of directors often finds itself in the center of the lawyers' fray with its valuation analyses a crucial factor in the case.[3] Senior bankers are in depositions and before judges more often than in

1. The authors are partners at Cleary Gottlieb Steen & Hamilton LLP in New York.

2. *See* Matt Egan, *M&A Lawsuits Skyrocket as Fee-Hungry Law Firms Smell Easy Money*, FOX BUSINESS (July 12, 2011), http://www.foxbusiness.com/markets/2011/07/11/ma-lawsuits-skyrocket-as-fee-hungry-law-firms-smell-easy-money/#ixzz1RzbBVXBE. There is substantial incentive for plaintiffs' firms to bring litigation relating to mergers and acquisition transactions as the typical award of attorneys' fees ranges from $400,000 to $500,000. *See* Gina Chon, *Delaware Chancery Court Judges Making Lawyers Earn It*, WALL ST. J., July 19, 2011, http://online.wsj.com/article/SB10001424052702304567604576454461091005264.html. Substantial fees often are awarded even in cases in which plaintiffs do not receive any monetary damages or the transaction is not enjoined so long as there are modifications to the disclosure documents filed with U.S. Securities and Exchange Commission in connection with the transaction or to non-financial deal terms. Recently, however, Delaware courts have taken a more critical look at applications for legal fees, and it remains to be seen whether this will lead to a decrease in questionable mergers and acquisitions related litigation.

3. Since the Delaware Supreme Court's decision in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), which held that the directors' failure to be adequately informed regarding a corporation's value in connection with a sale of control constituted a breach of their duty of care, it has become accepted practice for a board of directors agreeing to a sale of control to obtain a fairness opinion from an investment bank. *See* Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1559-1560 (2006). However, as the Delaware courts have recognized, it is the underlying valuation work, as opposed to the opinion itself, that has the "real informative value." *In re* Pure Resources, Inc., S'holders Litig., 808 A.2d 421, 449 (Del. Ch. 2002).

the past, and now, more than ever, financial advisors should expect their analyses to be subject to close scrutiny in the course of deal litigation.[4]

Recent cases decided in the state courts of Delaware, where most merger and acquisition litigation historically has been brought, provide useful guidance for lawyers who counsel financial advisors as well as those who advise principals to transactions regarding how to mitigate litigation risk arising out of a financial advisor's opinion and analyses. The cases helpful to practitioners can be divided roughly into two groups—appraisal/entire fairness cases and disclosure cases.

The appraisal and entire fairness cases provide guidance regarding the substance and application of valuation analyses. In a typical appraisal action, for instance, the court must determine the "fair value" of the shares at issue,[5] and such determination usually is based on a review of competing valuation analyses submitted by the parties. Similarly, the entire fairness standard, which is applied to certain conflict of interest transactions, requires the court to determine whether an "entirely fair price" was paid to shareholders.[6] In the course of such determination, the court often will closely scrutinize the valuation work performed by the financial advisor for the subject company's board of directors.

In the relevant disclosure cases, plaintiffs challenge the description of the financial advisor's analyses set forth in the shareholder disclosure document relating to the transaction, such as a proxy statement soliciting shareholder votes. In such cases, the court will focus primarily on the

4. Investment banks are well advised to ensure that a senior banker who has been involved directly in the subject transaction is available as a witness if the bank's financial analyses are scrutinized in litigation. As Vice Chancellor Laster remonstrated on one recent occasion,

> [W]e, as a Court, have long expected people to make their bankers available and to facilitate document production from their bankers. It would not allow these cases to be adjudicated responsibly if managing directors could decide that they are simply too busy to play a role in terms of the actual adjudication of the deals for which their investment banks are making seven-figure fees, and that they instead have better things to do, and therefore, they will send one of their junior members instead to answer non-responsively the questions that are put to them in deposition. . . .

Transcript of Ruling of the Court on Plaintiffs' Motion for Preliminary Injunction at 18-19, Steinhardt v. Howard-Anderson, No. 5878-VCL (Del. Ch. Jan. 24, 2011).

5. *See* DEL. CODE ANN. tit. 8, § 262 (2010).

6. For instance, the entire fairness standard is usually applied in cases where a controlling shareholder seeks to squeeze out minority shareholders or the board of directors is otherwise deemed conflicted in the relevant transaction. Such cases typically raise the issue of whether the board of directors adequately represented the interests of the minority shareholders, and it must be demonstrated that both the process that led to the transaction and the consideration paid in the transaction were entirely fair to the minority. *See, e.g.*, Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997); *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397 (Del. Ch. 2010).

adequacy of the disclosure regarding the bank's work as opposed to its methodology and judgments. The disclosure cases thus shed light on how to describe the bank's work in the disclosure document and, perhaps more importantly, how to prepare for such disclosure as the analyses are conducted.

Below are some of the lessons for practitioners that can be gleaned from the recent Delaware cases.

II. NUMBERS DON'T LIE: ENTIRE FAIRNESS AND APPRAISAL CASES

A. *There Is Some Measure of Safety to Be Found in Consistency and, to the Extent Practical, an Investment Bank Should Consider Adopting a Standard Approach to Valuation Analyses to Be Applied, or at Least Considered, in the Ccourse of all of its Financial Advisory Assignments.*

The plaintiffs' bar and the Delaware courts have become quite sophisticated in reviewing valuation analyses and are thoroughly conversant in the related, highly technical financial arcana. As a result, a financial advisor should be prepared, among other things, for questions relating to any differences in its valuation methods as compared to those used in other similar transactions. This argues in favor of adopting standardized approaches to analyses coupled with vigorous institutional oversight from a fairness committee or some other institutional reviewing body.[7] Of course, there are times when changes in approach are appropriate to reflect economic or industry conditions or facts about the particular company or transaction, but in such cases the banker should be prepared to explain in a deposition or before a court why the circumstances required a different approach from that previously applied. Presumably, such an explanation will be less of an ordeal for the banker if he or she has first explained the changes to an internal reviewing body.

In *Global GT v. Golden Telecom*, then Vice Chancellor Strine stressed the importance of consistency and the ability to justify changes to valuation methods used in previous transactions. There, the

7. FINRA Rule 5150 requires disclosure in a financial advisor's fairness opinion (which is then further disclosed in the relevant document sent to shareholders) whether the fairness opinion was approved or issued by a member firm's fairness committee. FINRA, Securities Offering and Trading Standards and Practices 5150, Fairness Opinions, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=6832 (last visited Dec. 9, 2011). In addition to reviewing the substance of the analyses, such a fairness committee may also be the appropriate institutional body to consider whether the analyses are consistent with firm standards, and if not, why departures from the standards are justified. Other institutional mechanisms could also be put in place to perform such function as the use of a distinct reviewing committee or review by individuals who are expert in the firm's valuation standards.

petitioners, shareholders in a Russian-based, NASDAQ-listed telecommunications company, claimed that the company was undervalued in a merger transaction and sought appraisal. The court noted that, "[a]s is typical, the outcome of this appraisal proceeding largely depends on [the court's] acceptance, rejection, or modification of the views of the parties' valuation experts."[8]

In finding for the petitioners and awarding a value per share significantly higher than the deal price, the court focused on a change by the defendants' valuation expert in the approach to the beta[9] used in discounted cash flow (DCF) analyses across cases. The Vice Chancellor remarked:

> [The expert] testified in this case that his opinion in *Travelocity* [an older case before V.C. Strine in which the same expert had provided valuation analyses] was in line with what he taught and understood about beta at that time and, since 2006, he has switched. . . . But, oddly, he cannot point to an epiphanic moment or any academic or other studies that prompted him to change his approach.[10]

While an epiphany or reams of academic support are not always necessary, bankers should be in a position to articulate sound reasons for differences with previous analyses when the judge, or more likely, a plaintiff's attorney, begins to ask questions. If a bank has a standardized approach, inadvertent changes are less likely to occur, and if any particular analysis does not conform to the bank's standard, the banker presumably will be required to explain his or her reasoning to an institutional reviewing body before the analysis goes out the door.

B. *Valuation Analyses Should Reflect Well-Accepted Methods and the Latest Industry Developments as Applicable, and the Banker Should Be in a Position to Explain the Nuances of the Analyses to Plaintiffs' Counsel and the Court.*

In recent appraisal and entire fairness cases, the Chancery Court has vigorously tested analyses against industry practice and the latest developments in the field. For instance, in *Golden Telecom*, the Vice Chancellor carefully examined the parties' treatment of inflation and industry trends and the underlying data they relied on with respect to the determination of terminal growth rates used in the discounted cash flow analyses.[11] He reviewed the tax rates applied to free cash flows by the

8. Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 498 (Del. Ch. 2010).
9. Beta is a measure of the volatility of the company's share price—measuring the extent to which the share price changes relative to changes in the market as a whole.
10. *Golden Telecom*, 993 A.2d at 521.
11. *Id.* at 511-13.

parties and the assumptions behind them, including management's view and the company's historical rate.[12] The Vice Chancellor painstakingly scrutinized whether an historical equity risk premium found in the 2008 Ibbotsen Yearbook or supply side equity risk premium from the 2007 Ibbotsen Yearbook was appropriate, ultimately choosing the supply side equity risk premium.[13] He also provided an analysis of whether the appropriate source for the subject company's beta was MSCI Barra or the Bloomberg historic raw beta (in the end, he came up with his own blended beta following a lengthy discourse on the company and industry).[14]

The Vice Chancellor's actual determinations were less important than his method. He held the analyses up to "the weight of academic thinking at our nation's finest finance departments" as well as recent industry practice to determine the appropriate approach.[15] As *Golden Telecom* illustrates, banks that may find their valuation analyses before a Delaware court would be well-served to establish procedures to ensure both that their methods reflect the latest accepted thinking in the field and that bankers are in a position to explain the nuances of those methods and how and why they were applied. As a result of this trend in the Delaware courts, some of the leading investment banks now routinely consult with academicians in finance regarding recent developments and best practices and have these experts conduct regular continuing education sessions for the bankers that conduct these sorts of analyses.

C. Look Beyond the Market Price, But Tread Carefully if Doing So May Be Construed as Ccontrary to the Shareholders' Interest.

It has long been accepted under Delaware law that a stock market trading price is not the only measure of a corporation's value and that a complete and informed study of value typically requires application of financial valuation analyses.[16] As a result, when advising boards of directors regarding the value of a corporation, investment banks rely not only on market price but also on other measures such as analyses of the present value of projected cash flows (typically referred to as a discounted cash flow analysis), prices and premia paid in similar transactions, the contribution each entity is expected to make to the *pro forma* combined entity with respect to certain financial metrics, the

12. *Id.* at 513-14.
13. *Id.* at 514-18.
14. *Id.* at 518-24.
15. *Id.* at 518.
16. *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989); Weinberger v. UOP, Inc., 457 A.2d 701, 712-13 (Del. 1983).

prices at which comparable companies trade, and the value of the corporation's distinct lines of business when considered separately, either in comparison with the value of comparable companies or the prices or premia paid in transactions involving companies in similar lines of business—so-called "sum of the parts" analyses.[17] In fact, in most cases, it likely would constitute a breach of a board of directors' fiduciary duties if the board did not consider some valuation analyses other than market price in the course of a sale of control.[18]

Chancellor Strine's recent decision in *In re Southern Peru Copper Corp. S'holder Derivative Litig.*,[19] however, counsels caution in slighting market price in favor of other metrics if doing so is not clearly in the shareholders' interest. Because the *Southern Peru* case provides several significant lessons for practitioners, it is worth reviewing its facts in some detail. Grupo Mexico, the controlling stockholder of Southern Peru Copper Corporation with a 54.17% economic interest and 63.08% of the vote, proposed that Southern Peru buy Grupo Mexico's financially troubled subsidiary, Minera Mexico.[20] Grupo Mexico initially proposed that Southern Peru purchase Minera for 72.3 million newly-issued shares of Southern Peru stock.[21] At the time of the proposal, the aggregate value of those shares was $3.05 billion based on the trading price of Southern Peru shares on the New York Stock Exchange.[22] By contrast, Minera was a privately owned company (Grupo Mexico owned over 99% of the equity), and thus there was no market-based measure of its value.[23] Because both Southern Peru and Minera were controlled by Grupo Mexico, the Southern Peru board formed a special committee to evaluate the proposed transaction and hired independent counsel and an independent financial advisor.[24]

Following its initial due diligence, the financial advisor to the Southern Peru special committee generated preliminary valuation analyses for Minera including a discounted cash flow analysis, a contribution analysis, and a sum-of-the-parts analysis.[25] Two sets of projections were used in the preliminary valuation analyses: one set

17. *See* Davidoff, *supra* note 3, at 1574-76 (discussing different types of analyses relied on by investment banks in connection with rendering fairness opinions).

18. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (finding that failure to obtain financial analyses of the corporation's value contributed to the directors' breach of their fiduciary duty of care in connection with a sale of control of the corporation).

19. *In re* S. Peru Copper Corp. S'holder Derivative Litig., 30 A.3d 60 (Del. Ch. 2011).

20. *Id.* at 65.

21. *Id.*

22. *Id.*

23. *Id.*

24. *Id.* at 97.

25. *Id.* at 101-02.

prepared by Minera management, and a second set prepared by the special committee's independent mining consultant that adjusted the Minera management projections downward. Only when using the low end of its range of assumed discount rates, the highest assumption regarding long-term commodity prices, and the unadjusted Minera management projections did the financial advisor get to a $3 billion value for Minera on a discounted cash flow basis.[26] Applying the same assumptions to the adjusted projections yielded a discounted cash flow value of $2.41 billion.[27] Using the discount rate and commodity price at the middle of the assumed ranges and the adjusted projections resulted in a $1.7 billion equity value for Minera.[28] Contribution analyses implied an equity value range for Minera of $1.1 to $1.7 billion, and the sum-of-the-parts analyses implied an equity value range for Minera of $227 million to $1.3 billion.[29]

In this preliminary presentation to the special committee, the financial advisor compared the results of its analyses of Minera to an equity value for Southern Peru of $3.1 billion based solely on the trading price of Southern Peru shares on the New York Stock Exchange.[30] The court focused on this fact, noting:

> The important assumption reflected in [the preliminary] presentation that a bloc of shares of Southern Peru could yield a cash value equal to Southern Peru's actual stock market price and thus worth its market value is worth pausing over. At trial, the defendants disclaimed any reliance upon a claim that Southern Peru's stock market price was not a reliable indication of the cash value that a very large bloc of shares—such as the 67.2 million paid to Grupo Mexico—could yield in the market.[31]

It is not clear from the opinion, however, whether reliance on market price as the primary measure of value of such a large bloc of Southern Peru shares actually was consistent with the financial advisor's reasoning. Moreover, from the recitation of the facts it also is not clear whether, at the time of its preliminary presentation, the financial advisor simply had not yet had the opportunity to perform detailed analyses of the intrinsic value of Southern Peru and as a result whether the market price comparison was primarily for illustrative purposes.[32] In any event,

26. *Id.* at 71.
27. *Id.*
28. *Id.*
29. *Id.* at 71.
30. *Id.* at 75.
31. *Id.* at 71-72.
32. It is worth noting that the case came to trial almost seven years after the announcement of the transaction and that, at that time, the lead banker for the special

the preliminary presentation and market price of Southern Peru stock would be central to the Chancellor's analysis.

Subsequent to its preliminary presentation, the financial advisor performed detailed analyses regarding the value of Southern Peru as is typical in most stock-for-stock transactions. For instance, a discounted cash flow analysis was performed for Southern Peru using Southern Peru management projections and a range of discount rates of 8% to 10%.[33] Based on the mid-range assumptions, this analysis implied an equity value for Southern Peru of $2.06 billion, which was about $1.1 billion less than the value implied by the trading price of Southern Peru shares at the time.[34] Other financial analyses performed were based on "relative" valuations of the two companies. These included a "Relative Discounted Cash Flow" analysis used to derive implied numbers of Southern Peru shares to approximate the value of Minera, a "Multiple Approach at Different EBITDA Scenarios" which the court described as "essentially a comparison of Southern Peru and Minera's market-based equity values as derived from multiples of Southern Peru's . . . estimated . . . EBITDA," and a "Contribution Analysis at Different EBITDA Scenarios"[35] to determine an implied number of Southern Peru shares to be issued based on the relative contributions of Southern Peru and Minera to the *pro forma* combined company.[36]

The court stated that the results of the financial analyses were "basically telling the Special Committee . . . that Southern Peru was being overvalued by the stock market," and that "even though Southern Peru's stock was worth an obtainable amount in cash, it really was not worth that much in fundamental terms."[37] The analyses apparently "comforted" the special committee,[38] but in the eyes of the court, "the more logical reaction of someone not in the confined mindset of directors of a controlled company may have been that it was a good time to capitalize on the market multiple the company was getting and monetize the asset."[39] In other words, the court concluded that, despite Grupo Mexico's controlling stake, the members of the special committee should have considered a sale of Southern Peru or some other alternative

committee was not available to testify. Thus, as the court acknowledged, it did not have a complete picture of the financial advisor's work or the reasoning behind its analyses. *Id.* at 66 n.6.

33. *Id.* at 73.

34. *Id.*

35. "EBITDA" is an acronym for earnings before interest, taxes, depreciation, and amortization.

36. *In Re S. Peru* at 81-82.

37. *Id.* at 73.

38. *Id.*

39. *Id.* at 73.

strategic transaction. The Chancellor noted that the special committee instead "began to devalue the 'give'" of Southern Peru shares in order to make the Minera "'get' look closer in value."[40]

After some mostly ineffective back and forth with Grupo Mexico, the special committee and the board of Southern Peru approved the acquisition of Minera for shares of Southern Peru stock with a value of approximately $3.1 billion based on the New York Stock Exchange trading price at the time of the approval.[41] The court found that the transaction was not entirely fair to the minority shareholders and required Grupo Mexico to pay Southern Peru a rather steep $1.263 billion in damages, which the court determined constituted "a damage award that approximates the difference between the price that the Special Committee would have approved had the Merger been entirely fair (i.e., absent a breach of fiduciary duties) and the price that the Special Committee actually agreed to pay."[42]

In finding that the board breached its fiduciary duties, the court focused on, among other things, the fact that the special committee appeared to ignore Southern Peru's trading price in the course of the negotiations with Grupo Mexico.[43] It is well-accepted, as Chancellor Strine acknowledged, that boards of directors and financial advisors typically must look beyond market prices to determine fair value, and certainly relative valuation analyses are commonly and validly used in evaluating transactions in which equity securities are exchanged, such as in a stock-for-stock merger. But *In re Southern Peru* warns that financial advisors and boards must tread with caution when using valuation techniques to go beyond market price if doing so may be construed as contrary to the shareholders' interest. As Chancellor Strine explained:

> [T]he Special Committee did not respond to its intuition that Southern Peru was overvalued in a way consistent with its fiduciary duties or the way that a third-party buyer would have. As noted, it did not seek to have Grupo Mexico be the buyer. Nor did it say no to Grupo Mexico's proposed deal. What it did was to turn the gold that it held (market-tested Southern Peru stock worth in cash its trading price) into silver (equating itself on a relative basis to a financially strapped, non-market tested selling company), and thereby devalue its own acquisition currency. Put bluntly, a reasonable third-party buyer would only go behind the market if it thought the fundamental values

40. *Id.*
41. *Id.* at 65.
42. *Id.* at 116.
43. *Id.* at 104.

> were on its side, not retreat from a focus on market if such a move disadvantaged it.[44]

It is important, however, to consider what *In re Southern Peru* does not address. The case involved a conflicted board of directors and a special committee that the court found was too deferential to the interests of the controlling shareholder and was not vigorous in guarding the shareholders' interests. The Chancellor was quite straightforward in this regard: "[T]his Special Committee was in the altered state of a controlled mindset. Instead of pushing Grupo Mexico into the range suggested by [the financial advisor]'s analysis of Minera's fundamental value, the Special Committee went backwards to accommodate Grupo Mexico's asking price—an asking price *that never really changed*."[45] This colored the Chancellor's entire approach and should be kept in mind in considering the court's commentary on the financial analyses. *In re Southern Peru* was not a situation where an independent board determined to accept a price lower than market value for the benefit of the shareholders. For instance, this was not a case of projected financial difficulties not fully understood by the market, or of a board acting to obtain synergies or opportunities not otherwise available. Although the case counsels caution and extreme care when a financial advisor and its client look beyond market price to accept a lower value particularly in the entire fairness context, it does not stand for the proposition that such a decision is never appropriate nor does it stand for the proposition that market price is the only relevant measure of value.[46]

44. *Id.* at 105.

45. *Id.* at 102 (emphasis in original).

46. The Delaware courts have recognized that directors must be accorded a significant degree of flexibility in obtaining the highest value reasonably available in a sale of control and that, outside the entire fairness context, the courts will focus on the board's process as opposed to the price at which a transaction is concluded. *See, e.g.*, Wayne Cnty. Emps.' Ret. Sys. v. Corti, No. 3534-CC, 2009 WL 2219260, at *15-16 (Del. Ch. July 24, 2009). Transactions are occasionally concluded at a price below the target's last trading price prior to announcement of the transaction because of financial or operational difficulties or industry or economic conditions not fully reflected in the market price. *See, e.g.*, Brooklyn Federal Bancorp, Inc., Definitive Proxy Statement (Form 14A) at 22 (November 18, 2011); Cascade Financial Corporation, Definitive Proxy Statement (Form 14A) at 28 (April 18, 2011); The Bear Stearns Companies Inc., Definitive Proxy Statement (Form 14A) at 37 (April 28, 2008); *see also* Matthew Karnitschnig, *IPC to Acquire Max Capital*, WALL ST. J., March 2, 2009 at C3 (describing IPC Holdings Ltd.'s acquisition of Max Capital Group, Ltd. for a price below Max Capital's trading price as reflective of "the realities of the current environment"). In the case of a healthy company, another reason a transaction may be effected at a price below the company's last trading price prior to announcement is if the trading price has increased as a result of speculation regarding a potential acquisition of the company. *See, e.g.*, Emergency Medical Services, Definitive Proxy Statement (Form 14A) at 23 (April 22, 2011); Compellent Technologies, Inc., Definitive Proxy Statement (Form 14A) at 22-

D. Be Prepared to Defend Those Comparables.

The Chancery Court judges tend to be extremely comfortable relying on discounted cash flow analyses in entire fairness and appraisal cases. As then Chancellor Chandler put it, "the DCF valuation has featured prominently in this Court because it is the approach that merits the greatest confidence within the financial community."[47] Thus, all things being equal, it is best to bring a discounted cash flow valuation to the party so long as it is an otherwise appropriate analysis under the circumstances.[48]

Alas, often the use of comparable companies and comparable transactions analyses is necessary for a thorough study of value. A banker using these analyses should expect judges and plaintiffs' lawyers to take an extremely critical look, and in particular, the banker should be prepared to explain why the comparables are in fact comparable (and why outliers have been excluded, if that is the case). In one case, Chancellor Chandler noted that the Delaware courts "have expressed reservations when using the [comparables] approach and that 'the burden of proof on the question whether the comparables are truly comparable lies with the party making that assertion.'"[49] He then went on to disregard the comparables analyses because of differences in size, products, and geographies in the comparable companies analysis and because of differences in deal terms in the comparable transactions analysis. In another case, a comparable companies analysis was dismissed because the judge determined that it failed to take into account important differences "including growth prospects, investment strategy, and business mix."[50] The court also dismissed the comparable transactions analysis on similar grounds, noting that the selection of transactions "appeared arbitrary, in that [it] omitted certain transactions

23, 27-28 (January 14, 2011); *see also* Palash R. Ghosh, *Dell's "Take-Under" of Compellent Technologies*, INT'L BUSINESS TIMES, Dec. 17, 2010, http://m.ibtimes.com/dell-s-take-under-of-compellent-technologies-93410.html.

47. *In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2011 WL 227634, at *4 (Del. Ch. Jan. 14, 2011) (quoting Cede & Co. v JRC Acquisition Corp., No. 18648-NC, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004)).

48. There are circumstances in which a discounted cash flow analysis is not useful. For instance, the Delaware courts have recognized that a discounted cash flow analysis is inappropriate in a circumstance in which reasonable projections of future cash flow are not available. *See* Globis Partners, L.P. v. Plumtree Software, Inc., No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007).

49. *In re* Sunbelt Beverage Corp. S'holder Litig., No. 16089–CC, 2010 WL 26539, at *9 (Del. Ch. Jan. 5, 2010) (quoting ONTI, Inc. v Integra Bank, 751 A.2d 904, 916 (Del. Ch. 1999)).

50. *In re John Q. Hammons*, 2011 WL 227634, at *5.

with characteristics similar to those . . . ultimately selected."[51] Because there always will be differences between the subject company and transaction and the companies and transactions used as bases for comparison, bankers must have a solid, explainable foundation for the choice of companies and transactions included (and excluded) from the analyses.

E. Be Prepared to Defend the Use or Failure to Use, as well as Any Adjustments Made To, Management Projections.

Although, as a fairness opinion invariably says, the financial advisor does not prepare the projections and relies on management's assurances regarding their reasonableness, it is important for the financial advisor to be able to articulate sound reasoning supporting its approach to projections that are used (or ignored).

For instance, management projections should not be lightly discarded. In *S. Muoio & Co. v. Hallmark Entertainment*, the Chancery Court considered the recapitalization of a struggling company by its controlling shareholder and primary debt holder.[52] After bargaining with a special committee of directors, the controlling shareholder agreed to exchange the debt it held for additional shares of common stock, a new issue of preferred stock, and a lower amount of debt with longer maturities, which the court noted permitted the company to avoid default and bankruptcy.[53] Shareholders sued claiming the recapitalization undervalued the company and resulted in an unjustified transfer of wealth from the minority shareholders to the controlling shareholder.[54] In support of its case, the plaintiffs presented the testimony of a valuation expert who dismissed management's projections and instead used his own set of significantly more optimistic projections.[55] In the course of finding for the controlling shareholder and the directors, the court disregarded the testimony of plaintiffs' valuation expert in part because of his failure to use management's projections.[56] The court emphasized that management's recent, reasonable, non-litigation biased projections, if available, are the best foundation for valuation analyses, and any departure from such projections must rest on solid reasoning.[57]

51. *Id.*
52. S. Muoio & Co. v. Hallmark Entm't Inv. Co., No. 4729–CC, 2011 WL 863007 (Del. Ch. Mar. 9, 2011).
53. *Id.* at *1.
54. *Id.*
55. *Id.* at *17-19.
56. *Id.* at *19-20.
57. *Id. But see In re* Orchid Cellmark Inc. S'holder Litig., No. 6373-VCN, 2011 WL 1938253 (Del. Ch. May 12, 2011) (endorsing the refusal of an independent board and

Accordingly, any dismissal of management's projections in favor of other estimates should only follow careful consideration by the financial advisor.

Of course, a banker should not rely blindly on projections just because they were produced in the executive suite, and it may in fact be appropriate to dismiss or adjust the projections. For instance, valuation analyses have been disregarded by the Chancery Court if the underlying management projections were not created in the ordinary course of business and the evidence demonstrates that they were not based on reasonable assumptions.[58] If the projections are for the most part acceptable, but adjustments are necessary, financial advisors should expect that such adjustments will be closely scrutinized. For instance, in *In re Southern Peru*, the court criticized the special committee for adjustments made to Minera's projections that effectively "optimized" Minera's cash flows.[59] The court concluded that those adjustments were unrealistic given Minera's historically poor performance and continuing financial difficulties.[60] In addition, because similar adjustments were not made with respect to estimates for Southern Peru, the court concluded that the analyses that employed these estimates did not provide sound bases for comparison of the relative values of the companies.[61] In any event, although not responsible for the projections, it is advisable for a financial advisor to do its due diligence to be comfortable that its analyses rest on a supportable foundation. If adjustments are deemed necessary, it is best for management or the board of directors to determine the necessary adjustments. If that is not possible, the bank should obtain the board's approval of any adjustments it has made and describe such adjustments in its board presentation materials.

F. Beware the Company-Specific Risk Premium.

Applying a company-specific risk premium in a discounted cash flow analysis to increase the applicable discount rate—and thereby decrease the resulting implied valuation—can be hazardous. In *In re Sunbelt Beverage Corp. S'holder Litig.*, a minority shareholder

financial advisor to use more optimistic projections prepared by the CFO, and endorsed by the CEO, of the subject company where the officers held options that were out of the money at the deal price supported by the lower projections that were used).

58. *In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2011 WL 227634, at *4-5 (Del. Ch. Jan. 14, 2011). *See also In re Orchid Cellmark*, 2011 WL 1938253, at *6.

59. *In re* S. Peru Copper Corp. S'holder Derivative Litig., 30 A.3d 60, 102 (Del. Ch. 2011).

60. *Id.* at 103.

61. *Id.* at 102-04.

challenged the price paid for her shares in a transaction orchestrated by the majority holder as a breach of the board of director's fiduciary duties and in the alternative sought appraisal of her shares.[62] Balancing the equities, the court determined that appraisal was the appropriate remedy and turned to the various valuation analyses presented by the parties.[63] The court relied on the discounted cash flow valuation analysis presented by the plaintiff in part because it considered the company-specific risk premium applied by the defendants inappropriate.[64]

In this regard, Chancellor Chandler noted that although the application of a small-firm risk premium often is warranted,[65] there is "baseline skepticism" towards any company-specific risk premium.[66] He explained that "to judges, the company-specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick."[67] Accordingly, proponents bear the burden of proof in justifying the use of such a premium based on company-specific facts. In *Sunbelt*, the court rejected the defendants' proposed company-specific risk premium in part because certain of the justifications advanced applied to the industry as a whole, not solely to the subject company.[68] The court also rejected the argument that overly optimistic management projections justified use of a company-specific risk premium.[69] Chancellor Chandler stated that he did not believe "a company should be able to manufacture justification for a company-specific risk premium (and all the quantitative uncertainty accompanied therewith) simply by adjusting its management projections such that there is a heightened risk in relying on those projections. . . ."[70]

G. All Will Be Viewed in Context.

It seems obvious, but in light of the case law, it apparently bears repeating—common sense should be applied. Although an analysis may be theoretically sound, bankers must be mindful of context. Valuation analyses will be subject to review in light of the economic realities facing the company and the results of other valuation methods used. For

62. *In re* Sunbelt Beverage Corp. S'holder Litig., No. 16089-CC, 2010 WL 26539, at *1 (Del. Ch. Jan. 5, 2010).
63. *Id.* at *6.
64. *Id.* at *13.
65. *Id.* at *11.
66. *Id.* at *12.
67. *Id.* (quoting Delaware Open MRI Radiology Assoc., P.A. v. Kessler, 898 A.3d 290, 339 (Del. Ch. 2006)).
68. *Id.* at *13.
69. *Id*.
70. *Id*.

instance, in *In re John Q. Hammons*, the court dismissed a high valuation because it was clearly at odds with the fact that the company was teetering on the edge of bankruptcy and that an auction had not produced any interest from potential bidders that supported the valuation analysis.[71] Similarly, in *In re Southern Peru*, the court criticized the special committee's application of Southern Peru's EBITDA multiples to Minera because Southern Peru was a healthy, publicly traded company while Minera was a private company beset with financial and operational difficulties.[72] The court also noted that such multiples were contrary to the conditions prevailing in the industry.[73]

If a banker plans to rely on one valuation analysis that has yielded results significantly different than those produced by other analyses, it should be prepared to defend that choice against vigorous scrutiny. Similarly, if a banker plans to rely primarily on one valuation analysis, it is ideal to conduct other analyses or provide other data, such as historical trading data, that support the primary analysis if at all possible. For instance, in rejecting plaintiffs' claims in *S. Muoio* that the recapitalization led by the controlling shareholder and primary debt holder was unfair to the minority shareholders, Chancellor Chandler noted:

> In this case, [plaintiffs' expert's] single methodology valuation of [the company] is roughly three times higher than any of the other valuations. The more robust approaches taken by defendants' experts and advisors, however, used multiple valuation methodologies and independently reached results that fell within the same range. Although there certainly may be circumstances where using only one valuation methodology is appropriate and reliable, this is not such a circumstance.[74]

Of course, as Chancellor Chandler has acknowledged in *S. Muoio* and other cases, sometimes only a single type of analysis is useful, and in such instances, the banker should be prepared to explain why in significant detail.[75]

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71. *See In re* John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2011 WL 227634, at *5, *13 (Del. Ch. Jan. 14, 2011).
72. *In re* S. Peru Copper Corp. S'holder Derivative Litig., 30 A.3d 60, 104 (Del. Ch. 2011).
73. *Id.* at 110-11.
74. S. Muoio & Co. v. Hallmark Entm't, No. 4729-CC, 2011 WL 863007, at *17 (Del. Ch. Mar. 9, 2011).
75. *In re John Q. Hammons*, 2011 WL 227634, at *4-5.

III. NUMBERS IN PROSE: DISCLOSURE CASES

A. The Good News Is that Disclosure Cases Turn on the Description of the Financial Advisor's Analyses in the Disclosure Document Sent to the Shareholders, Not on the Substance of the Work.

The Delaware courts have been clear that shareholder plaintiffs cannot attack the substance of a financial advisor's analysis in the guise of a disclosure claim. Plaintiffs often attempt to use this tactic because a disclosure claim generally is easier to establish than a claim based on the substance of the advisor's work, which would require a showing that the analysis contributed to a breach of fiduciary duty by the board.

The only relevant issue in a disclosure claim is whether the methods used by the bank are accurately described in all material respects so that, if a shareholder disagrees with the approach, he or she can vote against the transaction and exercise appraisal rights. For instance, shareholder plaintiffs brought suit challenging Hewlett Packard Company's acquisition of 3Com Corporation arguing in part that the proxy submitted to the 3Com shareholders in connection with the shareholder vote on the acquisition "fail[ed] to disclose why [3Com's financial advisor] deviated from accepted practices in its valuation methodology."[76] Among other things, the plaintiffs focused on the financial advisor's treatment of stock-based compensation as a cash expense in its discounted cash flow analysis. The court rejected this claim:

> Under Delaware law, the valuation work performed by an investment banker must be accurately described and appropriately qualified. So long as that is done, there is no need to disclose any discrepancy between the financial advisor's methodology and the Delaware fair value standard under Section 262 (or any other standard for that matter). If shareholders believe the financial advisor undervalued the company after reading a summary of its work, they are free to exercise their appraisal rights under Section 262. Indeed, an appraisal action addresses this concern by subjecting the financial advisor's fairness opinion to scrutiny. Valuing a company as a going concern is a subjective and uncertain enterprise. There are limitless opportunities for disagreement on the appropriate valuation methodologies to employ, as well as the appropriate inputs to deploy within those methodologies. *Considering this reality, quibbles with a*

76. *In re* 3com Shareholders Litigation, No. 5067-CC, 2009 WL 5173804, at *2 (Del. Ch. Dec. 18, 2009).

> *financial advisor's work simply cannot be the basis of a disclosure claim.*[77]

B. *The Bad News Is That, If the Disclosure Regarding the Financial Advisor's Analyses is Misleading or Inadequate, the Transaction May Be Enjoined.*

Given the importance of the financial advisor's work to the board of directors and shareholder decision making processes,[78] an error in the description of the analyses in a disclosure document may be deemed material and result in an injunction of the shareholder vote while corrective disclosures are made so that the shareholders have all material information relating to their decision.[79] Accordingly, counsel should work closely with the financial advisor to make sure the description accurately reflects all the material aspects of the financial advisor's analyses and presentation.[80]

The recent *Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*[81] case illustrates some of the hazards that arise in this process. There, shareholders moved to enjoin the acquisition of PLATO Learning, Inc. by Thoma Bravo, LLC as a result of inadequate disclosure.[82] In its description of the analyses performed by the financial advisor to the PLATO Learning board of directors, the proxy statement noted that the range of discount rates used by the target's financial advisor in its discounted cash flow analysis was based on "an analysis" of the target's weighted average cost of capital (or WACC).[83] However, the actual WACC analysis performed by the advisor yielded results that were lower

77. *Id.* at *6 (emphasis added) (citation omitted); *see also* Globis Partners, L.P. v. Plumtree Software, Inc., No. 1577-VCP, 2007 WL 4292024, at *11 (Del. Ch. Nov. 30 2007).

78. *See* Simonetti Rollover IRA v. Margolis, No. 3694-VCN, 2008 WL 5048692, at *8 (Del. Ch. June 27, 2008) ("The financial advisor's opinion of financial fairness for a proposed transaction is one of the most important process-based underpinnings of a board's recommendation of a transaction to its stockholders and, in turn, for the stockholders' decisions on the appropriateness of the transaction.").

79. Such a delay may put a transaction in jeopardy as events may occur (e.g., a significant disruption to the business that constitutes a "Material Adverse Effect" as defined in the transaction agreement) that result in a failure of one of the conditions to the transaction to be satisfied.

80. In practice, counsel to the financial advisor typically is charged in the first instance with summarizing the financial advisor's presentation to the target's board of directors for inclusion in the disclosure document submitted to shareholders in connection with a transaction. Ultimate responsibility for such disclosure, however, rests with the subject company, and its counsel typically reviews such disclosure closely.

81. Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc., 11 A.3d 1175 (Del. Ch. 2010).

82. *Id.* at 1175-76.

83. *Id.* at 1176.

than the bottom end of the range of discount rates used in the presentation materials submitted to the board of directors and disclosed in the proxy statement.[84] In other words, a higher discount rate was used in the discounted cash flow analysis and accordingly, the implied value of PLATO Learning was lower than it otherwise would have been had the advisor used the actual WACC range it had calculated.[85] Neither the board book nor the proxy explained the difference between the results of the actual WACC "analysis" and the range of discount rates used.[86] The court concluded this was a material error that justified enjoining the vote on the transaction until corrective disclosures were made.[87] To avoid such a fate (and the concomitant embarrassment), the description of the financial advisor's analysis must accurately reflect the work done by the financial advisor, including those subtleties that may prove material to a shareholder.[88] In addition, any deviation from actual calculations should have a reasonable basis, and if material, should be explained in both the board book and the shareholder disclosure document.[89]

C. A Financial Advisor Should Assume that Any Company Projections Used in its Analyses Will Be Disclosed to Shareholders.

The Delaware case law regarding disclosure of projections to shareholders is somewhat muddled.[90] In general, however, a financial advisor should expect that a summary of any projections received from the target and used by the financial advisor in its analyses will be disclosed. In particular, the Chancery Court recently clarified that if the financial advisor relies on a discounted cash flow analysis, any free cash

84. *Id.*
85. *See id.*
86. *Id.* at 1176-77.
87. *Id.* at 1176.
88. *See id.* at 1177-78.
89. *See id.*
90. *Compare In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 203 (Del. Ch. 2007) (requiring disclosure in merger proxy statement of adjusted management projections used in financial advisor's analysis), *with In re* Checkfree Corp. S'holders Litig., No. 3193-CC, 2007 WL 3262188, at *3 (Del. Ch. Nov. 1, 2007) (holding that disclosure of management projections not required if proxy statement otherwise includes a fair summary of the substantive work performed by the financial advisor). For another helpful analysis, see Jacob M. Mattinson, Comment, *Disclosure of Free Cash Flow Projections in a Merger or Tender Offer,* 116 PENN ST. L. REV. 577 (2011) (comparing Delaware case law on disclosure of projections used by financial advisor and proposing general rule that there be a rebuttable presumption that disclosure of such projections is required).

flow projections provided to the financial advisor by the company must be disclosed.[91]

Ideally, there will be one set of target projections that are prepared by management in a pre-transaction, unbiased context and are then used for all purposes in the transaction as opposed to having multiple, and perhaps contradictory, sets of projections that may turn up in the course of litigation. It is, of course, preferable that the projections process be managed to that end; however, the role of the financial advisor is limited in this regard. Projections are management's responsibility, and although the financial advisor can review projections and provide advice to management, the preparation and substance of the projections is ultimately the decision of the company. If there are multiple sets of projections, the financial advisor should have a sound basis for why it relied on one set and not the other. In addition, if in the course of its analysis the financial advisor makes adjustments or assumptions that result in differences between the projections used in its analysis and those included in the disclosure document distributed to shareholders, the financial advisor should consider describing such adjustments and the reasoning behind them in its materials for the board and in the description of its analyses disseminated to shareholders.

D. Should Disclosure Be Managed in Anticipation of Litigation and Potential Settlement?

Many lawsuits challenging transactions are settled by agreeing to modifications in the disclosure document distributed to shareholders without the payment of money damages. Given the prevalence of transaction-related litigation and the importance of the financial advisor's analyses in many such suits, one question that arises when preparing the shareholder disclosure document is whether disclosure regarding the financial advisor's analyses should be managed in the expectation that additions may be used to settle an expected lawsuit. This is a path fraught with risk, and the Chancery Court judges are aware that there is significant temptation to travel down it. Recently, Vice Chancellor Laster has noted that judges will cast an extremely wary eye on disclosure documents that omit disclosure that the Delaware case law

91. *See Maric Capital*, 11 A.3d at 1176**.** *But see* Steamfitters Local Union 447 v. Walter, No. 5492-CC, slip op. at 8-10 (Del. Ch. June 21, 2010) (holding that disclosure of projections actually provided to, and used by, financial advisor is sufficient; no disclosure of free cash flow estimates required where none were actually provided to financial advisor).

clearly requires.[92] Banks and transaction parties thus are well advised to tread carefully when considering this issue.

IV. CONCLUSION

Counsel to the financial advisor as well as counsel to the principals in a merger and acquisition transaction should heed the admonitions of these recent cases. Care and consistency in preparing valuation analyses, and in describing them adequately to shareholders, are essential to the smooth effectuation of transactions. The lessons thus learned can avoid costly challenges to the price paid in a transaction, injunctions delaying the consummation of the transaction (and exposing the transaction to continued deal risk in the interim) and the embarrassment of a published opinion from a sophisticated judge who is critical of the methodologies employed and who speculates as to the motivations underlying the challenged conduct.

92. *See* Transcript of Ruling of the Court on Defendants' Motion to Proceed in One Jurisdiction and Dismiss or Stay Litigation in Other Jurisdictions at 12-13, Kahn v. Chell (Del. Ch. June 7, 2011) (No. 6511-VCL).