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Selected Summaries of 2011 Decisions

Delaware Court of Chancery, Selected Business Valuation Case Summaries

Introduction

The Delaware Court of Chancery is widely recognized as one of the nation's leading business courts in terms of volume of 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 valuation and damages. In this survey we focus on six opinions from 2011 to highlight how certain valuation and damages analysis topics are viewed by the Court. We chose these six opinions based on the valuation themes they represent and depth of analysis contained in the Court's opinions. In our review 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 obtain a complete understanding of all the issues addressed and each judge's position. We have included the URL for your convenience: http://www.courts.delaware.gov

The cases we have summarized include the following:

In Re John Q. Hammons Hotels Inc. Shareholder Litigation
Chancellor Chandler
Issues: DCF projections, market approach, entire fairness

Ginette Reis v. Hazelett Strip-Casting Corporation, et. al.
Vice Chancellor Laster
Issues: capitalization of earnings, book value method, normalization adjustments

S. Muoio & Co., LLC, v. Hallmark Entertainment
Chancellor Chandler
Issues: recapitalization, triangulating approaches

In Re Answers Corporation Shareholders Litigation
Vice Chancellor Noble
Issues: unique subject company, lack of projections, liquidity discount

In Re Massey Energy Company Derivative and Class Action Litigation
Vice Chancellor Strine
Issues: non-operating assets (litigation claims)

In Re Southern Peru Copper Corporation Shareholder Derivative Litigation
Chancellor Strine
Issues: relative value analysis, entire fairness

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In Re John Q. Hammons Hotels Inc. Shareholder Litigation, Civil Action No. 758-CC (Del. Ch., January 14, 2011)

Click here to view the opinion.

In 2005, John Q. Hammons Hotels ("JQH" or the "Company") merged with an entity owned by Jonathan Elian. Class A shareholders in JQH ("Plaintiffs") received $24 per share in cash. Plaintiffs alleged that: (1) John Q. Hammons "Hammons" used his position as controlling shareholder to negotiate certain private benefits, and (2) the fair value of Class A shares was greater than $24 per share. This summary focuses on the Court's fair price analysis regarding the consideration received by Class A shareholders.

The Court ruled in favor of the Defendants on the issue of entire fairness, based on the facts of the case and the credibility of the expert testimony. The relevant case facts included: (1) the opinion of the financial advisor, Lehman Brothers, that the transaction was fair (an opinion that was not challenged by the Plaintiffs expert); (2) the fact that the acquisition price represented a third party purchase at the end of a 9-month competitive bidding process; and (3) the "overwhelming" approval of the deal by Class A shareholders. Critical factors in rejecting the Plaintiffs experts report were: (1) reliance on overly optimistic assumptions in the discounted cash flow analysis; (2) inconsistent application of market comparables and market comparable transactions analyses; and (3) failure to address the value of the consideration received by Hammons.

The Plaintiffs expert employed a discounted cash flow analysis, a comparable company analysis, and a comparable transactions analysis to determine that the Class A shares were worth $49 per share. The Plaintiffs expert's DCF analysis was based on management projections, however, the Court found that the expert performed no "independent analysis of the assumptions underlying management's projections". The Court found that the management projections were "not prepared in the ordinary course of business", and based on "numerous overly optimistic projections." The management projections also failed to account for the sale of three properties by JQH after the projections were prepared. The Court found that the Plaintiffs expert's terminal value analysis was flawed because it extrapolated "overly-optimistic" 2010 projections, resulting in a growth estimate that was overly-optimistic. The Court also found that the Plaintiffs expert's terminal value was inconsistent with the proper application of the Gordon Growth model because it assumed an "erratic pattern of growth" based on assumptions that were "fabricated" by the expert. In addition, the Court found that the Plaintiffs expert did not address the issues of industry competitiveness and competitive advantages in his analysis and his report was therefore "significantly impaired."

The Court found that the Plaintiffs expert's comparable company analysis was not a reliable indicator of value because the companies selected differed from JQH in terms of growth prospects, investment strategy, leverage, and corporate structure. In a comparable transaction analysis, the Plaintiffs expert was faulted for omitting certain comparable transactions that had the same characteristics as the ones selected, making his selection process appear "arbitrary." His selection of five transactions was "too small a sample set in the circumstances…to draw a meaningful conclusion."

The Defendant expert also used a discounted cash flow analysis, but came to a different conclusion, estimating that the Class A shares were worth between $14.97 and $18.71. The Defendant expert's valuation analysis was based on a DCF model based on "management-approved" projections, and used a convergence model to calculate the terminal value. The convergence model employs the idea that companies in competitive industries with no competitive advantages will exhaust value creating opportunities over a discrete forecast period. Beyond that point, growth will be value neutral. The Defendant expert also valued the company using a capital cash flow approach, which the Court found appropriate for valuing companies

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like JQH where the leverage ratios are expected to change over time. The Defendant expert determined that the comparable company analysis was not reliable because of a lack of sufficiently comparable companies. The Court determined that JQH did not have significant competitive advantages, such as a brand name or technology, and that the hotel business was highly competitive, especially in the markets in which JQH operated. The Court ultimately determined that the Defendant expert analysis was more credible and persuasive.

Ginette Reis v. Hazelett Strip-Casting Corporation, et. al., C.A. No. 3552-VCL (Del. Ch., January 21, 2011)

Click here to view the opinion.

The case involves the valuation of minority shares in Hazelett Strip-Casting Corporation ("Hazelett") a family-owned strip-casting business. The majority shareholder had executed a reverse stock split in order to squeeze out 169 minority shareholders who had received shares in the business upon the passing of a family member.

The Plaintiffs expert estimated the fair value of Hazelett's equity to be $6.3 million based on the capitalization of free cash flow and comparable company method. The Defendants expert estimated the fair value of Hazelett's equity to be $1.7 million, based on the capitalization of earnings method. The Court concluded on a fair value of $4.6 million based on a weighting of the capitalization of earnings (adjusted by the Court) and book value methods.

The Court rejected the Plantiffs analysis in part because it used an average of only two years to estimate free cash flow; the Court instead focused on the Defendant expert's capitalization of earnings method that used an average of five years of earnings. The Court also supported its use of the capitalization of earnings method by stating that it is an "indisputably valid method," and citing it as a component of the Delaware Block Method. The Court adjusted the Defendant expert's measure of earnings, however, to account for "controller self-dealing" and other normalization adjustments. That is, the Court reviewed various components of earnings to consider whether they should be excluded from the calculation of earnings for purposes of applying the capitalization of earnings.

The components that the Court reviewed included: (1) adjustments to R&D expenses such that they were more consistent with industry norms, (2) deducting revenue generated from non-recurring disposals and sales of assets, and (3) adjustments for ways in which Hazelett appeared to have generated tax-advantaged returns for controlling shareholders, including (a) increased compensation, (b) self-leasing of assets, and (c) activities that appeared to only serve the recreational interests of the controlling shareholders.

The Court rejected the adjustments to R&D expense, with the rationale that the adjustments would result in a value reflective of a third-party sale, rather than a going concern. The Court did adopt the adjustments related to non-recurring revenue generated by disposals and sales of assets, indicating that these were "standard and appropriate." The Court was inclined to make adjustments associated with methods in which tax-advantaged returns were generated by Hazelett except for the fact that the Plaintiff did not seek a normalizing adjustment for two of the methods: increased compensation or self-leasing of assets. The one area on which the Plaintiff focused was the Marine Division and Beach and Boat Motel operated by Hazelett; the Plaintiff argued this was unrelated to the company's manufacturing operations and provided a way to enjoy recreational opportunities. The Court agreed, and removed expenses associated with the Marine Division. However, the Beach and Boat Motel, which historically operated at a modest profit, was not removed from earnings. Vice Chancellor Laster stated that "this outcome forces the controller to bear the downside risk of his self-interested investment decision."

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In determining a capitalization rate to apply to earnings the Court did not use a P/E ratio, concluding that there were no publicly traded peer companies sufficiently comparable. The Court instead determined a discount rate (cost of equity), subtracted an anticipated growth rate, and used the inverse as the capitalization factor. In calculating the cost of equity, both parties used a version of the build-up method. The Court adopted the Defendant expert's build-up method, but used the company specific risk premium of 2 percent employed by the Plaintiff expert, as compared to the 6 percent employed by the Defendants expert, citing the "dangers inherent in overestimating the company-specific risk premium."

Finally, the Court included the addition of two non-operating assets to the total value: (1) the appraised value of certain real estate (unadjusted for selling costs or capital gains taxes), and (2) the estimated fair value of net operating losses ("NOLs") calculated by the Plaintiff expert.

As discussed above, in addition to the capitalization of earnings method, the Court used the book value of Hazelett as an indication of fair value. Ultimately the Court's concluded value of $4.6 million was based on an 80 percent weight for the capitalization of earnings method and a 20 percent weight for the book value.

S. Muoio & Co., LLC, v. Hallmark Entertainment, Civil Action No.4729-CC (Del. Ch. March 9, 2011)

Click here to view the opinion.

The case is a shareholder derivative suit stemming from the June 29, 2010 recapitalization of Crown Media Holdings, Inc. ("Crown") by its controlling stockholder and primary debt holder, Hallmark Cards, Inc. and its affiliates (collectively, "Hallmark"). In the recapitalization, Hallmark exchanged its Crown debt for additional common stock, new preferred stock and a new and far smaller amount of debt with longer maturities, thereby permitting Crown to avoid a debt default and bankruptcy. Hallmark's ownership interest increased from roughly 80 percent to 90 percent as a result of the recapitalization.

Crown had been unable to pay certain debts for a number of years, and ultimately Hallmark, its primary debt holder, refused to extend the debt any further. By 2006 Crown's debt was roughly $1 billion, and without Hallmark's extension of the terms, Crown sought a buyer for the business. However, Crown was unable to find a buyer willing to pay enough to cover the debt. Unable to meet its debt service obligation to Hallmark, in May, 2009, Crown's board received a recapitalization proposal from Hallmark. After a series of renegotiations, the recapitalization proposal was approved on June 29, 2010.

The shareholders challenged the fairness of the recapitalization proposal and claimed that the transaction "drastically undervalued Crown." The Court applied the entire fairness standard, and upon concluding that the process under which the recapitalization occurred was fair, Chancellor Chandler turned to issues of fair price.

At the outset, Chancellor Chandler found that without the recapitalization, Crown was "facing insolvency and its equity was worthless," given that Crown was saddled with debt that it was unable to repay absent some type of forbearance by Hallmark. With that backdrop, the Court found it significant that Hallmark's recapitalization proposal provided some upside to Crown's shareholders. Thus, the Court found that Hallmark's recapitalization proposal provided potential value to Crown's shareholders where there had been none, driving the Court's conclusion that the recapitalization was fair.

Both the Plaintiff shareholders and Hallmark presented expert testimony regarding the valuation of Crown in the recapitalization. The Plaintiff expert utilized three valuation methodologies: discounted cash flow ("DCF") analysis (valuing Crown at $2.95 billion);

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comparable companies analysis (valuing Crown at $803 million); and comparable transaction analysis (valuing Crown at $1.3 billion). The Plaintiff expert relied exclusively on his DCF analysis, to the exclusion of the other two methodologies, for the sole reason that these latter results were "absurdly low."

The Court rejected the Plaintiffs expert analysis and found the recapitalization to be fair. The Court did not find the Plaintiff expert to be credible because: (1) the Plaintiff expert relied exclusively on a discounted cash flow (DCF) analysis, which yielded a value nearly three times that of any of the other valuations (including valuations made by potential third-party buyers); and (2) the assumptions underlying the DCF were flawed. While the Court notes that there are cases where the exclusive use of one valuation methodology is appropriate, it concludes that Crown is not such a case. Here, the Court found that "more robust" approaches taken by the Defendant expert, who used multiple valuation methodologies and independently reached results that fell within the same range, were therefore more reliable than Plaintiff expert's one outlying conclusion of value.

The Court found the primary flaw in the Plaintiff expert's DCF assumptions to be his disregard of management's contemporaneous projections. First, the Plaintiff expert used his own, hypothetical and more optimistic projections, and then extended those projections to 2024, while Crown's management considered it problematic to project out more than five years. Plaintiff expert dismissed management's projections and used his own without consulting management, while the Court found that management's projections were "carefully crafted and reasonable." The Court noted that it has consistently recognized the importance of management's contemporaneous projections because the outcome of a DCF analysis depends heavily on the projections used in the model. The Court also stated that while the DCF valuation methodology merits "the greatest confidence within the financial community," it is preferable to take a more robust approach involving multiple techniques to triangulate a value range, as individual methodologies have their own limitations.

In Re: Answers Corporation Shareholders Litigation, Consolidated C.A. No. 6170-VCN (Del. Ch. April 11, 2011)

Click here to view the opinion.

In the Answers Corp. ("Answers") decision, Vice Chancellor Noble denied a preliminary injunction to prevent the consummation of a proposed merger between Answers and AFCV. Certain shareholders of Answers contended that the proposed transaction was the result of an unfair sales process and characterized by an unfair price. This summary addresses the Court's consideration as to whether the proposed price was unfair.

AFCV approached Answers concerning the possibility of a business combination. The two parties discussed a transaction. AFCV ultimately sent a non-binding letter of intent to Answers indicating an interest in acquiring Answers for between $7.50 and $8.25 per share (Answers stock had been trading below $5.00 per share a month prior). This bid was rejected and negotiations continued. After a number of exchanges, and expressions of interest from another party, AFCV ultimately increased its bid to $10.50 per share. Answers agreed to the deal after receiving a fairness opinion from its financial advisors that the offer was a fair price.

The Plaintiffs argued that the fairness opinion was flawed for several reasons including: (1) it did not use a discounted cash flow approach, and (2) the companies used in the comparable company analysis were not comparable to Answers. In defense of its decision not to use a discounted cash flow, the provider of the fairness opinion testified that "[I]t's fairly unusual, particularly for a public company to have such challenging fundamentals in their business that they have an inability to forecast financial performance beyond the next fiscal year, but there

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were clearly some unique characteristics of this business, in particular its dependence on Google that made it an understandable issue from our perspective." Answers derived over 75 percent of its revenue from traffic that came from Google, and as disclosed in its SEC filings, Answers had no control over the programs and algorithms used by Google to place ads on Answers' website, and changes to these programs and algorithms in the past have had a material adverse effect on the revenue that Answers earns through Google. This contributed to the inability to make long-term financial projections for Answers, preventing the development of a discounted cash flow analysis.

As it relates to comparable companies, the provider of the fairness opinion testified that "Answers doesn't have any pure comparables because their business is somewhat unique." The Court found that the Board acted reasonably in relying on the fairness opinion analysis which was "sensibly crafted given the limited universe of information available and the unique characteristics of the Company." In support of its decision, the Court noted that the Plaintiffs expert "even recognized that reasonable minds could differ as to the methodologies and comparables."

In addition to arguing about valuation methodologies, the Plaintiffs expert also raised a concern that, because Answers was thinly traded, any premium on the market price of the stock should be regarded skeptically. The Court considered this argument, and determined that even considering the liquidity discount associated with thinly traded stock the offer price still represented a premium for Answers' shareholders.

In Re Massey Energy Company Derivative and Class Action Litigation, C.A. No. 5430-VCS (Del. Ch., May 31, 2011)

Click here to view the opinion.

The issue facing Vice Chancellor Strine in Massey was whether or not to approve a preliminary injunction against the merger agreement between Massey Energy Company ("Massey"), a mining corporation, and its acquirer, Alpha Natural Resources, Inc. ("Alpha"). Stockholders of Massey ("Plaintiffs") sought the preliminary injunction charging that the purchase price agreed to by Massey's Board of Directors with Alpha did not appropriately take into account the independent value of Derivative Claims against former fiduciaries of Massey; Plaintiffs expert valued these assets at approximately $1 billion. Vice Chancellor Strine did not find in favor of Plaintiffs and denied the motion for preliminary injunction.

After a series of regulatory and safety violations at Massey mines, the company suffered a massive explosion on April 5, 2010 at the Upper Big Branch mine in West Virginia, where 29 miners died. As a result, Massey stock declined significantly and the Board pursued various strategies, including a sale of the business. On January 27, 2011, Massey's Board approved a merger with Alpha, with a purchase price of $69.33 per share. Based on Alpha's closing price on January 26, 2011, the purchase price represented a 25% premium to Massey's stock price. Plaintiffs claim, however, that the merger price did not take into account the value of the Derivative Claims arising from the West Virginia explosion, which should have been a significant asset considered in the purchase price valuation. Further, the Plaintiffs claimed that the Massey Board rushed into the transaction in order to insulate them from potential litigation.

As part of the transaction, Massey's Board hired an independent financial advisor, who concluded based on a discounted cash flow analysis that the bids offered for the purchase of Massey exceeded the upper reaches of the stock price for Massey on a stand-alone basis. Concurrently Massey's management provided higher valuations of the Company than the financial advisor. However, the advisor and Board found that management's estimates of Massey's value were overly optimistic based on the fact that other comparable companies

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were not in the same situation as Massey, particularly as it related to the recent explosion and violations of regulatory and safety violations.

Vice Chancellor Strine concluded that the Derivative Claims were not a material asset in the overall valuation of Massey and that it was not necessary to have them independently valued. Although Plaintiffs expert calculated a value of between $900 million and $1.4 billion for the Derivative Claims, the Court stated that this value reflected the aggregate negative financial effect on Massey resulting from the disaster, not the value of any claims resulting from that disaster. The Court noted that the difference between the aggregative negative financial effect and the recovery of claims is likely very large.

Vice Chancellor Strine found that while the Derivitive Claims might survive a motion to dismiss when ultimately pled, he concluded that the Board and its advisors appear to have exercised reasonable good faith efforts to obtain as favorable a value for Massey as possible. The Board had considered a stand-alone plan, but due to Massey's tarnished reputation and history of missing management's projections, they determined that pursuing a stand-alone plan would not be in the best interests of the company.

Moreover, in denying the motion for injunctive relief, Vice Chancellor Strine noted that any objection to the merger by Plaintiffs could be expressed through a shareholder vote on whether or not to approve the transaction.

In Re Southern Peru Copper Corporation Shareholder Derivative Litigation, C.A. No. 961-CS (Del. Ch., Oct. 14, 2011)

Click here to view the opinion.

The matter concerned a transaction where Southern Peru Copper Corporation ("Southern Peru") acquired a company owned by Southern Peru's majority shareholder. Chancellor Strine concluded that Southern Peru overpaid for the company, applying the entire fairness standard, and awarded $1.263 billion in damages to Plaintiffs – one of the largest awards in the history of the Delaware Court of Chancery. This extraordinary damages amount was calculated as the amount overpaid by Southern Peru in its purchase of Minera Mexico, S.A. de C.V. ("Minera") from Grupo Mexico, S.A.B. de C.V. ("Grupo Mexico" or the "Defendant").

In February 2004, Grupo Mexico proposed that Southern Peru purchase its 99.15 percent stake in Minera in exchange for Southern Peru's stock valued at approximately $3.1 billion (the "Merger"). As a result of the inherent conflict of interest due to the overlapping ownership, Southern Peru convened a special committee of disinterested directors (the "Special Committee") to evaluate the transaction.

The Special Committee hired Goldman Sachs ("Goldman") as its financial advisor to value Minera. Goldman's stand-alone valuation of Minera was significantly below $3.1 billion, which did not support the notion that the transaction was fair. However, Goldman also performed a "relative" value analysis comparing the discounted cash flow ("DCF") values of Southern Peru and Minera. The Special Committee determined that this relative value approach was supportive of the transaction's fairness. As part of this approach, Goldman prepared analyses suggesting that Southern Peru was being overvalued by the market as Goldman attempted to reconcile the results of their analysis. The Court found issues with the relative value approach taken by the Special Committee, calling it "artificial."

The Court ultimately concluded that the transaction was unfair, and turned its focus to the calculation of damages. To calculate the awarded damages, Chancellor Strine determined that the appropriate approach was to take the difference between the price that the Special

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Committee would have approved had the Merger been entirely fair and the price that was actually paid. Therefore, the issue of damages revolved around the fair value of Minera at the time of the transaction.

The Plaintiff expert determined a standalone value for Minera of $1.9 billion using the average of a DCF analysis and comparable companies analysis. The Plaintiff expert's DCF analysis utilized a long-term copper price of $0.90 per pound and a discount rate of 6.5 percent.

The Defendant expert did not value Minera as a standalone company, but did utilize the same relative valuation methodology as Goldman did to support the notion that the transaction was fair. One significant manner in which the Defendant expert's analysis differed from Goldman's related to the appropriate long term expected price for copper. While the contemporaneous Goldman analysis and internal planning documents used estimates of $1.00 and $0.90 respectively, the Defendant expert used a range of $0.90 per pound to $1.30 per pound.

The Court did not adopt the Plaintiff expert's valuation analysis directly, but rather prepared its own estimate of value based on three indications of value. The value of Minera was estimated using an average of the following: (1) a DCF model assuming a 7.5 percent discount rate and $1.10 per pound long-term copper price using the DCF model presented by the Plaintiff expert; (2) the market value of the Special Committee's counteroffer made in negotiations in July 2004; and (3) the equity value of Minera derived from a comparable companies analysis using comparable companies identified by Goldman including a control premium of 23.4 percent based on merger transactions in 2004 calculated by Mergerstat.

As of October 21, 2004, the DCF analysis yielded an equity value for one hundred percent of Minera of $2.452 billion, the Special Committee's counteroffer yielded an equity value of $2.388, and the comparable companies analysis yielded an equity value of $2.45 billion. The average of these approaches based on the 99.15 percent ownership of Minera yielded an equity value of $2.409 billion (the "Fair Price"). The difference between the Fair Price and the value of 67.2 million Southern Peru shares as of the Merger Date resulted in $1.263 billion in awarded damages. Additionally, Chancellor Strine granted only simple interest on the damages as a result of the delay by Plaintiffs in litigating the matter.

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Dispute Consulting Contacts

Global Business Unit Leader
Gregory Higgins
+1 312 697 4748

Managing Directors

Atlanta
Mark Gallagher
+1 678 916 2581

Boston
Paul Marcus
+1 617 378 9470

Chicago
Roger Grabowski
+1 312 697 4600

Dallas
Daniel Beaulne
+1 469 547 3900

Houston
Chris Bakewell
+1 713 237 5336

Los Angeles
Erik Laykin
+1 213 270 2370

Morristown
Allen Pfeiffer
+1 973 775 8260

New York
Michael Braverman
+1 212.871.7000

Toronto, Canada
A. Scott Davidson
+1 416 364 9700

Washington, DC
Bruce Dubinsky
+1 202 649 1200

Contributors
Jaime d'Almeida
Seth Fliegler
Andrea Roller
William Hrycay
Zain Saeed
John Imperiale
Rebecca Levy
Heather Schilling
Andrea Jimenez
Caitlin Kolb
James Miele

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