Recent Valuation Guidance from the Delaware Court of Chancery

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The Delaware Court of Chancery often provides useful valuation guidance to boards and other fiduciaries, corporate managements, investors, legal counsel, and valuation analysts. With regard to valuation analysts, the Chancery Court often provides professional guidance with respect to due diligence procedures. This discussion summarizes two Chancery Court decisions that relate to the valuation analyst's due diligence with respect to management's financial projections.

Introduction

The Delaware Court of Chancery is widely recognized as a forum for the resolution of disputes between Delaware corporations and other business entities. The sheer volume of cases decided by the Chancery Court indicates that it has developed significant case law related to business.

Specifically, valuation-related decisions by the Chancery Court offer important and practical guidance to valuation analysts.

Recent opinions issued by the Chancery Court highlight how valuation analysis topics, such as the use of management-prepared projections, are viewed by the Chancery Court. In this discussion, two selected Delaware cases are presented and the treatment of financial projections in a valuation analysis is discussed.

Gearreald v. Just Care, Inc.[1]

Just Care, Inc. ("Just Care") is a privately held company that operates a private health care detention facility in South Carolina. In 2009, Just Care was acquired by GEO Care, Inc., in a strategic transaction for $40 million.

GEO Care, Inc., a provider of mental health management and treatment services for civil, forensic, and special needs psychiatric patient populations, acquired Just Care through its acquisition subsidiary GEO Care Acquisition, Inc.

An appraisal action was brought by Tull N. Gearreald Jr. ("Gearreald"), the principal founder and former CEO of Just Care, and other petitioners that included former shareholders of Just Care.

In connection with the strategic transaction, Just Care retained the services of an independent financial adviser for the purpose of preparing a fairness opinion. The independent financial adviser requested that management prepare financial projections for Just Care through 2013.

It is noteworthy that Just Care typically did not prepare management projections beyond the current fiscal year, and thus management's projections were prepared outside the ordinary course of business. Moreover, the projections utilized by the financial adviser in issuing its fairness opinion were not formally approved by the board.

It is also noteworthy that management's projections were prepared at a time when the CEO and CFO of Just Care risked losing their positions if the acquisition bid succeeded, and they were trying to convince Just Care's board to pursue different alternatives.

Additionally, at the time that management's projections were prepared, the possibility of an appraisal action was imminent. Due to the aforementioned reasons, the credibility of the management projections relied on by the financial adviser was at issue.

The Chancery Court stated that the reliability of projections prepared by management may be

adversely impacted by management's hubris and the attempt to influence a board to pursue different alternatives.

A central dispute regarding management's projections was also the fact that these contained three different growth scenarios for Just Care.

The base case scenario assumed that Just Care would continue operating as a going concern, close to full capacity without further expansion of its facilities.

The second scenario included Just Care building a new facility to house sexually violent predators (the "SVP case"). The most optimistic and in turn most speculative scenario included the base case, the SVP case, and an additional expansion into a prison center in Milledgeville, Georgia (the "Georgia case").

The petitioners in this case contended that the fair value of Just Care was $55.2 million. Respondent Just Care in turn claimed the fair value of the company was $33.6 million.

Both the petitioners and the respondent used forensic analyst experts who relied primarily on a discounted cash flow (DCF) analysis in their determination of the fair value of Just Care.

The crux of the appraisal action—and much of the difference between each parties' valuation analysis—is accounted for by whether the cash flow projections should include the SVP and Georgia case scenarios in calculating the fair value of Just Care.

Upon reviewing the assumptions underlying each scenario, the Chancery Court concluded that the out-of-state expansion, or Georgia case scenario, was too sanguine and speculative to be included in Just Care's DCF analysis. Just Care had operated only one facility in its 11-year history, and the Just Care business model was simply not predicated on maintaining multiple facilities.

Just Care had no prior experience with expanding its business outside of South Carolina. The Court also concluded that the SVP case could be included in the Just Care DCF analysis but with an appropriate probability weighting.

Ultimately, the Court determined that the fair value of Just Care as of September 30, 2009, was $34.2 million, which was closely aligned to the fair value determined by Just Care of $33.6 million, which excluded the Georgia case scenario.

In its decision, the Chancery Court affirmed that management projections made in the ordinary course of business will usually be deemed reliable. In contrast, when management projections are made outside the ordinary course of business, they are not entitled to the same deference.

In re BJ's Wholesale Club, Inc. Shareholders Litigation[2]

BJ's Wholesale Club Inc. ("BJ's" or the "company"), a former publicly traded Delaware corporation, is the third largest warehouse club chain in the United States. The company operates warehouse clubs and gas stations in the eastern United States. It was founded in 1996 and is based in Westborough, Massachusetts.

BJ's was acquired by private equity firms Leonard Green & Partners, L.P., and CVC Capital Partners on September 30, 2011, in a leveraged buyout for $51.25 per share, for a total transaction value of $2.8 billion.

In connection with the buyout offer, the board relied upon a fairness opinion rendered by Morgan Stanley.

A collection of individual and institutional former shareholders of BJ's ("plaintiffs") brought a direct shareholder class action against BJ's former board of directors ("defendants" or the "board") for breach of their fiduciary duties in connection with the sale of BJ's on September 30, 2011.

The plaintiffs allege that BJ's improperly accepted a private equity buyout offer worth $51.25 per share when it could have accepted an offer from a strategic buyer willing to pay $55 to $60 a share.

The plaintiffs allege that the Board breached its fiduciary duties of loyalty and care by agreeing to a buyout that did not provide the best available value to the company's former shareholders.

Among their allegations, the plaintiffs alleged that the board justified its acceptance of an inferior offer by (1) knowingly ignoring an inaccurate valuation analysis in the fairness opinion issued by Morgan Stanley and (2) intentionally providing

pessimistic financial projections to Morgan Stanley that included a downward adjustment to a five-year plan.

Specifically, the plaintiffs asserted that the cash flow projections used by Morgan Stanley were significantly lower than those used in a May 2011 presentation by BJ's management.

Further, the plaintiffs asserted that the board was aware that the company was worth more than $51.25 per share, citing that various third-party analysts had valued the company at a higher price, which suggested that BJ's fair value was at least $55 and could be as high as $60 per share.

In addition, BJ's had recently turned down a $55 per share offer from Walmart due to antitrust concerns.[3]

In support of its decision, the Chancery Court noted that the governing pleading standard in Delaware to survive a motion to dismiss is reasonable conceivability. While reasonable conceivability is a minimal standard, a complaint cannot be dismissed unless the plaintiff would not be entitled to recover "under any reasonably conceivable set of circumstances."

The Chancery Court stated that plaintiffs assertions regarding the financial projections do not alone support a reasonable inference that the board knew that the financial projections used by Morgan Stanley were inappropriate. The only fact pled in the complaint in support of plaintiff's assertions was the suspected timing of the downward adjustment to the five-year plan that was provided to Morgan Stanley.

The Chancery Court sustained that even though the timing of the adjustment to the five-year plan is suspicious, the fact is that the private equity firms had access to the same confidential information as other bidders.

The plaintiffs failed to plead facts sufficient to show that the private equity firms convinced the board to adjust the five-year plan or that the private equity firms were aware that the adjustment was inappropriate.

Based on the fact presented by plaintiffs in its complaint, the Chancery Court determined that it is not reasonably conceivable that the board acted in bad faith or breached its fiduciary duty. The Chancery Court granted the defendant's motion to dismiss.

Conclusion

Financial projections are the starting point for many valuation analyses. As valuation analysts, an assessment of management's financial projections is an important due diligence procedure. The Just Care and BJ's cases presented above indicate the importance of the analyst's assessment of management's financial projections.

Whether financial projections are unreasonably optimistic, unduly pessimistic, or incorporate various strategic scenarios, the valuation analyst has a duty to perform appropriate due diligence related to the projections.

Ideally, management projections are prepared in the ordinary course—by the same people, using a consistent internal process, in the same manner as projections by which the company normally manages its business.

The analyst's due diligence may consider the assumptions used. Forensic analysts may also test the reliability of management's financial projections by comparing these against financial projections prepared for a company's various audiences—such as its board members, third-party analysts, and its auditors.

Forensic analysts may compare prior financial projections against actual results achieved to gauge management's ability to prepare reliable financial projections.

Notes:

1. Gerreald v. Just Care, Inc., C.A. No. 5233-VCP, 2012 WL 1569818 (Del. Ch. Apr. 30, 2012).
2. In re BJ's Wholesale Club, Inc. Shareholders Litigation, C.A. No. 6623-VCN 2013, WL 396202 (Del. Ch. Jan. 31, 2013).
3. "Walmart Made Bid to Acquire BJ's Wholesale Club," *The New York Post* (August 7, 2011).

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