Valuation-Related Issues as Decided by the Delaware Chancery Court

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The Delaware Chancery Court routinely rules on valuation issues relating to dissenting shareholder matters. Given its sophistication in this area, the Chancery Court's decisions are closely followed by both lawyers and valuation analysts who practice in areas involving shareholder litigation. This discussion describes several recent Delaware Chancery Court decisions, and it provides insights into the valuation aspects of each decision.

Introduction

The Delaware Court of Chancery (the "Court") decides on all matters concerning equity, with the most common form of equity being a shareholder's interest in a business entity. The Court is commonly regarded as a forum for deciding dispute litigation involving matters related to the merger, acquisition, and recapitalization of Delaware corporations.

As a result of the large number of business entities organized in the state of Delaware, the court has become an authoritative voice on matters relating to business valuation and security analysis.

Given its influence on valuation-related matters, litigators and analysts often look to the Court for guidance on how business interests should be valued for purposes of dissenting shareholder actions. Because of the somewhat limited case law regarding shareholder dissent matters in many other states, other jurisdictions routinely look to Delaware case law for guidance on certain legal and valuation issues.

This discussion reviews and describes various business valuation-related issues that have been addressed by the Court in the recent past. These issues relate to the following:

1. Liquidation preferences of preferred stockholders
2. Developing the cost of equity
3. Historical versus supply-side equity risk premium
4. Company-specific risk premium
5. Adjustment to size premium
6. Classification of debt within an agreement
7. Net income attributable to a noncontrolling interest included in an earnings before interest, taxes, depreciation, and amortization (EBITDA) calculation.

This discussion summarizes two recent Delaware judicial decisions that provide guidance regarding how the Court viewed each of the above-mentioned valuation issues.

This discussion provides the reader with an understanding of how the Court views these valuation-related issues. These judicial views often have a significant impact on valuation analyses.

In re Appraisal of the Orchard Enterprises, Inc.

In re Appraisal of the Orchard Enterprises, Inc.,[1] the Court provided insight into the following valuation-related issues:

1. How to handle liquidation preferences of preferred stockholders
2. The appropriate method to estimate the cost of equity
3. The use of a supply-side or historical equity risk premium when calculating the cost of equity capital

4. The use of a company-specific risk premium when calculating the cost of equity capital
5. Whether a size premium should be adjusted to reflect the use of a supply-side equity risk premium

Background

Orchard Enterprises, Inc. ("Orchard"), a distributor of digital music and video products, was involved in a merger (the "merger") with its controlling shareholder, Dimensional Associates, LLC ("Dimensional"). Prior to the merger, Dimensional, a private equity investor, owned 42.5 percent of the Orchard common stock and substantially all of the Orchard preferred stock. Due to the rights and benefits inherent in the preferred stock, Dimensional owned a 53 percent voting interest in Orchard.

In the merger, the minority common stockholders received $2.05 per share from Dimensional. Relying on a discounted cash flow method, the petitioners claimed the common stock was worth $5.42 per share as of the date of the merger, while the respondent argued the value of the Orchard common stock was only $1.53 per share.

The largest part of the value disparity stemmed from the parties' differing treatment of a $25 million liquidation preference that was owed by Orchard in certain circumstances to the holders of its preferred stock. The document governing the preferred stock required the payment of the $25 million liquidation preference to Dimensional upon dissolution of Orchard, a sale of all or substantially all of Orchard's assets, or a sale of control to an unrelated third party.

A second issue in contention was the present value discount rate to be applied in the discounted cash flow method. Each side used three different methods to calculate the discount rate: two methods consisted of some variation of the build-up model and the third method was comprised of a variation of the capital asset pricing model (CAPM).

Liquidation Preference

The petitioner's expert concluded the payment of the liquidation preference to the Orchard preferred stockholders "was speculative at best," and therefore allocated value to the preferred stock on an as-converted basis. The respondent's expert witness reasoned that the liquidation preference entitled the holders of the preferred stock to the first $25 million of the company's equity value; thus, the respondent's expert treated the $25 million liquidation preference like interest-bearing debt and subtracted it from the total equity value of Orchard, before dividing that value by the number of common shares outstanding.

The Court indicated that unlike a situation where a preference becomes a put right by contract at a certain date, the liquidation preference was only triggered by unpredictable events such as a third-party merger, dissolution, or liquidation.

In its opinion, the Court relied on legal precedent set forth by *Cavalier Oil Corporation v. Harnett*,[2] and concluded that the value of Orchard should not be determined on a liquidation basis, and that the company must be valued, "without regard to post-merger events or other possible business combinations." Thus, the Court concluded that the preferred stock should be valued on an "as-converted" basis, rather than treating the liquidation preference similarly to interest-bearing debt.

Appropriate Cost of Equity Method

Both experts calculated a cost of equity for Orchard using three different methods: the CAPM, the build-up model, and the Duff & Phelps Risk Premium Report model.

In rendering its opinion, the Court excluded any reliance on the latter two methods noting that they (1) are not well accepted by mainstream corporate finance theory, (2) involve a great deal of subjectivity, and (3) expressly incorporate a company-specific risk premium.

Additionally, the Court rationalized that taking a formulaic approach using the three cost of equity methods (i.e., selecting the median value indication of the three methods) was superfluous and used, "simply to make a discretionary human judgment about a debatable subject seem to have a false precision."

The Court indicated that its preferred method for calculating the cost of equity capital was the CAPM.

CAPM Cost of Equity Components—Equity Risk Premium

The Court rendered an opinion on the components of the CAPM on which the experts disagreed. The areas at issue included (1) whether a historical or supply-side equity risk premium should be used, (2) whether a 1 percent company-specific risk premium should be incorporated in the CAPM cost of equity calculation, and (3) whether the 6.3 percent size premium, used by both experts, should be adjusted if the supply-side equity risk premium is used.

Both experts relied on the equity risk premium data presented in the *2010 Ibbotson SBBI Valuation Yearbook* ("*2010 Ibbotson Yearbook*"). The respondent relied on the historical equity risk premium generated using historical market returns from 1926 to the relevant valuation date. The petitioners relied on the supply-side equity risk premium. The supply-side equity risk premium relies on the same historical data used to calculate the historical equity risk premium. However, the supply-side equity risk premium segregates the components of the equity risk premium by excluding the components of a stock's price-to-earnings ratio and including the components of a stock's expected earnings growth.

Citing precedent from a previous case, *Global GT LP v. Golden Telecom, Inc.*,[3] the Court concluded the use of the supply-side equity risk premium was appropriate. In its opinion the Court acknowledged that the use of a historical equity risk premium was more traditional, but indicated the academic community had shifted toward greater support for the supply-side equity risk premium.

CAPM Cost of Equity Components—Company-Specific Risk Premium

The respondent's expert incorporated a 1 percent company-specific risk premium in the CAPM cost of equity calculation. The rationale for the company-specific risk premium incorporated by the respondent's expert in the CAPM cost of equity calculation included the following:

1. To account for the specific risks facing Orchard that were not otherwise captured within the other components of the cost of capital
2. Orchard's ability to achieve revenue levels and profitability as forecasted
3. Orchard's ability to capitalize on its business strategy
4. The impact on Orchard of the general economic recession

The petitioner's expert indicated that, if warranted, including a company-specific risk premium is an appropriate consideration in a modified CAPM. However, and apparently based on consideration of the facts and circumstances regarding Orchard as of the valuation date, the petitioner's expert did not include a company-specific risk premium.

The Court cited the following reasons as general guidelines that eliminate the need to incorporate a company-specific risk premium in a CAPM cost of equity calculation:

1. The company-specific risk premium is not an addition to the CAPM that is accepted by corporate finance scholars.
2. Pure proponents of the CAPM argue that only systematic risk, as measured by beta, is relevant to the cost of capital, and that company-specific risks should be addressed by revisions in cash flow estimates.
3. Any concerns for projection risk (i.e. projections created by inexperienced management and/or variable company track record that would be difficult to create projections for experienced management) should be captured by different weighting of cash flow or revisions to projected cash flow.

The Court concluded that the respondent's expert witness had already dealt with projection risk through the weighting of the projected cash flows and, therefore, the addition of a company-specific risk premium was not appropriate.

CAPM Cost of Equity Components—Adjustment to Size Premium

In this case, both the petitioner's and the respondent's experts used the same size premium in their CAPM calculation. In each of their respective analyses, the experts used a 6.3 percent size premium, which was the size premium for the broader 10th decile published in the *2010 Ibbotson Yearbook*. The Court indicated that a size premium is an accepted part of the CAPM because there is evidence in empirical returns that investors demand a premium for the extra risk inherent in the operations of smaller companies.

The respondent's expert argued that if a supply-side equity risk premium is used in the CAPM calculation, then an adjustment to the selected size premium was appropriate. To defend this position, the respondent's expert cited a journal article by James Hitchner that suggested the use of the supply-side equity risk premium data reflected in the *Ibbotson Yearbook* mandates an upward adjustment to the size premium employed in a valuation analysis.

The journal article argues that the size premium data presented in the *Ibbotson Yearbook* is not calculated using the supply-side equity risk premium, but instead is calculated using the historical equity risk premium. In summation, the article indicated that if an analysis uses the supply-side equity risk premium presented in the *Ibbotson Yearbook*, then the corresponding result from the CAPM cost of equity calculation would be understated, and thus, an upward adjustment to the size premium would be appropriate.

The Court failed to accept the argument for an upward adjustment to the size premium presented by the respondent's expert witness. In its ruling, the Court cited a valuation text book authored by Shannon Pratt and Roger Grabowski—*Cost of Capital: Applications and Examples*.[4] The text book concludes that the Ibbotson size premium data should not be adjusted if the supply-side equity risk premium is used because, "If one believes that economic factors not expected to recur caused the returns on the broad market to be higher than one would have expected, then the returns of stocks comprising all deciles were probably influenced by the same factors." The Court concluded that no adjustment to the selected size premium was necessary.

Fiat North America, LLC v. UAW Retiree Medical Benefits Trust

In *Fiat North America, LLC v. UAW Retiree Medical Benefits Trust*,[5] the Court provided insight into the following valuation-related issues:

1. The consideration of debt in context to language in an agreement
2. Whether net income attributable to noncontrolling interests should be incorporated in an EBITDA calculation

Background

Fiat North America, LLC ("Fiat" or the "Plaintiff"), a wholly owned subsidiary of Fiat S.P.A. ("Fiat Parent"), engages in the design, manufacture, and sale of automobiles. UAW Retiree Medical Benefits Trust ("VEBA" or the "Defendant") is a voluntary employee beneficiary association trust that funds medical health care benefits for retired and to-be-retired members of the International Union, the United International Union, and the United Automobile, Aerospace, and Agriculture Implement Workers of America (UAW). The issue in this case stemmed from the redemption of an option by Fiat to purchase shares of Chrysler, which were held in VEBA, after Chrysler's reemergence from bankruptcy.

In 2009, during the economic recession, Chrysler ("Old Chrysler") filed for bankruptcy. Ultimately, Old Chrysler sold its assets to a newly formed entity ("New Chrysler"), which issued membership interests to, among others, the United States Department of Treasury ("U.S. Treasury"), Fiat, and VEBA. Fiat, VEBA, and the U.S. Treasury entered into a subsequent agreement whereby Fiat was granted the option to purchase a percentage of New Chrysler's shares, from VEBA, pursuant to a set formula.

In 2012, Fiat exercised its option to purchase shares from VEBA for a purchase price of $139.7 million. VEBA did not deliver the shares and issued a counterclaim asserting that Fiat misinterpreted and misapplied the formula, and that the shares involved were worth approximately $343.1 million.

The Court indicated the two largest drivers of the difference in the parties' respective price calculations were whether (1) notes worth billions of dollars issued to two health care trusts represented debt of Fiat and New Chrysler, and (2) net income attributable to noncontrolling interests should be included in Fiat Parent's EBITDA calculation.

Debt Classification

Fiat, VEBA, and the U.S. Treasury entered into a call option agreement (the "Call Option Agreement") that granted Fiat certain rights to purchase, from VEBA, 40 percent of the 676,924 New Chrysler shares owned by VEBA. The Call Option Agreement contained formulas detailing the calculation of the purchase price for any called shares: a pre-IPO price and a post-IPO price.

In this instance, the undisputed formula was equal to the pre-IPO price less a contingent value rights settlement price. The pre-IPO price was equal to one percent of New Chrysler's equity value. The contingent value rights settlement price was equal to no greater than 20 percent, and no less than 10 percent, of the pre-IPO price. In this instance, Fiat agreed to use the minimum 10 percent figure.

New Chrysler's equity value was calculated as follows:

	Fiat Parent Enterprise Value
divided by:	Fiat Parent EBITDA
times:	New Chrysler EBITDA
minus:	New Chrysler Net Industrial Debt
equals:	New Chrysler Equity Value

The primary issue in the matter was the amount to be used for the last piece of the formula: the New Chrysler net industrial debt, defined in the Call Option Agreement as, "for any entity, total indebtedness for borrowed money less cash and cash equivalents, of the entity and its subsidiaries each as reported on a consolidated cash basis in accordance with GAAP; provided that the calculation of the net industrial debt shall exclude obligations in respect of retirees and indebtedness of finance companies to the extent included in the consolidated results of such entity."

According to the Court, two notes (the "Notes") were the subject of the price disagreement between the parties. The Notes had respective face values of $4.587 billion and $976 million. The Court indicated the dispute arose from whether the Notes were (1) indebtedness for borrowed money and/or (2) obligations in respect of retirees.

If the Notes were not indebtedness for borrowed money or if the Notes were obligations in respect of retirees, then Fiat should not have included them as net industrial debt. By categorizing the Notes as net industrial debt, the Plaintiff effectively reduced the value per share of the New Chrysler stock.

Indebtedness for Borrowed Money

The Court indicated Fiat characterized the Notes as "indebtedness for borrowed money" for the following reasons:

1. Under Delaware and New York law, notes evidence indebtedness for borrowed money.
2. Certain agreements between the parties (not mentioned in this discussion) refer to one of the Notes as debt.
3. New Chrysler treated the Notes as debt in public filings.

VEBA argued that New Chrysler did not borrow any money in procuring the Notes, and instead issued the Notes in exchange for terminating certain obligations it purportedly owed to Chrysler retirees. Additionally, VEBA proclaimed Fiat Parent did not list the Notes under bonds, borrowings from banks, or asset-based financing. Rather, Fiat Parent listed the Notes under "payables represented by securities. Further, VEBA argued that New Chrysler, for tax purposes, deducted principal payments of one of the Notes as contributions to VEBA.

The Court determined the Notes were "indebtedness for borrowed money." The Court's opinion was developed from the description of the Notes in two contemporaneously executed documents: the Settlement Agreement and the Indenture.

The Settlement Agreement between UAW and Old Chrysler provided that, among other things, the retiree medical benefits obligations would be transferred to the UAW Chrysler Retirees Medical Benefits Plan and that VEBA would be responsible for funding the Plan. In connection with the Settlement Agreement, one of the Notes was issued. A second executed document, the Indenture, was the governing document of the second of the Notes, which was established in the Settlement Agreement.

The Court concluded that the language in the Settlement Agreement and the Indenture equate "notes" with "indebtedness for borrowed money." Specifically, "debt" was defined in these agreements as "notes, bonds, debentures, or other similar evidences of indebtedness for money borrowed." Therefore, the Court concluded that the Notes were indebtedness for borrowed money, even though no money was actually exchanged.

Obligations in Respect of Retirees

If the Notes were considered to be "obligations in respect of retirees," then the Notes should not have been included in the New Chrysler equity value calculation as net industrial debt.

Due to the nature of the language in certain governing documents, the Court indicated that Old Chrysler issued the Notes to settle and terminate their health care obligations to the retirees. This termination, in effect, substantiated that Old Chrysler's only obligation was to VEBA and the other Notes holder, not to the retirees specifically.

The Court quoted the Settlement Agreement, that stated, "all (Chrysler) obligations regarding retiree medical benefits for the class and the covered group are terminated." This language indicated New Chrysler was absolved from its obligation to the retirees, and the obligation had shifted to VEBA and the other Note holder. The Court ruled that New Chrysler was not obligated in respect of retirees, only to VEBA and the other Note holder to repay the Notes.

Inclusion of Net Income Attributable to Noncontrolling Interests in EBITDA Calculation

VEBA argued that net income attributable to noncontrolling interests should not be included in the Fiat Parent EBITDA calculation to determine the equity value of New Chrysler.

The Call Option Agreement defined EBITDA as, "for any Person, the consolidated net income (loss) of that Person plus (1) interest charges to the extent deducted from consolidated net income; (2) consolidated income taxes; (3) depreciation, amortization, depletion, and non-cash charges; and (4) other extraordinary charges. In this context, "Person" was an individual or, among other forms of entities, a corporation.

VEBA argued that the EBITDA of Fiat Parent should not include income attributable to noncontrolling interests because the Call Option Agreement defined "Person" as a corporation, and did not include affiliated entities consolidated for accounting purposes. Additionally, VEBA claimed that it would not be feasible to calculate an EBITDA that excludes noncontrolling interests from reported data because Fiat Parent's financial statements do not report interest charges, income taxes, and depreciation attributable to noncontrolling interests.

The Court declared that, under VEBA's theory for net income attributable to noncontrolling interests, the calculation of Fiat Parent's market enterprise value would be inconsistent. The Court continued by stating that while the market value of equity may exclude noncontrolling interests, as VEBA asserted, net industrial debt does not. Further the Court recognized that, under both GAAP and IFRS, consolidated net income would include Fiat Parent's noncontrolling interests.

The Court cited the Financial Accounting Standards Board Statement of Financial Accounting Standards No. 160, which "changed the way the consolidated income statement is presented. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest."

The Court ruled in favor of allowing net income attributable to noncontrolling interests to be included in the calculation of Fiat Parent's EBITDA.

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Summary and Conclusion

Given the sophistication of the Delaware Chancery Court regarding addressing valuation-related issues, its decisions are closely followed by both lawyers and analysts throughout the country. The Court routinely addresses issues related to business and security valuation.

This discussion considered how the Court has a fair amount of discretion in estimating the fair value of a business interest, based on consideration of the facts and circumstances specific to each case.

An understanding of these decisions can assist an attorney in developing a legal framework for arguing his or her case. Similarly, a review and understanding of the Court's decisions can provide a valuation analyst with guidance regarding how the Court views certain valuation-related issues, particularly in the context of shareholder dissent matters.

Notes:

1. Memorandum Opinion, re Appraisal of the Orchard Enterprises, Inc., decided July 18, 2012, by Chancellor Leo E. Strine Jr.
2. Cavalier Oil Corporation v. Harnett, 564 A.2d 1137, 1144 (Del. 1989).
3. Global GT LP v. Golden Telecom, Inc., 993 A.2d 497, 507 (Del. Ch.2010)
4. Shannon P. Pratt and Roger J. Grabowski, *Cost of Capital: Applications and Examples*, 3rd ed. (New York: John Wiley & Sons, 2008).
5. Memorandum Opinion, Re Fiat North America, LLC v. UAW Retiree Medical Benefits Trust, Decided July 30, 2013, by Chancellor Donald F. Parsons Jr.

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