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Flawed Process Results in Flawed Valuation Determination

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A recent post-trial memorandum opinion issued July 28 in *Fox v. CDx Holdings*, C.A. No. 8031-VCL (Del. Ch. July 28, 2015), highlights the Delaware Court of Chancery's continuing focus on the integrity of valuation determinations in the context of controller-induced mergers. In *CDx*, the court evaluated claims brought by a class of the defendant company's option holders challenging a fair market value determination made as part of a spinoff merger.

The *CDx* opinion provides an illustrative example of the Court of Chancery's regular scrutiny of the degree of faithfulness exercised by fiduciaries in adhering to procedural and substantive rigors when valuation determinations are made in the context of a merger, especially where a controller is involved. In addition, though no financial advisers were parties to the case, the decision also follows a line of cases examining the work of third-party financial advisers for indications of undue influence over the outcome.

The *CDx* litigation arose out of a spinoff merger transaction structured, according to the court's findings, to permit Caris Life Sciences Inc., a manufacturer of medical diagnostic tools, to sell its most profitable business unit—Caris Diagnostics—to Miraca Holdings Inc. without incurring any corporate-level tax. To do so, Caris spun off its unprofitable and developmental-stage businesses—TargetNow and Carisome—to a new subsidiary, which Caris then spun off to stockholders. The remaining company, then owning only the profitable Caris Diagnostics business, merged with Miraca in exchange for $725 million.

Under the terms of Caris' stock incentive plan, the spinoff triggered a right of option holders, who accounted for 2.9 percent of Caris' fully diluted equity, to receive for each share covered by an option the amount by which the fair market value of the share exceeded the strike price. After the merger, the plaintiff sued, alleging among other things that the valuation attributed to the TargetNow and Carisome businesses was not the result of a good-faith determination and disadvantaged option holders, whose options were either cashed out or extinguished as a result of the merger.

After trial, the court concluded the $0.61 per share valuation attributed to the TargetNow and Carisome businesses was the product of a flawed process directed by Caris' CEO—who also owned 70.4 percent of Caris' fully diluted equity—and chief financial officer, and was motivated by a need to satisfy Miraca's desire that it—as buyer—not incur any taxable gain attributable to those businesses in connection with the transaction. To determine the extent of Caris' tax liability in connection with the transaction, the company's CFO initially commissioned a valuation report from an accounting firm. The court found that, instead of allowing the accounting firm to perform its valuation work independently, the CFO indicated what the results of the valuation should be and provided reduced projections—which were lower than projections that had been provided to prospective bidders in connection with the sale process—to support the desired result. Although the accounting firm's valuation conclusion exceeded the CFO's target, it nonetheless achieved the goal of zero corporate-level tax.

The court also examined the opinion of a second financial adviser. According to the court's findings, after Miraca expressed concerns about the first valuation, Caris' CFO commissioned a second valuation opinion from a different firm, which the company previously had engaged to prepare valuations for income tax and financial reporting related to the issuance of stock options, as well as to determine potential goodwill impairments relating to TargetNow. The court, however, likened the work of the second firm to "copying," finding that after its meeting with the CFO, the second firm appeared to simply have reproduced the results of the first firm's report to achieve Caris' goal of incurring zero corporate-level tax—and had made significant errors that the court believed excluded the possibility of independent analysis by the second firm.

In addition to its findings that the CFO had effectively directed the financial advisers' results, the court also held that the company had separately violated the terms of its stock incentive plan by failing to obtain approval from the company's board of directors for the valuation determination. Although the board approved the Miraca transaction, it did not separately determine the fair market value of Caris' shares as required by the stock incentive plan. Rather, the court found the amount to be paid to option holders effectively was determined by Caris' CFO, and approved by the CEO.

The *CDx* opinion reflects the Court of Chancery's continued scrutiny of the integrity of valuation determinations in transactions involving a controlling stockholder. Critical to the court's decision was its finding that Caris' board did not fulfill its duty under the stock incentive plan to determine the fair market value of the company's shares. *CDx* therefore reaffirms the principle that, even in controlled companies, the board—not a controlling stockholder—is the ultimate corporate decision maker, especially where minority interests are affected.

Additionally, as the court itself recognized, *CDx* is the latest in a series of Court of Chancery decisions questioning perceived "erroneous or seemingly motivated analyses" by financial advisers. As *CDx* illustrates, the Court of Chancery will not hesitate to scrutinize financial advisers' fairness opinions and other reports in the context of merger transactions, especially where there are allegations that the opinions and reports are not reasonably supportable.

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