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Chancery Court Looks Beyond Deal Price to Determine 'Fair Value'

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In Delaware Court of Chancery Chancellor Andre G. Bouchard's first opinion in an appraisal action, issued June 17 in *Owen v. Cannon*, C.A. No. 8860-CB (Del. Ch. June 17, 2015), he awarded the stockholder plaintiff nearly $16 million more for his shares than the merger consideration. The opinion follows recent decisions crediting and utilizing for valuation purposes management projections created in the ordinary course of business pre-merger, and declining to utilize projections developed in connection with litigation. At the same time, the decision stands in contrast to several recent appraisal decisions in which the court has concluded that the merger price was the fair price for the stockholder plaintiff's shares.

The appraisal action was brought by Nathan Owen, who at the time of the merger was the largest stockholder of Energy Services Group Inc., a closely held company sold in May 2013. The merger was orchestrated by ESG's two other large shareholders, Lynn Cannon and Bryn Owen, who voted to approve the merger over the stockholder plaintiff's objection and after giving him just one-day notice of a special board meeting at which the merger was approved. Cannon had replaced Nathan Owen as ESG's president in 2009, but the company continued making significant profit distributions to Owen after he no longer had a day-to-day role at the company. In fact, Cannon testified that he was interested in effecting the merger quickly in order "to stop the hemorrhage" of these distributions paid to Owen.

After the merger was completed, the stockholder plaintiff brought an action seeking appraisal of his 35 percent stake in the company and also asserting claims for breach of fiduciary duty against Cannon and Bryn Owen. To determine the "fair value" of the stockholder plaintiff's shares, as required under the Delaware appraisal statute, Bouchard adopted the discounted cash flow methodology utilized by both parties at trial. Although the parties agreed on the relevant methodology for calculating fair value, they disagreed on the inputs into the DCF model. Recognizing that a DCF model is "only as good as the inputs to the model," Bouchard undertook a careful analysis of the company's financial projections relied upon by both plaintiff and defendants in performing their DCF analysis.

The principal question, which drove a significant gulf in the parties' respective positions on "fair value," was which set of projections should be utilized in the DCF analysis—management projections that had been developed by Can-

non and the company's financial advisers prior to the litigation, or projections developed by the defendants' experts in connection with the litigation. Noting that "Delaware courts place great weight on contemporaneous management projections," Bouchard accepted the management projections relied upon by the plaintiff because the projections were the product of a "deliberate" and "iterative" process and prepared by Cannon, who was "extremely well-informed" about ESG and its potential growth. The chancellor also placed "great weight" on the fact that these projections had been provided to lenders prior to the merger in connection with the company's efforts to raise money to buy out the stockholder plaintiff's shares.

At the same time, the chancellor rejected the more pessimistic projections urged by the defendants, which lacked the same indicia of reliability as the ordinary-course management projections. Noting that the Chancery Court is "generally skeptical" of projections created by experts for the purpose of litigation, Bouchard found this data unreliable because the financial incentive to lower the valuation was "just too great to overcome" since about half of any damages paid to the stockholder plaintiff would come directly out of Cannon's pocket. Thus, Bouchard concluded that the defendants' "after-the-fact projections … created for purposes of this litigation are tainted by hindsight bias."

Owen goes against the trend of recent cases such as *Huff Fund Investment Partnership v. CKx*, C.A. No. 6844-VCG (Del. Ch. Nov. 1, 2013); *In re Appraisal of Ancestry.com*, C.A. No. 8173-VCG (Del. Ch. Jan. 30, 2015); *Merlin Partners LP v. AutoInfo*, C.A. No. 8509-VCN (Del. Ch. Apr. 30, 2015); and *LongPath Capital LLC v. Ramtron International*, C.A. No. 8094-VCP (Del. Ch. June 30, 2015), in which the Chancery Court determined that the merger price was the fair value of shares in an appraisal action. This is not surprising, given that *Owen* involved a "conflicted merger" of a closely held private corporation orchestrated by two stockholders that was designed, at least in part, to cash out the largest stockholder. As the court noted in *LongPath Capital*, to defer to the merger price in this situation would leave a minority shareholder "effectively without the remedy" of appraisal, thus warranting close scrutiny by the Chancery Court. Moreover, in connection with the breach of fiduciary duty claims, Bouchard determined that the merger was not the result of fair dealing, due to impermissibly short notice the defendants provided of the meeting to consider the merger and their failure to accommodate Owen's request to delay the meeting. In contrast, *CKx*, *Ancestry.com*, *Merlin Partners* and *LongPath Capital* all dealt with arm's-length, non-conflicted mergers.

Owen is the latest example of the Chancery Court carefully reviewing all facts and circumstances—including the conduct of the parties leading up to the merger—and scrutinizing the inputs into valuation analyses, in order to make the difficult determination of "fair value" in an appraisal action. Companies and practitioners involved in appraisal actions can be sure that the Chancery Court will take a close look at the source and process for developing company financial projections, the purpose for which they were developed, and their application in valuation analyses when determining the fair value of appraised shares.

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