DUFF & PHELPS

Selected Summaries of 2014 Decisions

The Delaware Court of Chancery
Selected Business Valuation Case Summaries

Introduction

Duff & Phelps' experts testify on commercial and shareholder disputes across the country as well as in the Delaware Court of Chancery. However, the Delaware Court of Chancery is widely recognized as one of the nation's leading business courts in terms of volume of complex 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 business and security valuation and economic damages. In this Court Case Update we focus on eight opinions from 2014 to highlight how certain valuation and damages analysis topics are viewed by the Court. We chose these eight opinions based on the valuation themes they represent and depth of analysis contained in the Court's opinions.

In our review of the cases herein 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 gain a complete understanding of all the issues addressed and each judge's position. We have included a hyperlink to each decision below its case caption.

The cases we have summarized include the following:

In Re Orchard Enterprises, Inc. Stockholder Litigation, C.A. No. 7840-VCL (Del. Ch., February 28, 2014)
Vice Chancellor Laster
Issues: business judgment rule, entire fairness standard
Click here to view the opinion.

In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., March 7, 2014)
In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., October 10, 2014)
Vice Chancellor Laster
Issues: DCF, discount rate
Click here to view the March 7, 2014 opinion.
Click here to view the October 10, 2014 opinion

Kahn v. MFW Worldwide Corp., C.A. NNo. 6566 (Del., March 14, 2014).
Issues: business judgment rule, entire fairness standard
Click here to view the opinion.

Laidler v. Hesco Bastion Environmental, Inc., C.A. No. 7561-VCG (Del. Ch., May 12, 2014)
Vice Chancellor Glasscock
Issues: direct capitalization of cash flow method, discount rate, comparable companies
Click here to view the opinion.

Huff Fund Investment Partnership v. CKx Inc.., C.A. 6844-VCG (Del. Ch., May 19, 2014)
Vice Chancellor Glasscock
Issues: synergies, adjustments to merger price
Click here to view the opinion.

PharmAthene, Inc. v. SIGA Technologies, Inc., C.A. No. 2627-VCP (Del. Ch., August 8, 2014)
Vice Chancellor Parsons
Issues: lump-sum damages, book of wisdom
Click here to view the opinion.

In Re Nine Systems Corporation Shareholders Litigation., C.A. No. 3940-VCN (Del. Ch., September 4, 2014)
Vice Chancellor Noble
Issues: private company discount, projections, market multiples
Click here to view the opinion.

Case Summaries

In Re Orchard Enterprises, Inc. Stockholder Litigation, C.A. No. 7840-VCL (Del. Ch., February 28, 2014)

Click here to view the opinion.

In 2010, Orchard Enterprises, Inc. ("Orchard") merged with Dimensional Associates, LLC ("Dimensional"), Orchard's controlling stockholder. Orchard's common shareholders of Orchard received $2.05 per share in the transaction. In a 2012 appraisal action the Court found that the fair value of common stock was $4.67. The 2012 decision was covered in our 2012 Delaware Summaries.

In the 2014 matter, the Plaintiffs sought damages based on their contention that Dimensional and the directors who approved the merger breached their fiduciary duties. The parties filed cross motions for summary judgment. Specifically, the Plaintiffs claimed that the Defendants breached their duty of disclosure, that entire fairness is the operative standard of review, and that the merger was not entirely fair. The Defendants contended that neither rescissory damages nor quasi-appraisal are available remedies, and argued that Orchard cannot be held liable for breach of fiduciary duty or for aiding and abetting.

In the 2014 decision, the Court granted summary judgment in favor of the Plaintiffs in two respects: (i) that the proxy statement contained material misstatements, and (ii) that the standard of review for trial would be entire fairness with the burden of persuasion on the Defendants. The Court also granted summary judgment in favor of the Defendants in two respects: (i) that one of the alleged disclosure violations was in fact accurate, and (ii) that Orchard cannot be held liable for breach of fiduciary duty or for aiding and abetting. All other motions were denied.

The Court held that at trial, the entire fairness standard, rather than the business judgment rule, would be applied. In reaching its decision, the Court adhered to its own reasoning in *In re MFW Shareholders Litigation*, in which the Court held that the business judgment rule is the standard of review if the controlling stockholder agrees up front not to proceed with the transaction unless it is approved by, (i) an independent special committee with sufficient authorization; and (ii) a majority of the unaffiliated minority shareholders. The Court stated that in this matter, the controlling stockholder, Dimensional, did not agree up front to proceed unless the two conditions above were met. In reaching this conclusion, the Court pointed to several of its findings that raised doubts as to both the independence and effectiveness of the special committee and the accuracy of information provided to the shareholders.

The Court denied the Plaintiffs' request for summary judgment that the merger was unfair despite its findings that raised questions about both the process and the price of the merger. Although the Court concluded that there was a material misstatement in the Proxy Statement, the Court held that at trial, "a single disclosure problem may not be outcome-determinative," and that "depending on the evidence as a whole, the Defendants may be able to overcome this mistake."

Regarding the price element of entire fairness, the Court stated that the fair value judgment of $4.67 per share in the appraisal decision, more than two times the merger price, "is certainly evidence of financial unfairness." The Court went on to say, however, that this does not necessarily mean that the $2.05 per share price was unfair. The Court explained that unlike the appraisal statue, which insists on a point calculation when awarding fair value, the entire fairness test allows for "a range of reasonable values." In other words, "[a] price may fall within the range of fairness for purposes of the entire fairness test even though the point calculation demanded by the appraisal statute yields an award in excess of the merger price."

Case Summaries

In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., March 7, 2014)

In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., October 10, 2014)

Click here to view the opinion.

On June 30, 2011, Rural/Metro Corporation ("Rural" or the "Company"), a provider of ambulance and fire protection services throughout the United States, merged with an affiliate of Warburg Pincus LLC. Each publicly held share of Rural common stock was converted into the right to receive $17.25 in cash. In a March 7, 2014 decision ("Liability Opinion"), the Court concluded that Rural's board of directors (the "Board") breached their fiduciary duty by approving the merger and by failing to disclose material information in the Company's proxy statement and that Defendant RBC Capital Markets, LLC ("RBC"), the principal advisor to the Board, "aid[ed] and abett[ed] breaches of fiduciary duty by the board of directors of Rural." In an October 10, 2014 decision ("Damages Opinion"), the Court set RBC's liability at $75.8 million, or 83% of total damages to the class of shareholders (the "Class"), plus pre- and post-judgment interest.

The Liability Opinion found that the individual Defendants, who all served as members of the Board before the merger, "breached their fiduciary duties by making decisions, taking actions, and allowing steps to be taken that fell outside the range of reasonableness." The Court concluded that the individual Defendants' conduct fell outside the range of reasonableness on two occasions: (i) when the Board "allowed [one of the Defendants with a significant role in the events leading up to the merger] and RBC to initiate a sale process in December 2010, without Board authorization and contrary to the Board's instruction that the Special Committee should simply pursue 'an in-depth analysis of the alternatives discussed during the [December 8, 2010] meeting'" and (ii) when the Board approved the Merger.

Additionally, the Court held that the individual Defendants provided "materially misleading information in the Proxy Statement." This information related to two items: (i) the precedent transaction analyses, in which RBC claimed to use Wall Street research analyst consensus projections to derive 2010 EBITDA for Rural, while the figures were in fact Rural's unadjusted reported results; and (ii) information RBC provided about its conflicts of interest.

While the Liability Opinion found RBC liable, the Court did not determine a remedy in that decision. Instead, the Court instructed the two opposing experts to submit revised valuations using inputs that the Court identified, related to projections and discount rate.

In terms of projections, the Court noted that management's five-year projections did not address benefits of the acquisition program beyond 2016 and that Rural was not anticipated to reach a steady state until at least 2021. The Plaintiffs' expert accounted for this by extending management's projections an additional five years to reach a steady state, then using 2021 EBITDA to derive the terminal value. The Defendants' expert used 2016 to derive the terminal value, but used a "normalized EBITDA or an elevated terminal value multiple." While the Court noted weaknesses in both methods, it instructed the experts to extend the projections based on the Plaintiffs' projections.

Case Summaries

In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., March 7, 2014)

In Re Rural Metro Corporation Stockholders Litigation, C.A. No. 6350-VCL (Del. Ch., October 10, 2014)

Continued

Click here to view the opinion.

As it relates to the discount rate, the Court instructed the experts to use the Capital Asset Pricing Model and provided guidance on the following inputs: (i) size premium; (ii) equity risk premium; (iii) beta; and (iv) cost of debt.

First, the Court instructed the experts to use a size premium of 2.94% based on Ibbotson Associates, "a generally accepted method," as used by the Plaintiffs' expert.

Second, the Court instructed the experts to perform two calculations, one using Ibbotson's historical equity risk premium and one using Ibbotson's supply side equity risk premium.

Third, in calculating beta, the Court instructed the experts to use the weekly Bloomberg beta for Rural measured against the S&P 500 from September 11, 2009 to March 25, 2011. The Plaintiffs' expert used a 2-year weekly beta and the Defendants' expert used a 5-year monthly beta. The Court stated that both were acceptable methods "[i]n the abstract," but that "the reliability of an observed beta depends on an efficient trading market." The Court stated that "[f]or a company like Rural that is traded on a major exchange, '[t]urnover measured by average weekly trading of…1% would justify a substantial presumption' of market efficiency." The Court selected September 11, 2009 as the start date for the beta calculation, noting that this was when Rural's stock reached the benchmark "on a reasonably consistent basis."

Lastly, for the cost of debt, the Court adopted the Plaintiffs' expert's rate of 7.5%, based on the yield to maturity of an index of B-rated bonds, over the Defendants' rate of 7.3% based on the Company's new term loan and LIBOR rates. The Court noted that the Plaintiffs' analysis "credibly assumed that Rural would be able to refinance its debt at a similar rating within approximately ten years, at which time the Company would have a similar capital structure."

In the Damages Opinion, the Court adopted the valuation instructions above, with two additional determinations. First, the Court used the Plaintiffs' expert's beta, as the beta calculated as instructed in the Liability Opinion would have been lower, "awarding value beyond what the Plaintiffs sought." Second, the Court adopted a perpetuity growth rate of 3.7%, the low end of the Defendants' expert's range, noting that it "falls comfortably between the expected long-term rate of inflation and the expected long-term growth rate of nominal GDP."

Using these assumptions the Court valued Rural as of the merger date at $21.42 per share. Given the $17.25 per share received by shareholders, the Court arrived at damages of $4.17 per share, or $91.3 million for the Class. The Court determined that RBC was responsible for 83% of the damages (based on 17 percent of the responsibility for damages being attributable to joint tortfeasors), or $75.8 million, plus pre- and post-judgment interest.

Case Summaries

Kahn v. MFW Worldwide Corp., C.A. No. 6566 (Del., March 14, 2014)

Click here to view the opinion.

The Delaware Supreme Court affirmed the judgment of the Court of Chancery in *In re MFW Shareholders Litigation*, which held that the business judgment rule, rather than entire fairness, should be applied to a very limited category of controlling mergers. That matter was covered in our 2013 Delaware Summaries. In 2013 the Chancery Court stated that the business judgment rule should apply if: (i) the transaction requires both the approval of a special committee and a majority of minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."

The Delaware Supreme Court explained that the entire fairness standard is applied in the context of a controlling merger as a substitute for the dual protections of disinterested board and stockholder approval, because both protections are potentially undermined by the controlling shareholder. However, the Court stated, "where the controller irrevocably and publicly disables itself from using its control to dictate the outcome of the negotiations and the shareholder vote, the controlled merger then acquires the shareholder-protective characteristics of third-party, arm's-length mergers, which are reviewed under the business judgment standard."

The Delaware Supreme Court agreed with the Chancery Court, stating that the dual procedural protection merger structure optimally protects the minority stockholders in controller buyouts, and that the application of the business judgment standard will provide a strong incentive for controlling stockholders to grant minority investors the transactional structure that provides them the best protection. In addition, the application of the business judgment standard in this case "is consistent with the central tradition of Delaware law, which defers to the informed decisions of impartial directors, especially when those decisions have been approved by the disinterested stockholders on full information and without coercion."

Finally, the Delaware Supreme Court stated that the underlying purposes of the dual protection merger structure and the entire fairness standard of review both share a focus on price. The Court has consistently held that, "although entire fairness comprises both fair dealing and fair price, in a non-fraudulent transaction 'price may be the preponderant consideration outweighing other features of the merger.'" The Court noted that the dual protection merger structure requires two price-related pretrial determinations: first, that a fair price was achieved by an empowered, independent committee that acted with care; and, second, that a fully-informed, uncoerced majority of the minority stockholders voted in favor of the price that was recommended by the independent committee.

The Delaware Supreme Court concluded in this case that both procedural protections - (i) approval by an independent and empowered special committee; and (ii) approval by an uncoerced informed majority of the minority stockholders - had been established, and that the business judgment standard of review therefore applied.

Case Summaries

Laidler v. Hesco Bastion Environmental, Inc., C.A. No. 7561-VCG (Del. Ch., May 12, 2014)

Click here to view the opinion.

On May 23, 2013, Patricia Laidler filed a petition for appraisal of her 10,000 shares of common stock in Hesco Bastion USA, Inc. ("Hesco"), a company involved in the assembly and marketing of "Concertainer units," multi-cellular steel wire mesh containers that are filled with sand and rock to create mobile barriers. The Petitioner was a minority shareholder in Hesco as well as the former Company Secretary, General Manager, and Managing Director for Hesco Bastion Limited. In January 2012, Hesco merged with Hesco Bastion Environmental, Inc. ("Environmental"). In connection with the merger, the Petitioner was offered $207.50 per share as consideration for each of her shares. The Petitioner declined the offer and filed a petition for appraisal.

Both parties engaged experts to value the shares of Hesco. The Petitioner's expert valued the shares at $515 per share. The Respondent's expert had previously estimated the fair market value of Hesco shares prior to the merger to determine a price should the Petitioner decide to sell her shares back to the company, arriving at a valuation of $180 per share. This value was intended to reflect fair market value, but not the going-concern value, and included a minority discount. For purposes of the appraisal proceeding, the Respondent's expert estimated the fair value of Hesco shares to be $250.30 per share. The Respondent's expert had initially valued the going-concern value of the shares to be $322 per share, but after meeting with management, the expert revised the valuation, resulting in a value per share of $250.30. The Court ultimately concluded on a value per share of $364.24.

Both experts relied on an income approach, the direct capitalization of cash flow method ("DCCF"), to estimate the fair value of Hesco. The DCCF differs from the traditional discounted cash flow method ("DCF") in that a DCCF considers a normalized level of cash flow into perpetuity, divided by a capitalization rate. A traditional DCF was not performed by either party in part because management did not prepare projections in the normal course of business, and as noted by the Court, Company sales are in part, driven by natural disasters, "the frequency of which are of dubious predictability."

The experts disagreed on both the level of normalized cash flows and the capitalization rate to use in the DCCF. The Petitioner's expert weighted actual revenues in 2010 and 2011 (40% and 60% respectively), then multiplied the resulting figure by a 55% profit margin and subtracted an estimate of overhead expenses. The Respondent's expert weighted actual and normalized EBITDA figures for 2009, 2010 and 2011, where normalized figures backed out revenues associated with "non-recurring" events.

In assessing the weights, the Court considered qualitative factors about which the experts disagreed: the expiration of patents, the termination of licensing, and the planned construction of a plant. The Court found that the parties failed to demonstrate that these issues materially impact the analysis of the fair value of Hesco.

The most significant difference between the two experts' normalized cash flows was the treatment of "non-recurring revenues." The parties disputed whether past cash flows were a reliable predictor of future cash flows, or whether future cash flows should take into account certain revenues in previous years that were generated by non-recurring or extraordinary

Case Summaries

Laidler v. Hesco Bastion Environmental, Inc., C.A. No. 7561-VCG (Del. Ch., May 12, 2014)

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Click here to view the opinion.

events. The Court found it inappropriate to decrease estimates of future cash flows based on the Respondent's contention that past revenue was generated by specific events unlikely to occur again. The Court noted that the "Company is primarily in the business of providing asset protection in anticipation of natural disasters, so the…suggestion that all natural disasters are non-recurring, and therefore a poor predictor of future revenues streams, seems…misplaced."

The Court found that the best predictor of future cash flows was past cash flows in 2009, 2010, and 2011, weighted equally. The parties' experts only had minor disagreements over the applicable tax rate, depreciation, and capital expenditures. With respect to the tax rate, the Court selected a tax rate in between the two rates offered by the experts. With respect to depreciation and capital expenditures, the Court adopted the actual 2011 depreciation expense and 2011 capital expenditures, which were equal.

With respect to the capitalization rate, both experts agreed on a long-term growth rate of 4 percent, and both experts used a build-up approach to estimate the Cost of Equity. However, they disagreed with respect to other components of the cost of capital including the industry risk premium, size premium, and capital structure. As it relates to the industry risk premium, the Court found that the latest available data from Morningstar was more appropriate to use than a multi-year average, based in part on information from Morningstar. As it relates to the size premium, the Court found that decile 10 was more appropriate to use than decile 10a because decile 10 included companies with more similar debt structure (from decile 10a) as well as companies with more similar market capitalizations (from decile 10b). Both experts assumed debt in the capital structure despite the Company not having any debt as of the merger. The Court adopted the Respondent's "more conservative" estimate of 90 percent equity, over the Plaintiff's expert's use of 85 percent equity. The Court concluded on a WACC of approximately 22 percent resulting in a capitalization rate of roughly 18 percent (WACC less the growth rate).

Based on the Court's findings with respect to the normalized cash flows and capitalization rate, the Court calculated a value of $364.24 per share.

There were two other indications of value that the Court addressed. First, the Respondent argued that the merger price should be relied on as an indication of fair value. The Court declined, stating that Environmental controlled 90% of Hesco, and one man's estate controlled 100% of Environmental. The Court determined that the merger was not an arms-length transaction and the controlling stockholder decided what it would pay for the shares of the minority shareholder.

Second, the Respondent's expert employed a comparable companies analysis and a comparable transactions analysis as "cross-checks" on the DCCF valuation analysis. Both of these analyses were criticized by the Court. The Court noted that the Respondent's expert failed to provide convincing evidence that the companies selected were "truly comparable" to Hesco such that they could provide a reliable cross-check on the Company's value. The Court also noted that the Respondent's expert testified in deposition that the chosen comparable companies did not have "weather-driven, event-related sales volatility" and had diversified business streams resulting in less volatile financials.

Case Summaries

Huff Fund Investment Partnership v. CKx Inc., C.A. 6844-VCG (Del. Ch., May 19, 2014)

Click here to view the opinion.

This matter involved the acquisition of CKx, Inc. ("CKx") by Apollo Global Management ("Apollo"). In a decision in 2013, the Court ruled that the merger price of $5.50 per share represented the best indication of the fair value of CKx for purposes of an appraisal (see Delaware Case Summaries 2013). In the 2014 follow-up decision, the Court responded to arguments regarding whether the merger price should be adjusted downward to exclude synergies, and whether the merger price should be adjusted upward to account for the value of certain assets not reflected in the merger price. The Court ultimately decided that no adjustments should be made and concluded that the merger price of $5.50 per share represented the best indication of fair value.

The Court stated that in an acquisition involving a financial buyer, it is possible that the acquisition value could exceed the going-concern value if the market price "includes speculative elements of value which arise only from the merger." The Respondent pointed to an Investment Memo that demonstrated that Apollo sought to realize $4.6 million in cost savings by taking CKx private. However, the Court found insufficient evidence to support a finding that Apollo's bid was based on cost savings that CKx management could not have realized itself had the company continued as a going concern, and therefore declined to adjust the merger price downward.

The Court also addressed the question of increasing the merger price to reflect going-concern by adding value: (i) derived from CKx's post-merger acquisition of Sharp Entertainment, (ii) to account for other unexploited revenue opportunities identified by Apollo in due diligence, (iii) for support agreements between Apollo and large CKx stockholders, and (iv) to reflect that other buyers were willing to pay more than $5.50 per share.

The Court stated that "situations may exist where the market is unable to reflect the value of an asset, even if the sales price is the best evidence of fair value of the company, and thus where the value of the asset must be added to the sales price to equal fair value." In this case, in which a market-derived sales price is used as the indication of value, the Court stated that the relevant question is whether market participants were aware of the business opportunities, such that the value of those opportunities was incorporated into the sales price. The Court ultimately found that both Apollo and the other bidders were aware of the possibility of acquiring Sharp, and of the other unexploited business opportunities. Because the market had the chance to value these opportunities (with Apollo topping the market in the auction), adding value for the unexploited opportunities would overstate the value of CKx. Therefore, the Court declined to adjust the merger price upward.

The Court declined to adjust the merger price for the support agreement due to the lack of a reasonable method by which to determine the value that flowed to the large stockholders which was not shared by the common stockholders. The Court also made no adjustment to reflect the possibility of a higher offer, as it remained unconvinced that the sales process failed to achieve the full value available in the market.

The Court ultimately concluded that "neither party ha[d] demonstrated…that [the merger price] should be adjusted consistent with Section 262(h)" and determined that the merger price of $5.50 was the best indicator of fair value.

Case Summaries

PharmAthene, Inc. v. SIGA Technologies, Inc., C.A. No. 2627-VCP (Del. Ch., August 8, 2014)

Click here to view the opinion.

In a 2011 decision the Court found that SIGA Technologies, Inc. ("SIGA") and PharmAthene, Inc. ("PharmAthene") had entered into a "contractual obligation to negotiate a license agreement" for ST-246, a smallpox drug. As a remedy for SIGA's violation of its explicit contractual obligation to negotiate in good faith a license agreement, the Court award damages to be an "equitable payment stream or equitable lien" based on SIGA's future profits. While the Plaintiff argued for lump-sum damages exceeding $1.0 billion, in the 2011 decision the Court found that lump-sum expectation damages were too speculative. Both parties appealed the 2011 decision.

In 2013, the Delaware Supreme Court upheld the Chancery Court's 2011 determination that SIGA had "breached, in bad faith, its contractual obligation to negotiate a license agreement." However, the Supreme Court reversed the Chancery Court's conclusion that SIGA also was liable under promissory estoppel and reversed the Chancery Court's damages award. In this 2014 decision, the Chancery Court reconsidered, and awarded lump-sum expectation damages to PharmAthene.

On remand, the Court considered two main remedies for potential damages to PharmAthene: a lump sum payment of expectation damages or an equitable payment stream sourced from SIGA's profits from the drug. As discussed above, in 2011 the Court determined that expectation damages were too speculative. However, on remand, the Court identified three reasons that supported a re-examination of expectation damages: (i) the Supreme Court requested specifically that the Court reconsider an award of lump sum expectation damages; (ii) SIGA had earned a contract with the U.S. government to sell the drug through BARDA (thereby reducing the concern in 2011 that "the drug might not generate any profits at all;" and (iii) the Supreme Court clarified relevant law in that expectation damages could be awarded for bad faith.

The Court reconsidered the expert testimony as it related to expectation damages, and determined that expectation damages were appropriate. One of the issues considered by the Court in 2014 was what, if any, consideration should be given to post-breach developments. In citing the "book of wisdom" the Court noted, "to the extent that evidence of any post-breach events…are helpful to the Court in assessing the parties reasonable expectations for ST-246's commercialization prospects in December 2006, [the Court] can and ha[s] considered that evidence. In all other respects, however, post-breach events are irrelevant." The Court stated that for example, while it is appropriate to consider that SGIA had sold "X dollars" worth of ST-246, it would be inappropriate to use the "X dollars" as the basis of a damages award because it was neither known nor knowable at the time of SIGA's breach.

In determining lump-sum damages the Court focused on one of six damages scenarios using the discounted future earnings method as presented by the Plaintiff's expert. The Court determined that the damages analysis was driven by four key factors: the likelihood that the drug would sell commercially, the timing of the sales, the selling price of the product, and the quantity sold.

The Defendant argued that the likelihood that the drug would sell was speculative as the likelihood of the drug's approval by the FDA was speculative. The Plaintiff argued that the U.S. government was the primary market for the drug and the standards for that market were substantially lower than those of the FDA. The Court agreed that FDA approval of the drug was not required, and noted that the U.S government clearly stated the criteria needed to accept new drugs. Moreover the Court stated that at the time of breach the drug was sufficiently developed to meet the criteria of acceptance by the government.

Case Summaries

PharmAthene, Inc. v. SIGA Technologies, Inc., C.A. No. 2627-VCP (Del. Ch., August 8, 2014)

Continued

Click here to view the opinion.

In terms of timing, the Plaintiff's expert used 2008 as a start date for sales. The Defendant argued that the first deliveries of the drug did not occur until 2013. The Court found "no persuasive evidence" that sales would begin in 2008, and instead found that based on the facts presented, there was a reasonable expectation that the US government would begin purchasing the drug by 2010. The Court determined that as of the breach date, the drug had raised millions in development funding, was granted the fast track status by the FDA, and showed great potential in early studies. The Court stated that this reasoning would lead to the expectation that the drug could be sold within 4 years and determined a sales start date in 2010.

In terms of pricing, the Plaintiff's expert assumed a price of $100 per course of treatment. While the Defendant criticized this assumption as lacking a sufficient factual basis, the Court found that a sale price of $100 per course lined up with historical government purchases of similar pharmaceutical products, and SIGA's government contract for the drug required the government to pay more than $100 per course.

In terms of sales quantity, the Plaintiff's expert estimated sales quantity for three categories of customers, SNS (affiliated with the U.S government), U.S. Department of Defense ("DoD") and the rest of the world. The Court agreed with the Plaintiff's expert's estimation of SNS sales, adjusted down by 50 percent the Plaintiff's expert's estimation for DoD sales, and eliminated all other sales.

The Court ordered the parties to recalculate lump-sum damages based on the adjustments contained in the decision. On January 15, 2015 the Court entered a Final Order and Judgment. The Court's judgment against SIGA totaled $194.7 million, including $113.1 million in lump-sum expectation damages, and $81.5 million in pre-judgment interest and attorneys' and expert witness fees.

Case Summaries

In Re Nine Systems Corporation Shareholders Litigation, C.A. No. 3940-VCN (Del. Ch., September 4, 2014)

Click here to view the opinion.

This matter centered on a 2002 recapitalization transaction of a start-up company, now known as Nine Systems, which was sold approximately four years later, in 2006, for roughly $175 million. The Plaintiffs contended that the recapitalization was a dilutive, conflicted transaction that failed the entire fairness standard, and sought damages of over $130 million.

The Court found that several of the Defendants constituted a control group during the recapitalization, and because they stood on both sides of the transaction (because each received a benefit not shared with the company's other stockholders), the entire fairness standard of review applied. The Court evaluated the two components of entire fairness – fair dealing and fair price – and concluded that while the recapitalization was approved at a fair price, the process was not fair. The Court ultimately declined to award damages to the Plaintiffs.

The recapitalization transaction was based on a "back of the envelope" valuation of approximately $4 million, which was performed by an individual affiliated with one of the controlling stockholders, in "a series of handwritten guesstimates." In evaluating the issue of fair price, the Defendants asserted that the $4 million valuation was a fair price because the company's equity had no value. The Plaintiffs argued that the value of the company at the time of the recapitalization was $30.89 million. Each side submitted expert reports regarding the value of the company. In evaluating the expert testimony, the Court considered three key issues: (i) the credibility of contemporaneous evidence regarding the company's value; (ii) the proper entity to be valued; and (iii) the reliability of management's January 2002 pro forma projections.

The Court found that, of the five pieces of contemporaneous evidence offered, none provided a reliable indication of the value of the company. Two of the indications of value were based on projections that the Court deemed unreliable. One statement regarding the value of the company was what the Court described as "an unsubstantiated opinion in a brief email." Two other pieces of evidence were based on conversion ratios for convertible debt, which the Court concluded could not be used to determine a reliable value without knowing the actual value (rather than the face value) of the notes. As a result, the Court did not place any weight on these indications of value.

The experts differed on the entity to be valued. The Plaintiffs' expert valued the company plus the acquisitions that were made possible by the recapitalization transaction. The Defendants valued the company prior to the recapitalization transaction, excluding the impact of the acquisitions. The Court explained that there may be instances in which it is appropriate to include the expected value from a company's non-speculative expansion plans or strategy changes. However, because the company in this case had insufficient capital to fund either of the acquisitions without the recapitalization, the relevant value was the $4 million price attributed to the company prior to the transaction.

Finally, the experts disagreed on the reliability of management's January 2002 projections. The Defendant's expert demonstrated the unreliability of the January projections by comparing prior monthly projections with the actual company results. The Court found that the company's management "grossly overstated the Company's revenues, even two or three months away,"

Case Summaries

In Re Nine Systems Corporation Shareholders Litigation, C.A. No. 3940-VCN (Del. Ch., September 4, 2014)

Continued

Click here to view the opinion.

and ultimately stated that "[t]he Court cannot accept that the same people who missed projections three-months out in September 2001 by a factor of three…would have been able to produce reliable projections in January 2002 for an entire year." The argument that the projections were consistent with recent performance of comparable companies did not change the Court's conclusion that the projections were unreliable.

Without reliable projections, the Court stated, there can be no reliable discounted cash flow analysis. The Court therefore looked to the multiples-based approaches provided by the experts. All multiples considered by the Court were based on last twelve months ("LTM") revenue, because the company did not have positive earnings or cash flow in January 2002.

The Defendants' expert used the two acquisitions made by the company to generate an average private transaction multiple, and used five comparable public companies to generate an average trading multiple. The expert also argued that the public company trading multiples should be discounted by "at least 20%" based on the discount "commonly applied to private company valuations."

The Plaintiffs' expert did not consider the two Nine Systems acquisitions to be sufficiently comparable, and did not use them. Instead, the expert used a different set of five comparable public companies (unlike the Defendants' expert, the Plaintiff's expert did not apply a private company discount). The Plaintiff's expert also produced a multiple based on public transactions, but placed no weight on it due to "weakness in the data."

The Court accepted the application of the private company discount submitted by the Defendants' expert, stating:

> "In the appraisal context, it is thought to be impermissible under Delaware law to discount the value of a private company solely because its stock is not publicly traded. Here, however, the Court finds that the theoretical justifications for a private company discount cited by [the Defendants' expert]—chief among them being lower quality and more variable earnings—should apply to the Company. The Court thus concludes that a conservative 20% discount, at the low end of the range, is appropriate to apply to [the Defendants' expert's] trading multiple." [Note that the private company discount was applied to the enterprise value multiple, not to the resulting equity value]

The Court computed the company's equity value using all four multiples provided (two from the Defendants' expert and two from the Plaintiffs' expert), using the company's LTM revenue and the pre-transaction capital structure, and concluded that all four methods resulted in a negative implied equity value. As a result, the Court concluded that the recapitalization was approved at a fair price, stating "because their common stock had no value that could have been diluted, the Plaintiffs necessarily received the substantial equivalent in value of what they had before."

While the Court concluded that the price at which the recapitalization was conducted was fair, the Court was "reluctant to conclude that the recapitalization, even if it was conducted at a fair price, was an entirely fair transaction because of the grossly inadequate process employed by the Defendants." Of particular concern was the fact that the fair price analysis

Case Summaries

In Re Nine Systems Corporation Shareholders Litigation, C.A. No. 3940-VCN (Del. Ch., September 4, 2014)

Continued

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was severely hampered by the unfairness of the process by which the Board came to the $4 million valuation, including the lack of reliable projections, the Board's ignorance of a certain valuation methodology, and the decision not to have any input from an independent director or financial advisor. The Court went on to state that even if the fair price component "may be the preponderant consideration" for most non-fraudulent transactions, it must hold true that a grossly unfair process can render an otherwise fair price not entirely fair, even when a company's common stock has no value. Ultimately, the Court concluded that the Defendants did not carry their burden of proof in demonstrating that the transaction was entirely fair.

Lastly, the Court considered whether an award of damages would be appropriate, stating that the Court "has very broad power to fashion equitable and monetary relief under the entire fairness standard," and that "this discretion is greater when fashioning an award of damages in an action for a breach of the duty of loyalty than it would be when assessing fair value in an appraisal action." The Court found that the most compelling damages theory offered was that the Plaintiff should be awarded damages in the amount of consideration they would have received in the 2006 merger had they participated in the recapitalization pro rata. However, the Court stated that (i) the Defendants were under no obligation to allow the Plaintiffs to participate in the transaction, (ii) the price attributed to the company in the transaction was fair, and (iii) "calculating damages for a lost opportunity to invest is too speculative based on the facts and circumstances [of this case]." Ultimately, the Court declined to award damages to the Plaintiffs.

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