The Delaware Court of Chancery

Selected Business Valuation Case Summaries

SELECTED SUMMARIES OF 2021 DECISIONS

Introduction

Kroll experts testify on commercial and shareholder disputes across the country, including in the Delaware Court of Chancery (the "Court" or the "Chancery Court"). The Chancery Court is widely recognized as one of the nation's leading business courts in terms of volume of complex business-related cases. As a result, the Court has developed significant case law in this area.

This high volume of business cases results in the Court issuing numerous opinions, many of which address business and security valuation and economic damages. Despite Court closures and restrictions due to COVID-19, there were numerous opinions issued throughout 2021 related to these topics.

In this Court case update, we focus on three opinions from 2021 to highlight how certain valuation and damages analysis topics are viewed by the Court. In addition, we focus on one Chancery Court decision that was overturned by the Delaware Supreme Court in 2021. We also note that the Delaware Supreme Court confirmed two 2020 decisions in January 2021 and April 2021, respectively: *SourceHOV Holdings, Inc. v. Manichaean Capital, LLC, et al.*, C.A. No. 2017-0673-JRS (Del. Ch. January 30, 2020) (Del. Supreme Court January 22, 2021) and *James A. Zachman v. Real Time Cloud Services, LLC, et al.*, C.A. No. 9729-VCG (Del. Ch. March 31, 2020) (De. Supreme Court April 2, 2021).

In our review of the cases herein, we do not summarize every relevant issue but rather focus primarily on certain topics related to valuation and damages. We recommend that interested readers review 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.

In this Court Case Update, we summarize the following cases:

Delaware Court of Chancery

Adrian Dieckman v. Regency GP LP and Regency GP LLC
C.A. No. 11130-CB (Del. Ch. February 15, 2021)
Chancellor Bouchard
Issues: damages, value comparison
Click here to view the opinion

In re: Appraisal of Regal Entertainment Group
C.A. No. 2018-0266-JTL (Del. Ch. May 13, 2021)
Vice Chancellor Laster
Issues: discounted cash flow (DCF) method, unaffected market price, deal price, synergies, taxes
Click here to view the opinion

Bandera Master Fund LP, et al. v. Boardwalk Pipeline Partners, LP, et al.
C.A. No. 2018-0372-JTL (Del. Ch. November 12, 2021)
Vice Chancellor Laster
Issues: projections, unaffected market price
Click here to view the opinion

Delaware Supreme Court

Marion Coster v. UIP Companies, Inc., et al.,
(Del. June 28, 2021)
Delaware Chancery Court opinion: C.A. No. 2018-0440 (Del. Ch. January 28, 2020)
Chief Justice Seitz
Justices Valihura, Vaughn, Traynor and Montgomery-Reeves
Issues: fair price, fair process
Click here to view the opinion

CASE SUMMARIES

Adrian Dieckman v. Regency GP LP and Regency GP LLC, C.A. No. 11130-CB (Del. Ch. February 15, 2021)

This matter is related to a unit-for-unit merger pursuant to which Energy Transfer Partners L.P. ("ETP") acquired Regency Energy Partners LP ("Regency") for approximately $10 billion in a transaction that closed in April 2015 (the "Merger"). At the time of the Merger, Regency and ETP were both controlled by Energy Transfer Equity, L.P. ("ETE").

The Plaintiffs sought approximately $1.7 billion in damages, alleging a breach of a provision of the partnership agreement requiring the Merger to be fair and reasonable, as well as a breach of the implied covenant of good faith and fair dealing. The latter largely focused on an individual's appointment to the conflicts committee. The Court ruled in favor of the Defendants. This summary focuses on quantification of damages.

The Plaintiffs' expert opined that damages to the Class were $1.7 billion by comparing: (1) the value of a Regency unit as of the Merger close date based on a discounted cash flow analysis using a dividend discount model ("DDM") to (2) the value of the Merger consideration using ETP's closing stock price.

The Court described the Plaintiffs' expert's damages analysis as a "give-get" analysis premised on an "apples-to-oranges comparison" of the units that were exchanged in the Merger; the "give" (Regency units) is calculated based on a DDM valuation model and the "get" (ETP units) is calculated based on market price.

The Court noted that the Plaintiffs' expert did not "provide any authority from finance literature to support his methodology of comparing a DDM-derived value to a market value to determine monetary damages rather than making a DDM-to-DDM or market-to-market comparison."

The Defendants' expert presented multiple apples-to-apples methodologies, i.e., one market to-market analysis and two variations of a DDM-to-DDM analysis. The Court opined that "every apples-to-apples comparison...demonstrated that members of the Class suffered no damages."

The Plaintiffs argued that the DDM-to-market comparison in its expert's damages model was a valid valuation methodology on the theory that ETE had a "financial incentive to favor ETP over Regency" which "caused Regency's unit price to suffer a valuation overhang."

However, the Court opined that "[g]iven the lack of any empirical support for drawing a distinction between Regency and ETP based on a valuation overhang theory, [the Plaintiffs' expert's] use of a DDM to-market comparison is illogical and at odds with well-established Delaware precedent, rejecting similar attempts to utilize apples-to-oranges comparisons to justify damages in actions challenging the fairness of stock-for-stock mergers."

The Court concluded that the Plaintiffs' expert "failed to provide a valid rationale for valuing the Merger consideration based on DDM-to-market comparison and that [the Plaintiffs' expert's] damages analysis is unreliable and is accorded no weight because it illogically 'attempts to equate two different standards of value.'"

The Plaintiffs presented an alternative damages theory for the first time in post-trial briefings (the "Dilution Analysis"). The theory began with a calculation presented by the Plaintiffs' industry expert at trial that "quantified the amount of Regency's cash flows Defendants diverted through the Merger to ETE," which "diluted the distributions to Regency unitholders."

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The Plaintiffs discounted the cash flows to present value using the cost of equity presented by the Defendants' expert at trial, resulting in an updated alleged damages totaling between approximately $338 million and $340 million.

The Court acknowledged that this Dilution Analysis was not fairly raised and suffered two obvious deficiencies that convinced the Court it was unreliable and must be rejected.

The first deficiency was that the Plaintiffs' Dilution Analysis failed to account for the differing manner in which the two companies were impacted by the historic decline in energy prices, due to the nature of their businesses, their respective sensitivity to commodity prices and their respective financial strength. The DDM-to-DDM comparison performed by the Defendants' expert showed that, when accounting for this risk, zero damages were incurred.

Second, the Plaintiffs did not consider other benefits the unitholders received from the Merger. In particular, the Dilution Analysis did not take into account the premium achieved based on the unaffected unit prices as of the announcement date of the Merger, which substantially exceeded the damages that the Plaintiffs projected.

The Court ruled in favor of the Defendants and awarded no damages.

CASE SUMMARIES

In re: Appraisal of Regal Entertainment Group, C.A. No. 2018-0266-JTL (Del. Ch. May 13, 2021)

On May 13, 2021, the Court issued a decision regarding the fair value of Regal Entertainment Group ("Regal" or the Company"), a U.S. movie theater chain. On February 28, 2018, Cineworld Group plc ("Cineworld") acquired Regal for $23.00 per share in cash. At trial, each side offered a valuation expert to opine on the fair value per share of Regal.

The Petitioners argued that the fair value of Regal was $33.83 per share, based entirely on a discounted cash flow ("DCF") methodology. The Court observed that "a more subjective valuation technique, like a DCF methodology or a comparable company analysis, 'is necessarily a second-best method' when 'market-based indicators are available.'" As such, the Court found that a DCF model was unlikely to provide more reliable evidence of fair value than a market-based indicator. In addition, the Court questioned the Petitioners' expert's valuation for two reasons: (1) the divergence between the DCF valuation and market-based indicators, and (2) reliance on optimistic management projections. Regarding the former, the Court concluded that the Petitioners' expert's DCF valuation "was not so extreme as to strain credulity, but the degree of divergence weighs against using it to value Regal." Regarding the latter, the Court concluded that "[s]ufficient doubt surrounds the 2017 Projections that [the Petitioners' expert's] DCF valuation is a less desirable approach than a market indicator."

Cineworld argued that the Court should not consider a DCF and instead should rely on (1) Regal's unaffected trading price and (2) the adjusted deal price. Cineworld argued that the resulting fair value under this method was $18.02 per share. While the Court noted that Cineworld's expert identified attributes that suggest Regal's common stock had sufficient attributes of market efficiency to warrant considering it as an indicator of fair value, it identified three countervailing reasons that ultimately drove the Court's conclusion not to rely on the unaffected trading price: (1) Regal had a controlling shareholder, (2) Regal's controlling shareholder engaged in block sales that created an overhang that capped the price of Regal's stock and (3) there was evidence that Regal's stock was "in a 'trough' due to the disastrous film slate in summer 2017." As a result, the Court found that the market for Regal's common stock was not "sufficiently efficient to be used as an indicator of fair value when another market-based indicator is available."

Cineworld also argued that deal price minus synergies provides reliable evidence of the fair value of Regal. The Court concluded that the sale process that led to the Merger was sufficiently reliable to make it a reliable starting point for the determination of fair value.

The Court then analyzed the deal price to determine whether any synergies were allocated to the seller that should be deducted to arrive at fair value. The synergies were broken into two categories: (1) operational synergies and (2) financial savings. Cineworld asserted that it anticipated $8.10 per share of operational synergies. While the Petitioners did not dispute these operational synergies, they argued that the estimate of the synergies was unreliable, and that Regal was already pursuing many of the initiatives. Based on examination of the evidence, the Court concluded that of the total expected operational synergies, $4.26 per share of synergy value arose from the accomplishment or expectation of the Merger, while the rest of the operating synergies were in fact already a part of Regal's "operative reality" at the time of the Merger.

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In addition to the operational synergies, the Court concluded that Cineworld expected to achieve financial savings of $2.73 per share as a result of the Merger that Regal could not have achieved as a standalone entity.

While the Court concluded that the Merger was expected to generate operational synergies of $4.26 per share and financial saving of $2.73 per share, it then had to estimate how much of the $6.99 in total synergies was allocated to Regal's stockholders in the purchase price. Cineworld's expert relied on a 2018 BCG Study, which found that "since 2007, the shareholders of target companies have captured, on average, 54% of the value of synergies, thanks to share price increases near the announcement date." While the Petitioners objected to its reliability, the Court found that the 2018 BCG Study was the "best tool available for an imprecise task" and calculated $3.77 per share of synergies included in the deal price ($6.99 times 54%). Thus, the deal price less synergies was $19.23 per share.

Lastly, the Court needed to determine whether the value of Regal changed between signing and closing. Both sides agreed that a change in value occurred between signing and closing when the Tax Cuts and Jobs Act (the "Tax Act") became law on December 22, 2017, and that this event required an upward adjustment to the value derived using the deal price less synergies approach. Ultimately, the Court adopted a change in value between signing and closing of $4.37 per share, based on the value implied by Cineworld's disclosures about the financial savings it could achieve before and after the passage of the Tax Act.

Based on the foregoing, Vice Chancellor Laster's decision concluded deal price provided a reliable indicator of the fair value of Regal at the time of signing. He then adjusted the deal price to eliminate value arising from the accomplishment or expectation of the Merger by subtracting $3.77 per share, representing the portion of Cineworld's anticipated synergies that the deal price allocated to Regal's shareholders. The resulting value of $19.23 per share reflects the fair value of Regal when the Merger Agreement was signed. Because the Tax Act increased Regal's value when the corporate tax rate was reduced from 35% to 21%, the Court added $4.37 per share to the value of the deal price minus synergies to reflect that valuation increase. As a result, the Court found that the fair value of the Company's common stock at the effective time of the Merger was $23.60 per share.

CASE SUMMARIES

Bandera Master Fund LP, et al. v. Boardwalk Pipeline Partners, LP, et al., C.A. No. 2018-0372-JTL (Del. Ch. November 12, 2021)

This matter involves Loews Corporation ("Loews") which formed Boardwalk Pipeline Partners, LP, a master limited partnership ("MLP") (collectively the "Defendants"), in 2005 to serve as a holding company for subsidiaries that operate interstate pipeline systems for the transportation and storage of natural gas. Defendants were taken public in 2005 after a policy enacted by the Federal Energy Regulatory Commission ("FERC") made MLPs a "highly attractive investment vehicle for pipeline companies." Loews held a "Call Right" which allowed Defendants to be taken private again, provided certain conditions were met, including if the FERC later took regulatory action that had a material adverse effect on Defendants. In March 2018, FERC proposed regulatory action that could have made MLPs less attractive; however, after pushback from industry players, when the regulatory action was ultimately implemented in July 2018, it made MLPs more attractive. During the period between the proposal and implementation, Loews executed the Call Right, closing one day before FERC announced the final regulatory action.

The Court found that the Call Right was improperly exercised, and Plaintiffs suffered damages as a result. The Court found that, by improperly exercising the Call Right, Plaintiffs were deprived of the stream of distributions they would have received. The Court determined that the appropriate measure of damages was the difference between the present value of those future distributions and the transaction price. The transaction price was undisputed, however the parties disputed the present value of the future distributions.

Plaintiffs' expert measured damages using a discounted distribution model which discounts the value of expected future distributions at the investor level and applies a discount rate of the company's cost of equity capital, given that the model only looks at returns to equity. The central question in this model was whether the cash flow projections, one of the principal inputs, were sufficiently reliable to use for valuation purposes. The Plaintiffs' expert relied on cash flow projections prepared by Loews' management team in the ordinary course of business, which the Court found acceptable, as it noted that "Delaware cases express a strong preference for management projections prepared in the ordinary course of business…"

The Defendants' expert also prepared a distribution model but discarded it in favor of a valuation based on the market price of Defendants' units. Nevertheless, the Court considered both the distribution model prepared by the Plaintiff and Defendant experts. In developing their distribution models, both experts made adjustments to the projections model prepared by Loews' management team. For example, the Defendants' expert arbitrarily removed 2028 and 2029 projections and progressively increased projected capital expenditures in 2023-2027 which reduced projected distributions in his model. The Court found these adjustments neither reasonable nor persuasive, as they were "based on an interview with two Loews executives" and were "inconsistent with 'Boardwalk's actual operational history.'" The Court noted that "[t]his court has rejected expert opinions when the experts downsized management projections for purposes of litigation…A party seeking to vary from reliable projections must 'proffer legitimate reasons to vary from the projections.'"

The Plaintiffs' expert made one modification to the model prepared by Loews management, which allowed a user to toggle between three possible scenarios of the "FERC Impact." The Plaintiffs'

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expert chose to use the "Off" scenario which equates to no FERC impact. However, the Court noted that this scenario resulted in an alteration to the Loews model which assumed the "Base FERC impact." The Court adopted the Base FERC impact, noting that it was a "conservative approach."

To derive a damages estimate based on unaffected market price, the Defendants' expert started with the market price on the last trading day before the issuance of the "Potential Exercise Disclosures," then used a regression analysis to bring the market price forward to the date on which the Call Right was exercised. Based on this analysis, he concluded that the unaffected market price of the units would have been lower than the purchase price and therefore Plaintiffs did not suffer any damages.

The Court did not find the Defendants' expert's analysis to be persuasive because "he failed to account for the General Partner's control over the Partnership and the resulting valuation overhang... [t]he presence of a controlling stockholder matters because 'participants will perceive the possibility that the controller will act in its own interests and discount the minority shares accordingly.'" The Court stated that it was undisputed that Loews controlled the Partnership through the general partner, and thus found that the Defendants' expert's starting point—the market price on the last trading date before the issuance of the Potential Exercise Disclosures—was not a reliable estimate of fair value. Additionally, the Court found that the Defendants' expert's analysis also "failed to account for the fact that the market did not possess material information about the level of distributions that Boardwalk could make in the future." In this case, the Court viewed this as an issue because, "[Defendants] projected internally that the Partnership's distributions would quadruple in 2023... [b]ecause [Defendants] controlled the Partnership, [Defendants]had the ability to make that happen. The market was not aware of [Defendants'] internal projections, and the unaffected trading price of the units could not and did not reflect this information... [b]y relying on the unaffected trading price, [Defendants' expert's] approach failed to take into account this source of value."

Using Plaintiffs' expert's distribution model without the modification from the management projections resulted in a valuation of $17.60 per unit. The transaction price was $12.06 per unit; therefore the Court found Plaintiffs were entitled to damages of $5.54 per unit, or total damages of $689,827,343.38.

CASE SUMMARIES

Marion Coster v. UIP Companies, Inc., et al., (Del. June 28, 2021)
Delaware Chancery Court opinion: C.A. No. 2018-0440 (Del. Ch. January 28, 2020)

This matter is related to a stock sale of UIP Companies, Inc. (UIP), ("Stock Sale") a closely held private real estate investment services company.

On June 28, 2021, the Supreme Court reversed and remanded the Court of Chancery decision.

The Court of Chancery initially determined that the entire fairness standard applied to the stock sale, and concluded that the "[s]tock [s]ale passes entire fairness review." The Court of Chancery decided not to cancel the Stock Sale despite its opinion that UIP's conflicted board issued stock to break a stockholder deadlock. According to the Court of Chancery, the UIP board approved the Stock Sale at a fair price and set that price through a fair process.

However, the Court of Chancery's decision was appealed to the Supreme Court, and the Supreme Court found that the Court of Chancery incorrectly declined to consider any other aspects of the transaction and held that the board did not breach any fiduciary duty owed to the Plaintiff. The Supreme Court reversed the Court of Chancery's decision on the conclusive effect of its entire fairness review and remanded for the court to consider the board's motivations and purpose for the Stock Sale. The Supreme Court explained that the price at which the board agreed to sell was entirely fair, as was the process to set the price for the stock. But the Supreme Court concluded that "inequitable action does not become permissible simply because it is legally possible."

In the details of its initial decision, the Court of Chancery found that a majority of the defendant's board was interested in the Stock Sale and held that the defendants had to prove the Stock Sale was entirely fair to the Plaintiff. The Court of Chancery found that while the process behind the Stock Sale was not optimal, the valuation was credible, which led the Court of Chancery to conclude that the price had been set after a fair process. The Court of Chancery similarly found that the valuation was the most reliable indicator of UIP's fair value. Having decided that the price of the Stock Sale was entirely fair, the Court of Chancery dismissed the action.

The Supreme Court found that the Court of Chancery fully supported its factual findings and legal conclusion that the Stock Sale price was determined through a process that was entirely fair and that its entire fairness analysis was "the end of the road for judicial review." However, the Supreme Court determined that the Court of Chancery bypassed a different and necessary judicial review where, as here, an interested board issued stock to interfere with "corporate democracy" and that stock issuance entrenched the existing board. The Supreme Court stated that it has been clear that activity "where boards of directors deliberately employ[ed] various legal strategies either to frustrate or completely disenfranchise a shareholder vote" violates Delaware law. The Supreme Court relied on precedent, which established that even if the court found that the board acted in good faith when it approved the Stock Sale, if it approved the sale for the primary purpose of interfering with the Plaintiff's statutory or voting rights, "the Stock Sale will survive judicial scrutiny only if the board can demonstrate a compelling justification for the sale."

The Court determined that the Court of Chancery should have an opportunity to review all of its factual findings in any manner it sees fit in light of its new focus.

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