The World According to Delaware Chancery: A Vice Chancellor Offers Ten Tips to Appraisers

At the recent AICPA National Business Valuation conference in Austin, an attendee was trying to get the attention of Dr. Shannon Pratt—when he turned and introduced her to Vice Chancellor Donald F. Parsons, of the Delaware Chancery Court. "It was like meeting the equivalent of a U.S. Supreme Court Justice," she said. "I was overwhelmed."

Indeed, the Delaware Chancery is renowned among business appraisers and attorneys as the forum to which many states defer on corporate matters, as its five Vice Chancellors have been entrusted with the development of Delaware General Corporate Law since 1792. The Chancery Court hears no criminal or jury trials, but as a court of equity, is empowered to issue temporary injunctions and declaratory judgments—including those in judicial appraisal actions.

Judge is sole determiner of fair value

The history of Delaware appraisals began in 1943, according to Vice Chancellor Parsons, in his address to AICPA attendees, when a statute introduced judicial review into the appraisal process. Subsequent amendment have made the presiding judge the sole determiner of fair value—which is the standard in Delaware Chancery appraisal actions, Parsons reminded the audience, citing last year's *Finkelstein* case (see sidebar). "We value the firm as a going concern, specifically recognizing its market position and future prospects."

Appraisal actions "present huge challenges," he conceded, as they require familiarity with finance theory and valuation methodology. "None of us is a CPA or has been in private BV practice," he said. "But we are reasonably intelligent, diligent about our jobs and do our best to understand the law and the evidence in the case."

Neal Beaton, CPA/ABV, CFA, ASA (Grant Thornton LLP, Seattle), who participated in Parsons' session, cited his experience in the recent *Gesoff v. IIC Industries Inc.*, in which V.C. Lamb had a "total command of valuation theory," he said, including some esoteric valuation issues. (See the Sept. and Oct. 2006 *BVUs* for more on Gesoff and Beaton's expert insights.)

Beaton also brought up the very recent *In re Nellson Nutraceutical, Inc.* (abstracted in this issue), where a federal bankruptcy court struck a valuation expert's DCF analysis under *Daubert*. "I ran that opinion by the other judges," Parsons said, and they agreed that a *Daubert* hearing is rare in any bench trial—and would be "fairly extreme" in the Delaware Chancery. But he alerted appraisers to the primary issue in *Nutraceutical*: The expert had apparently become so partisan, he said, that his opinion became "worthless."

Top ten suggestions for presenting business appraisals

Appearing in the Delaware Chancery Court can be "a little like Alice in Wonderland," Parsons said. To help business appraisers present valuation evidence with the greatest likelihood of success, he offered these "top ten" suggestions—which broadly apply to expert testimony in any judicial forum:

#10. *Be familiar with Delaware law and the judge's prior decisions.* "We don't look that frequently to the law in other states," Parsons said, "because very few have developed the statutory scheme we have—and fair value is always dependent on statute particulars." (Other states do look to Delaware Chancery precedent, he added, most frequently when their law is silent on a corporate issue.)

Appraisers should know which valuation methods have met with the Court's prior approval; a new or less-favored method requires a well-prepared explanation and justification. "I don't go into a case saying,' I'll never use a company specific risk premium,'" Parsons said; it depends on the facts presented—and "persuasive reasoning" by the experts.

Beaton brought the point home by describing the cross-examination of an opposing expert in *Gesoff*. "Judge Lamb had a specific opinion on the use of management financials," Beaton said, "and he interrupted the witness at one point to caution: 'Make sure you know how I ruled before answering.'"

#9. *Prepare an effective report.* "Explain how the company makes money and tell a persuasive story concerning your valuation," Parsons said. Describe your approaches and methods; explain the inputs and assumptions; and determine an appropriate weight for each method. If a particular method is not appropriate, be prepared to explain. "Mistakes and last-minute changes undermine credibility."

The report should be in plain, understandable terms—"but feel free to use charts, graphs, and CDs with spreadsheets." Take advantage of your attorneys' resources, "but don't bury us with paper."

#8. *Critique opponent's report or prepare alternate valuation?* This is a tactical decision, and "sensitivity analysis is critical." Appraisers should assess the strategical risks of the decision with their attorney. In *Finkelstein*, for example, the Vice Chancellor (Strine) rejected one expert's report, but as the same expert had failed to critique the opposing report, the Court was left with "nothing to go on."

#7. *Post-valuation synergies.* May an appraiser consider post-merger information in a Chancery appraisal? "Normally—no," Parsons said. Section 262(h) of the Delaware statute excludes "any element of value [such as synergies] arising from the accomplishment or expectation of the merger." But appraisers may consider all facts that are "known or knowable" as of the date of the merger.

Parsons cited *Gholl v. eMachines, Inc.* (2004), where the company had completely changed its way of doing business eleven months before going private—and so there was only 11-months of real data. In reviewing several management projections, the Court (in an opinion by Parsons) selected a post-merger budget plan, which nevertheless was "primarily completed" by the merger date and contained facts "known or knowable" at the time. (Note, the full-text of all referenced court opinions are available to subscribers of *BV Law* at BVResources.com.)

#6. *Reliability of projections.* The *eMachines* case emphasizes the Court's preference for contemporaneous management projections, especially those prepared in the ordinary course. "You're not doing your job if you don't question the managers (and the attorneys) you're working with," Parsons said. Projections prepared when a fairness opinion or deal is in the offing are generally less reliable.

#5. *Be prepared to justify a DCF.* All inputs and aspects of a discounted cash flow analysis will come under scrutiny, including the discount rate and its inputs (WACC, cost of equity and debt) and the terminal value (growth in perpetuity model and exit multiples model). "Make sure that it all holds together."

#4. *Implicit minority discount (IMD).* When is it appropriate to factor in the IMD? A current working paper by University of Pennsylvania's Lawrence Hamermesh[1] calls the IMD a "doctrinal weed" in the soil of Delaware appraisal law

> [The basic premise] posits that, no matter how liquid and informed the financial markets may be, all publicly traded shares persistently and continuously trade in the market at a substantial discount relative to their proportionate share of the value of the corporation.

The academics fail to find "a single piece of financial or empirical scholarship" affirming the IMD. But the Delaware Chancery is still researching the issue; three of the five Vice Chancellors have recently attended an all-day educational session on the topic. "I don't know how the debate will come out," Parsons said, "but I will take it seriously, listen and see who has the most persuasive argument."

#3. *Check your 'reality-checks.'* Market prices, control premiums, evidence of a "thorough and fair auction," etc.—in some cases, the Court has found these "reality" or reasonableness checks helpful.

#2. *Don't forget interest.* Interest compensates the petitioner for losing the use of cash, and causes the company to disgorge a proportionate benefit. The Delaware Chancery often derives the rate from equal weightings of the "prudent investor rate" and the corporation's cost of debt. As the parties bear the burden of proof, appraisers should assist with this calculation, or—absent reliable evidence, the Court will use the statutory rate of 5%.

#1. *Be skeptical and independent.* V.C. Parsons once again cited *eMachines*, where the corporation's COO had tried to characterize the budget plan (eventually adopted by the Court) as a "hail Mary, triple reverse, flea-flicker with a pass to the quarterback in the end zone." Despite the company having produced the baseline budget in the ordinary course of business, at trial, its appraiser had "jumped on the litigation team" and become an advocate instead of an independent analyst.

"The more you do that," Parsons warned, "the less likely you'll be able to persuade the Court—at least the Delaware Chancery." But the caution applies to most litigation settings, where appraisers who get "too cozy" with their own side risk losing their credibility.

[1] www.law.upenn.edu/ile/Hamermesh%20and%20Wachter,%20Implicit%20Minority%20Discount.pdf.

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