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Case No. 5713-CS

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE: APPRAISAL OF THE ORCHARD ENTERPRISES, INC.	))))	C.A. No. 5713-CS

MEMORANDUM OPINION

Date Submitted: May 30, 2012
Date Decided: July 18, 2012

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STRINE, Chancellor.

I. Introduction

This is the post-trial decision in an appraisal arising out of a merger in which the common stockholders of The Orchard Enterprises, Inc. were cashed out at a price of $2.05 per share by Orchard's controlling stockholder, Dimensional Associates, LLC (the "Going Private Merger" or the "Merger"). Relying upon a discounted cash flow ("DCF") analysis, the petitioners, who together owned 604,122 shares of Orchard's common stock, claim that each Orchard common share was worth $5.42 as of the date of the Going Private Merger.[1] By contrast, the respondent Orchard contends that the Merger price was generous and that Orchard common shares were worth only $1.53 a piece as of the date of the Merger.

The largest part of this value disparity stems from the parties' differing treatment of a $25 million liquidation preference that is owed by Orchard in certain circumstances to the holders of its preferred stock. Not by coincidence, Orchard's preferred stock is held almost entirely by Dimensional, which initiated the Going Private Merger, and constituted part of the equity votes that gave Dimensional majority control of Orchard before the Merger. Orchard's position regarding the liquidation preference is simple and is based on the practical reality that the "Certificate of Designations" governing the preferred stock required the payment of the $25 million liquidation preference to Dimensional upon a dissolution of the company, a sale of all or substantially all of Orchard's assets leading to a liquidation of the company, or a sale of control of Orchard

[1] The petitioners are Merlin Partners, LP, Quadre Investments, L.P., Matthew Giffuni, and Christopher Yeagley.

to an "unrelated third party."[2] Although Orchard admits (in the most tortured and begrudging manner one could ever conceive) that the liquidation preference was not triggered by the Going Private Merger and that Dimensional in fact still owns the preferred stock and may obtain the liquidation preference in the future, Orchard claims that as a market reality, Dimensional could demand the liquidation preference as a precondition to any third-party merger and that therefore the full $25 million liquidation preference must be deducted from the enterprise value of Orchard before calculating the value of its common stock in this statutory appraisal.

The petitioners rightly contend that Orchard's position is wrong as a matter of law. They correctly point out that the liquidation preference was not triggered by the Going Private Merger, as was indicated by Orchard in the proxy statement in support of the Merger (the "Proxy Statement.").[3] Whether the liquidation preference would ever be triggered in the future was entirely a matter of speculation as of the Merger date, because that turned on whether one of the events triggering it under the Certificate of Designations would occur. Unlike a situation where a preference becomes a put right by contract at a certain date,[4] the liquidation preference here was only triggered by unpredictable events such as a third-party merger, dissolution, or liquidation.[5] Most important, according to settled law as originally set forth by the Delaware Supreme Court

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[2] JX-5 (Certificate of Designations) §§ 2(a), 2(c).

[3] JX-9 (Proxy Statement) at 25 ("There will be no liquidation payment to the holders of [preferred stock] under the [Going Private Merger] agreement.").

[4] *Compare Shiftan v. Morgan Joseph Hldgs., Inc.*, 2012 WL 120196, at *9 (Del. Ch. Jan. 13, 2012).

[5] *See In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 906 (Del. Ch. 2009).

in *Cavalier Oil Corporation v. Harnett*,[6] the petitioners are entitled to receive their pro rata share of the value of Orchard as a going concern.[7] This means that the value of Orchard is not determined on a liquidated basis,[8] and the company must be valued "without regard to post-merger events or other possible business combinations."[9] Although Dimensional, as a holder of Orchard's preferred stock, had important control rights and economic protections in the event of a third-party merger, dissolution, or liquidation, its only right to share in cash flow distributions made by Orchard while the company was a going concern (*i.e.*, dividends) was on an as-converted basis.[10] That is, Dimensional's entitlement to dividends was based on the number of common shares into which the preferred shares could be converted. As a matter of law, therefore, Orchard's argument fails in the face of *Cavalier Oil*. The proper way to value the petitioners' shares is to value Orchard as a going concern, and to allocate value to the preferred and common stock based on the allocation made by the Certificate of Designations in that context. This approach marries perfectly with the DCF method of valuation, which is based on the notion that a corporation's value equals the present value of its future cash flows. By allocating the DCF value of Orchard in accordance with the dividend formula in the Certificate of Designations, as the petitioners did in this appraisal action, the

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[6] 564 A.2d 1137 (Del. 1989).
[7] *Id.* at 1144.
[8] *E.g.*, *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996).
[9] *Cavalier Oil Corp.*, 564 A.2d at 1144.
[10] *See* JX-5 § 1.

mandate of 8 *Del. C.* § 262 to award the petitioners "the fair value of [their] shares"[11] is faithfully implemented.

After I address the parties' arguments regarding the liquidation preference, I address the technical corporate finance valuation issues that commonly arise in appraisal proceedings decided by law-trained judges. The first major decision I make is to concentrate solely on the DCF method in reaching my determination of fair value. Although Orchard purports to rely upon both the comparable companies and comparable transactions methods in coming to its position on value, its analyses based on these methods are not reliable. None of those comparables is really similar to Orchard – a unique business in a niche in the music industry – in the way that, say, Bank of America is to Citigroup. What is more important to me, though, is that Orchard's expert generated an array of comparables from which valuation multiples in the form of medians and means could be derived, but then chose multiples well below the median and mean for each analysis without providing a sensible explanation. At bottom, the expert did not draw any reasoned inference about the value of Orchard from his comparables. Rather, all he did was come up with a sample of comparables, conclude that Orchard was a much worse performer than any of them for reasons that are inconsistent with the data in his own analysis and then subjectively pick a lower multiple to justify an outcome. I cannot embrace that approach.

Because Orchard failed to make a convincing case for the use of a comparable companies or comparable transactions analysis, I focus my determination of value on the

[11] 8 *Del. C.* § 262(h).

DCF value of the company. Fortunately, in this case, the parties' dispute about the core input to that method – the financial projections – is relatively minor, as the parties largely agree on the reliability of the projections provided by Orchard management, with only a minor skirmish about which set of projections to use, certain adjustments to be made to the chosen set of projections, and what weight to give to management's aggressive and base case scenarios. I find for Orchard for the most part on these issues, giving 90% weight to the base case and only 10% weight to the aggressive case, and using the projections most current as of the date of the Going Private Merger.

The largest disagreement between the parties over DCF value is over the discount rate to use. Each side's expert used three different methods to come to a discount rate. Two of these methods are versions of the so-called "build-up" model. The build-up model is a method larded with subjectivity, and it incorporates elements that are not accepted by the mainstream of corporate finance scholars. By contrast, the third method each of the experts used is based on the capital asset pricing model ("CAPM") that remains the accepted model for valuating corporations. The experts used a modified CAPM method that takes into account academic acceptance that the size of a corporation affects the expected rate of return and should be factored into the calculation of a corporation's discount rate.

Rather than (i) use methods that involve great subjectivity and lack firm grounding in corporate finance theory, and (ii) shroud my determination of fair value in the false precision of averaging the results of three different methods of calculating cost of capital in coming to a single discount rate, I choose to determine the discount rate using only the

CAPM method. When the supply-side equity risk premium, the use of which is supported by relevant professional and academic literature and prior decisions of this court in appraisal proceedings, is applied, and Orchard's decision to include a company-specific risk factor that is inconsistent with the CAPM method is put to the side, as it should be, the petitioners and Orchard agree that the discount rate under the CAPM method is 15.3%.

After making these and some other minor decisions about the inputs to the DCF analysis, I arrive at a per common share value of $4.67 for Orchard, subject to confirmation by the parties because of the uncertainties that come with making changes to both experts' inputs and plugging them into one expert's DCF model, which I supplement with an award of interest at the statutory rate.

II. Factual Background

A. Orchard's Business And Capital Structure Before The Merger With Dimensional

Orchard primarily makes money from the retail sale (through digital stores such as Amazon and iTunes) and other forms of exploitation of its controlled, licensed music catalogue, which includes artists ranging from the rapper Pitbull to jazz musician Wynton Marsalis. As of 2010, this core business made up 90% of Orchard's total revenue, with the other revenue coming from the distribution of other digital content. Until Dimensional, a private equity investor, cashed out Orchard's common stockholders in the Going Private Merger, Orchard was traded on the NASDAQ.

Orchard's capital structure before the Going Private Merger consisted of (i) common stock, which was 42.5% owned by Dimensional, and (ii) preferred stock, which was essentially wholly owned by Dimensional. Dimensional had 53% of the voting power of Orchard's outstanding capital stock, because the preferred stock could vote on an as-converted basis.

The rights and preferences of the preferred stock are set forth in the Certificate of Designations. The preferred stock has no set dividend rights, but is entitled to participate in any dividends declared by Orchard on its common stock on an as-converted basis. Specifically, each share of Orchard's preferred stock is convertible at the option of the holder at any time into 3.33 Orchard common shares, subject to adjustments for stock splits, combinations, and distributions.

Upon the occurrence of certain events described in § 2 of the Certificate of Designations, the preferred stock is entitled to a liquidation preference of $25 million. These events are limited to: (i) a "voluntary or involuntary liquidation, dissolution, or winding up" of Orchard;[12] (ii) "the sale or exclusive license of all or substantially all of [Orchard's] assets or intellectual property," in which case the company is required to liquidate, dissolve and wind up" as soon as possible thereafter;[13] and (iii) a "Change of Control" transaction "in which the stockholders of [Orchard] will receive consideration from an unrelated third party."[14]

B. <u>The Going Private Merger</u>

In 2008, Orchard's business was suffering along with many others in a declining economy. Dimensional looked to exit from Orchard by selling the company, but

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[12] JX-5 § 2(a).
[13] *Id.* § 2(c).
[14] *Id.*

demanded that any buyer pay it the $25 million liquidation preference before according any value to the common stock. According to Dimensional, no buyer emerged that would pay a value that would result in an attractive price for the common stock on that basis. Thus, Dimensional turned into a buyer from a potential seller, claiming that it "had no option … but to try to facilitate the transaction [itself] and actually pay out [the] common shareholders" by taking Orchard private.[15] In other words, Dimensional chose to deepen its investment in Orchard's future but only on the condition that it could run Orchard as a private portfolio company without other investors.

In October 2009, Dimensional therefore informed Orchard's board of directors that it was making an offer for the outstanding shares of Orchard's common stock that it did not already own. In response, the board formed a special committee of independent directors to review and evaluate any offer made by Dimensional. The special committee hired Fesnak and Associates, LLP as its financial advisor.

After negotiations, Dimensional and the special committee reached agreement that Dimensional would cash out the other holders of Orchard's common stock at a price of $2.05 per share. Fesnak and Associates reviewed the fairness of this consideration by performing a variety of financial analyses, including a comparable companies analysis, a comparable transactions analysis, and a DCF analysis. On March 15, 2010, Fesnak and Associates delivered a fairness opinion to the special committee that a price of $2.05 per share was fair, from a financial point of view, to Orchard's common stockholders. The Going Private Merger was then approved by both the special committee and Orchard's

[15] Tr. 239-40 (Stein).

board, and Orchard and Dimensional entered into a merger agreement. At Orchard's annual meeting on July 29, 2010, a majority of the minority stockholders of Orchard voted in favor of the Going Private Merger and the Merger became effective.

In addition, the common stockholders of Orchard (including Dimensional) voted earlier that day to approve an amendment to the Certificate of Designations to facilitate the Going Private Merger. As it then existed, the Certificate of Designations prohibited all types of "Change of Control Event[s]" other than the two Events requiring payment of the liquidation preference to Orchard's preferred stockholders – a sale of all or substantially all of Orchard's assets or a sale of control to an unrelated third party.[16] The Going Private Merger did not fall within either of these exceptions, and it was therefore necessary that the Certificate of Designations be amended so as to allow the Merger to take place. The amended language, which was also approved by Orchard's preferred stockholders, allowed Orchard to enter into a transaction that would constitute an otherwise-prohibited Change of Control Event "upon the prior vote or written consent of at least a majority of the then outstanding [preferred stock]."[17] In other words, the amendment allowed Orchard to engage in a merger with its majority stockholder, Dimensional, that would have otherwise been barred by the Certificate of Designations.

As was made clear by the Proxy Statement, the agreement entered into by Orchard and Dimensional did not provide for any payment to the holders of Orchard's preferred

[16] JX-5 § 2(c).
[17] JX-31 (Certificate of Amendment to the Certificate of Designations).

stock (*i.e.*, Dimensional).[18] Thus, the preferred stock was left in place by the Going Private Merger, Dimensional continues to own it, and as a matter of contract the liquidation preference remains payable in the event that one of the triggering events described in the Certificate of Designations occurs in the future.

Orchard makes some rhetorical hay out of its search for other buyers. But this is an appraisal action, not a fiduciary duty case, and although I have little reason to doubt Orchard's assertion that no buyer was willing to pay Dimensional $25 million for the preferred stock and an attractive price for Orchard's common stock in 2009, an appraisal must be focused on Orchard's going concern value. Given the relevant legal standard, the trial record did not focus extensively on the quality of marketing Orchard by Dimensional or the utility of the "go shop" provision contained in the merger agreement, which could obviously have been affected by Dimensional's voting power and expressed interest to acquire all of Orchard for itself.

Instead, the testimony at trial focused mostly on the question that is relevant under *Cavalier Oil* and its progeny, which is the going concern value of Orchard as of the date of the Merger. In this opinion, I concentrate on answering the key questions raised by the parties relevant to determining that value, which are: (i) whether the preferred stock should be valued at the $25 million liquidation preference value or on an as-converted basis in determining the value to subtract from Orchard's equity value to derive a value for its common stock; and (ii) the enterprise value of Orchard as a going concern on the Merger date.

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[18] *See* JX-9 at 25.

I turn to those questions now.

III. Legal Analysis

The standards I must apply in reaching my determination are well known. Under § 262, this court must "determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value."[19] For purposes of an appraisal proceeding, "fair value" means "the value of the company to the stockholder as a going concern, rather than its value to a third party as an acquisition."[20] The court should consider "all relevant factors known or ascertainable as of the merger date that illuminate the future prospects of the company,"[21] but "any synergies or other value expected from the merger giving rise to the appraisal proceeding itself must be disregarded."[22]

In an appraisal action, both parties bear the burden of proving their respective valuations by a preponderance of the evidence.[23] After considering the parties' arguments and the respective experts' reports and testimony in support of their valuation positions, this court has discretion to select one of the parties' valuation models or to

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[19] 8 *Del. C.* § 262(h).
[20] *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 795 (Del. 1999).
[21] *Gearreald v. Just Care, Inc.*, 2012 WL 1569818, at *3 (Del. Ch. Apr. 30, 2012).
[22] *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 507 (Del. Ch. 2010).
[23] *See M.G. Bancorp., Inc. v. LeBeau*, 737 A.2d 513, 520 (Del. 1999).

create its own.[24] But, the court may not adopt an "either-or" approach to valuation and must use its own independent judgment to determine the fair value of the shares.[25]

A. Orchard's Preferred Stock Should Be Valued On An As-Converted Basis

As indicated, the parties' different approaches to value are primarily driven by the question of how to value Orchard's preferred stock. The petitioners' expert, Timothy J. Meinhart, a managing director of Willamette Management Associates, concluded that any payment of the $25 million liquidation preference to Orchard's preferred stockholders "was speculative at best,"[26] and therefore allocated value to the preferred stock on an as-converted basis. Orchard's expert Robert W. Fesnak, a partner of Fesnak and Associates, the financial advisor to the special committee, took a different approach. Reasoning that the liquidation preference entitles Orchard's preferred stockholders to the first $25 million of the company's equity value, Fesnak subtracted the value of the liquidation preference from the equity value he derived for Orchard in his analysis before dividing that value by the number of common shares outstanding as of the date of the Going Private Merger. In light of the plain terms of the Certificate of Designations and settled Delaware law governing appraisal actions, I reject Orchard's ever-evolving yet constantly confused arguments in defense of Fesnak's treatment of the liquidation preference, which are detailed below.

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[24] *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 299 (Del. 1996).

[25] *See M.G. Bancorp., Inc.*, 737 A.2d at 526; *Gonsalves v. Straight Arrow Publishers, Inc.*, 701 A.2d 357, 361-62 (Del. 1997).

[26] Tr. 58 (Meinhart).

In its pre-trial briefs, Orchard advanced the incredibly confusing, illogical, and non-factual argument that "a proper valuation" of Orchard's common stock "must take into account the probability and economic reality [] that the holders of [p]referred [s]tock were entitled to their liquidation preference upon the [Going Private] Merger, as set forth in the Certificate of Designations."[27] To wit, Orchard contended that the amendment to the Certificate of Designations that allowed the Going Private Merger to take place "reflect[ed] that the transaction could not occur without the payment of a *change of control premium*" to Dimensional.[28] The amendment provided that a Change of Control Event other than the two Events giving rise to payment of the liquidation preference could take place so long as it was approved by a majority of the holders of preferred stock. According to Orchard, Dimensional's approval of the Going Private Merger under the terms of the amended Certificate of Designations was an implicit recognition that the "liquidation preference was a negotiated component of [the Going Private Merger]."[29]

This argument dances around the plain terms of the amended Certificate of Designations, which make clear that payment of the liquidation preference is only triggered upon the occurrence of three events. Specifically, only the following events require payment of the liquidation preference, which I have described earlier but will restate here: (i) a "voluntary or involuntary liquidation, dissolution, or winding up" of Orchard;[30] (ii) "the sale or exclusive license of all or substantially all of [Orchard's]

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[27] Resp. Pre-Tr. Op. Br. at 28.
[28] *Id.* at 31 (emphasis added).
[29] Resp. Pre-Tr. Ans. Br. at 15.
[30] JX-5 § 2(a).

assets or intellectual property," in which case the company is required to liquidate, dissolve and wind up" as soon as possible thereafter;[31] and (iii) a "Change of Control" transaction "in which the stockholders of [Orchard] will receive consideration from an unrelated third party."[32] The Going Private Merger was not an event triggering the payment of the liquidation preference, as the Proxy Statement made clear.[33] Indeed, the preferred stock remains outstanding and the liquidation preference is due if one of the triggering events occurs in the future. But as of the date of the Merger, the liquidation preference had not been triggered, and the possibility that any of the triggering events would have occurred at all, much less in what specific time frame, was entirely a matter of speculation.

Faced with the inescapable fact that the Going Private Merger did not trigger the liquidation preference, Orchard also argued that Dimensional's legal rights as a preferred holder and its firm voting control as an overall holder of equity "increased the probability of payment of the liquidation preference such that it was near certainty on the Merger date."[34] This court has considered an argument similar to the one made by Orchard recently and rejected it. In his decision in *In re Appraisal of Metromedia International Group, Inc.*,[35] Chancellor Chandler, in the context of an appraisal of shares held by preferred stockholders, rejected the petitioners' request that the court award an appraisal value based on "what preferred holders would have been entitled to had their stock been

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[31] *Id.* § 2(c).
[32] *Id.*
[33] *See* JX-9 at 25.
[34] Resp. Pre-Tr. Op. Br. at 34.
[35] 971 A.2d 893 (Del. Ch. 2009).

redeemed or had there been a liquidation event."[36] The petitioners in *Metromedia* based their argument on the assumption that the preferred shares would be redeemed in three to five years because the private equity buyer of Metromedia would probably seek to exit its investment within that time frame.[37] The Chancellor found that such an assumption was "speculative in that it assumes the probability of a future event, that is not certain to occur, and that has not occurred as of the appraisal date,"[38] and noted that the certificate of designation governing the preferred stock did not "contemplate the probability of future events."[39] Thus, the preferred stockholders' "untriggered contractual rights" to redemption offered "no non-speculative value upon which this Court is entitled to rely in an appraisal proceeding."[40]

Here, as in *Metromedia*, the liquidation preference is payable only if one of the triggering events under the Certificate of Designations occurs, events that involve the end of Orchard's existence as a going concern. Therefore, not only does one have to engage in the kind of speculation that *Metromedia* rightly found our Supreme Court to have found an improper basis for valuing shares in an appraisal, but one also has to speculate that transactions will occur that are not supposed to be the basis for appraisal value – such as a merger or liquidation – and to base the appraisal award on the assumption that such a transaction would occur and that the economic pie should be divided as it would be when

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[36] *Id.* at 904.
[37] *Id.* at 904-05.
[38] *Id.* at 905.
[39] *Id.*
[40] *Id.* at 906.

such a transaction did occur. I cannot base my award on such a game theory approach to the future, as it is inconsistent with *Cavalier Oil*.

The argument that Orchard makes contrasts nicely with the type of argument that can be fairly considered in an appraisal. In *Shiftan v. Morgan Joseph Holdings, Inc.*,[41] a merger was effected six months before the relevant certificate of designation gave the preferred stockholders the right to exit their investment by putting their shares to the corporation and getting their liquidation preference.[42] In that context, the going concern value of the company as of the date of the merger had to take into account the non-speculative obligation of the company to pay out the liquidation preference in six months.[43] This was a firm legal obligation owed by the company that gave the preferred stockholders a specific claim to the liquidation preference. By contrast, in this case, if Orchard remains a going concern, the preferred stockholders' claim on the cash flows of the company (if paid out in the form of dividends) is solely to receive dividends on an as-converted basis. That is, in the domain of appraisal governed by the rule of *Cavalier Oil*, the preferred stockholders' share of Orchard's going concern value is equal to the preferred stock's as-converted value, not the liquidation preference payable to it if a speculative event (such as a merger or liquidation) that *Cavalier Oil* categorically excludes from consideration occurs.

Given that reality, the petitioners are correct that the preferred stock should be valued on an as-converted basis, because that is the basis on which the preferred shares

[41] 2012 WL 120196 (Del. Ch. Jan. 13, 2012).
[42] *Id.* at *9.
[43] *Id.* at *10.

would share in the cash flows of Orchard if the company remained a going concern. In so finding, I acknowledge that there is some market force to the argument Orchard focused on post trial, which is that "there was an inarguable $25 million liability overhanging the [c]ommon [s]tock" on the day of the Going Private Merger that "reduced the value of the [c]ommon [s]tock."[44] According to Orchard, no third-party investor or market participant would value Orchard without taking into account this overhanging liability, and Dimensional would never approve a transaction with a third party in which it did not receive its liquidation preference. In other words, Orchard argues that the stock market might discount the value of the common stock of Orchard to take into account the leverage held by Dimensional through the combination of the Certificate of Designations (which required the payment of the liquidation preference in any third-party merger) and its majority voting power.

Although Orchard's premise may be grounded in market realities, it runs into the problem that the appraisal remedy exists to a large extent to address the potential that majority power such as Dimensional wielded will be abused at the expense of the minority. *Cavalier Oil* and its progeny embrace an approach to valuing shares that is, in the main, quite favorable to minority stockholders. Although Delaware law putatively gives majority stockholders the right to a control premium, *Cavalier Oil* tempers the

[44] Resp. Post-Tr. Ans. Br. at 18.

realistic chance to get one by requiring that minority stockholders be treated on a pro rata basis in appraisal.[45]

Thus, *Cavalier Oil* makes clear that in an appraisal action, the petitioners are entitled to their "proportionate interest in a going concern."[46] Importantly, this means that the value of the company under appraisal is not determined on a liquidated basis,[47] and the company must be valued "without regard to post-merger events or other possible business combinations."[48] In other words, the duty of this court in an appraisal is not to speculate about the price at which the corporation whose shares are to be valued would be sold in a hypothetical auction, but to make a determination of its value as a going concern, without reference to the merger giving rise to the appraisal rights or speculative events. Allocating the value of the liquidation preference to Orchard's preferred stockholders would be tantamount to valuing the company on a liquidation basis or presuming a sale of the company, because it is only in those circumstances that the preference would be triggered.

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[45] *See Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144 (Del. 1989). This could also reflect the Supreme Court's recognition, although not expressed in *Cavalier Oil*, that appraisal is a risky, time-consuming, and burdensome remedy that involves a stockholder tying up its investment in a legal proceeding for several years and having to bear its own cost of prosecution, without any guarantee to receive any floor percentage of the merger consideration.

[46] *Id.* (citing *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950)).

[47] *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996); *Rapid-Am. Corp. v. Harris*, 603 A.2d 796, 802-03 (Del. 1992); *Bell v. Kirby Lumber Corp.*, 413 A.2d 137, 141-42 (Del. 1980).

[48] *Cavalier Oil Corp.*, 564 A.2d at 1144.

Cavalier Oil also precludes the application of a minority discount at the stockholder level.[49] "The amount of the holdings of a particular dissenting stockholder is not relevant, except insofar as they represent that shareholder's proportionate interest in the corporation's overall 'fair value.'"[50] What Orchard is in substance arguing is that Dimensional's majority voting control and the Certificate of Designations gave it power to command the payment of the liquidation preference in a future merger – as Orchard calls it, a "change of control premium"[51] – and therefore that Dimensional should be treated as having the ability to extract $25 million as of the date of the Going Private Merger as a right of this power position. This is exactly the sort of argument that *Cavalier Oil* bars in an appraisal.

Thus, I adopt the petitioners' treatment of the liquidation preference and value Orchard's preferred stock on an as-converted basis. Dimensional had strong leverage as a preferred investor to push for certain contractual rights.[52] What it got in terms of cash flow rights when Orchard existed as a going concern was to share in dividends on an as-

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[49] *Id.* at 1145 ("The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a 'going concern'"); *cf. Paskill Corp. v. Alcoma*, 747 A.2d 549, 557 (Del. 2000) (finding that a non-marketability discount "would [constitute] an improper discount at the shareholder level" in an appraisal action).
[50] *Cavalier Oil Corp. v. Harnett*, 1988 WL 15816, at *8 (Del. Ch. Feb. 22, 1988), *aff'd*, 564 A.2d 1137 (Del. 1989); *see also Rapid-Am. Corp.*, 603 A.2d at 805 ("[A] court cannot adjust its valuation to reflect a shareholder's individual interest in the enterprise.").
[51] Resp. Pre-Tr. Op. Br. at 31.
[52] The rights of preferred stockholders are "contractual in nature." *In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 899 (Del. Ch. 2009); *see also In re Appraisal of Ford Hldgs., Inc. Preferred Stock*, 698 A.2d 973, 977 (Del. Ch. 1997) ("All of the characteristics of [] preferred [stock] are open for negotiation; that is the nature of the security.").

converted basis with the common stock. This decision honors those contractual rights specifically in valuing Orchard in the manner required by *Cavalier Oil*.

B. The Enterprise Value Of Orchard As A Going Concern

Having now determined the value to use for the preferred shares in calculating the value of the Orchard common shares, I come to the more common task required in an appraisal proceeding, which is determining the going concern value of the firm.

1. Orchard Should Be Valued Using The DCF Method

As previously indicated, the petitioners relied solely on a DCF analysis to support their argument that the fair value of an Orchard common share on the date of the Going Private Merger was $5.42. By contrast, Orchard's expert Fesnak gave nearly equal weight to his DCF analysis, comparable companies analysis, and comparable transactions analysis in coming to a per common share value for Orchard of $1.53. As an initial matter, I find that the comparable companies and comparable transactions analyses performed by Fesnak cannot be reliably used on this record and the DCF method should be given exclusive weight in this appraisal.[53]

[53] *See Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *9 (Del. Ch. Aug. 19, 2005) (noting that "[t]he DCF method is frequently used in this court" and that the method may be given "great, and sometimes even exclusive, weight when it may be used responsibly."); *see also M.G. Bancorp., Inc. v. LeBeau*, 737 A.2d 513, 523 (Del. 1999) ("The [DCF] methodology has been relied upon frequently … in other statutory appraisal proceedings."); *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004) (DCF analysis "has featured prominently in this court because it … merits the greatest confidence within the financial community.").

A comparable, or market-based, approach to valuation is rooted in the same intuition as the DCF method.[54] But rather than directly estimating the future cash flows of the subject company and reducing them to present value, the market-based methods draw inferences about the future expected cash flows from the market's expectations about comparable companies.[55] The idea is that if the market expects comparable companies to grow at a certain rate, then one can infer the growth of the subject company by applying a multiple drawn from the comparables to a relevant metric, such as EBITDA or revenues.[56]

For obvious reasons, the utility of a market-based method depends on actually having companies that are sufficiently comparable that their trading multiples provide a relevant insight into the subject company's own growth prospects. When there are a number of corporations competing in a similar industry, the method is easiest to deploy reliably.[57] For example, fast food restaurant chains, commercial banks, and automobile manufacturers might be seen as industries with a number of recognizable players who

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[54] *See* Aswath Damodaran, *The Dark Side of Valuation* 102 (2d ed. 2010) ("In the introduction to discounted cash flow valuation, we observed that a firm's value is a function of three variables – its capacity to generate cash flows, its expected growth in these cash flows, and the uncertainty associated with these cash flows. Every [market] multiple, whether it is of earnings, revenues or book value, is a function of the same three variables – risk, growth, and cash-flow generating potential.").

[55] *See id.* at 91; Bradford Cornell, *Corporate Valuation: Tools for Effective Appraisal and Decision Making* 56-57 (1993).

[56] *See* Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 265-66 (5th ed. 2008) (stating this principle).

[57] *See* Shannon P. Pratt, *The Lawyer's Business Valuation Handbook* 148 (2000) ("The most obvious criterion for comparability is line of business."); Cornell, *supra* note 55, at 61 ("For the direct comparison approach to be useful, there must be a way to identify comparable companies without developing detailed cash flow forecasts for each firm. One common solution is to rely on industry classifications.").

compete in the same markets. By generating a good set of comparables, one can obtain a sense of how the market perceives the growth prospects of the industry to be, and one can apply the resulting multiples to the relevant metric of the subject company to make a judgment about its value.[58]

When, by contrast, it is difficult to find companies that actually do the same thing as the subject company, the comparables method is less reliable.[59] Reliance on a comparable companies or comparable transactions approach is improper where the purported "comparables" involve significantly different products or services than the company whose appraisal is at issue, or vastly different multiples.[60] "At some point, the

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[58] *See* Damodaran, *The Dark Side of Valuation*, *supra* note 54, at 92-94.

[59] *See In re Radiology Assocs., Inc. Litig.*, 611 A.2d 485,490 (Del. Ch. 1991).

[60] *E.g.*, *Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *7 (Del. Ch. Feb. 10, 2004) (rejecting comparable transactions analysis because comparables were "manufacturing companies, not retailers"); *ONTI v. Integra Bank*, 751 A.2d 904, 916 (Del. Ch. 1999) (rejecting comparable companies analysis because comparables performed "medical oncology," rather than "radiation oncology" like the subject company, and thus were more equipment intensive and derived a larger amount of revenue from pharmaceuticals than did the subject company); *Radiology Assocs.*, 611 A.2d at 489-90 (rejecting comparable companies analysis based in part on differences in product mix, geographic market, and assets).

Corporate finance and valuation texts support this principle as well. *See generally* Tim Koller, Marc Goedhart & David Wessels, *Valuation: Measuring and Managing the Value of Companies* 315-16 (5th ed. 2010) (discussing the importance of using an appropriate peer group when undertaking a comparable companies analysis and instructing that "to choose a peer group, only use companies with the same underlying characteristics."); Pratt, *Valuing a Business*, *supra* note 56, at 270 (stating that "the microeconomic factors that drive the [comparable] companies should be sufficiently similar to the microeconomic factors that drive the subject company. Otherwise, the [comparable] companies will not provide meaningful pricing guidance to the analyst."); *but see* Damodaran, *The Dark Side of Valuation*, *supra* note 54, at 105-06 (discussing the selection of comparable firms, and noting that although most analysts limit the set of comparables to other firms within the subject company's industry, a firm in a different industry may be comparable to the subject company as long as "the two are identical in terms of cash flows, growth, and risk.").

differences become so large that the use of the comparable company method becomes meaningless for valuation purposes."[61]

Likewise, if a sample of comparables is identified by a party using this method, and that party determines not to use either the median or the mean of the multiples derived from her sample, but instead picks a multiple that has no logical relation to either, that party is indicating that her comparables are in fact not at all very comparable.[62] She is in that case not deriving a value by inferring that the growth prospects of the subject company are like her sample of comparable companies, but rather she is inferring that they are materially different from her sample. In essence, the party simply picks her own multiple, throwing away her sample as being too different from the subject company to provide a reliable basis for determining its value.

I do not know whether it would be possible for me to find an unbiased financial analyst to perform a ground-up comparables valuation of Orchard. But I do know that the one proffered by Orchard is not a reliable one that would be accepted by a disinterested mind.

For starters, not one of the eight comparables chosen by Fesnak was really similar to Orchard. Although the comparables were in a related "space," there were no other companies that derived most of their revenue by obtaining the right to and then distributing digital access to music. Orchard competes to acquire digital rights to music

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[61] *Radiology Assocs.*, 611 A.2d at 490.

[62] *See* Cornell, *supra* note 55, at 68 (noting that an investment bank that valuates a company using the market approach by employing the mean and median multiples generated by the comparables "is less likely to be accused of 'cherry picking' in order to reach a particular conclusion.").

and video content and to distribute digital content with the independent label distribution subsidiaries of the four major record label groups – Sony, Universal Music Group, EMI and Warner Music Group – but these competitors are embedded in larger entertainment behemoths. The only companies that both Fesnak and the petitioners' expert Meinhart embraced as comparable to Orchard were Glu Mobile, Inc., Limelight Networks, Inc. and RealNetworks, Inc.[63] These are companies in a variety of businesses providing various digital content and services, but that often make money in ways that do not resemble Orchard's business at all. For example, Glu Mobile designs, markets and sells games for mobile phones through wireless carriers and other distributors. Orchard is a distributor of content to online retailers, but does not create any of the content itself. A comparable used by Fesnak but not by Meinhart, Edgar Online, Inc., creates and distributes financial data and public SEC filings, a business that has no strong similarity in logical consumer market terms to digital music licensing and distribution. Thus, on a basic level, Fesnak's analysis fails for lack of a good sample of actual comparables.

What compounds this problem is what Fesnak did with his comparables, which was essentially to ignore them. His sample of comparable companies yielded a mean market value of invested capital ("MVIC")/ EBITDA multiple of 15.14 and a median multiple of 14.37.[64] Had Fesnak used either of these metrics and thus given real weight

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[63] Meinhart identified comparables in his report and performed a comparable companies analysis of Orchard, *see* JX-20 (Meinhart Report) at 34-39, but ultimately decided that the comparables were so incomparable that he could not use a market-based method of valuation. *See id.* at 43.

[64] JX-21 (Fesnak Report) at 9. Fesnak also derived a MVIC/Revenue multiple from his sample of comparable companies, but I focus on his problematic departures from the median and mean

to his sample, he would have generated equity values for Orchard of $47.92 million and $45.77 million, which would translate to $6.09 and $5.81 per common share valuing the preferred on an as-converted basis. Instead, however, of using either the median or mean multiple, Fesnak used a self-chosen multiple of 11, which was much lower, and produced a value of only $4.62 per share.[65] In his report, Fesnak attributes this to Orchard having "lower liquidity ratios than the public comparables and lack[ing] tangible net worth."[66] But Fesnak fails to explain why these factors are important, and, as the petitioners point out, these factors do not seem to correlate to a lower multiple. For example, in his rebuttal to Fesnak's report, Meinhart shows that the comparable with the greatest EBITDA multiple of 25 – EDGAR Online, Inc. – had a liquidity ratio of 1.8 and a tangible book value of *negative* $1.31 million.[67] He also shows that the comparable with the lowest EBITDA multiple of 6.8 – Internap Network Services – had a liquidity ratio of 2.6 and a book value of $131.8 million.[68] This data indicates that the liquidity and tangible book value of the comparable companies do not seem to correlate with the direction of the EBITDA multiples, which undermines Fesnak's stated rationale for applying a multiple below the median or mean.

EBITDA multiples generated by his sample because he gave 95% weight to the EBITDA multiple and only 5% weight to the Revenue multiple in his analysis.

[65] For the sake of consistency and clarity, all of Fesnak's analyses have been adjusted to generate outcomes based on valuing the preferred stock on an as-converted basis. When that is done, it reveals how much of the difference is due to the preferred's valuation. When the preferred is valued at $25 million rather than on an as-converted basis, Fesnak's value of $4.62 is only $1.79 per common share.

[66] JX-21 at 9.

[67] JX-22 (Meinhart Rebuttal Report) at 4-5.

[68] *Id.*

Looked at from a broader perspective, Orchard also had a variety of strengths – such as being debt free – that other firms in Fesnak's sample of comparables did not,[69] and I can perceive no principled basis for sharply departing from the median or mean EBITDA multiple. Fesnak might be right in subjectively perceiving Orchard's growth prospects to be totally different from the sample of comparables he chose. But when an expert throws out his sample and simply chooses his own multiple in a directional variation from the median and mean that serves his client's cause, he is not using the comparables method in any reliable way that accords with my understanding of its proper deployment. All the expert is doing is a more obscure and less principled direct measurement of the corporation's future cash flows, by tethering that measurement to a sample of comparables the expert has in fact tossed aside. When that is the case and there is a basis for the expert to justify this direct measurement of the company's future cash flows by applying the proper straightforward method – the DCF method – the court should focus on a DCF valuation.

The same issues compromise Fesnak's comparable transactions analysis. Fesnak developed MVIC/Revenue multiples from a sample of twelve transactions. The sample yielded a mean multiple of 1.36 and a median multiple of 1.10. These mean and median multiples, if used, would generate an equity value for Orchard of $91.28 million and $73.83 million, or a per share value of $11.59 and $9.38. But Fesnak used neither, and

[69] In addition to being debt free, Orchard had positive EBITDA and a liquidity ratio of 0.9 in the last twelve months ended June 30, 2010. JX-20 Ex. 6. By comparison, four of the comparable companies in Fesnak's sample had no EBITDA, JX-22 at 4, and two had lower liquidity ratios than Orchard. *Id.*

instead employed a much lower revenue multiple of 0.60, yielding an equity value of only $40.27 million and a per share value of only $5.11. His reasons for ignoring his own sample of comparable transactions are as problematic and unsupportable as for ignoring his sample of comparable companies. Fesnak explained that "Orchard had no historical EBITDA through December 31, 2009 and minimal EBITDA for the last twelve months ended June 30, 2010" and that "Orchard had negative working capital and negative tangible net worth as of June 30, 2010."[70] Fesnak also reasoned that "[m]ost of the guideline company transactions were prior to the economic recession … thus valuation multiples were higher than current multiples."[71]

This was the same approach that Fesnak and Associates took in the comparable transactions presentation supplementing its March 15, 2010 fairness opinion, but importantly the comparable transactions analysis in Fesnak's valuation report in this case is not identical to his firm's prior one. In his report, Fesnak added two transactions to his sample that were not included in the fairness opinion analysis – the acquisition of Somerset Entertainment Income Fund and the acquisition of The Feed Room, Inc. Both of these transactions closed in late 2009 after the economy began to recover from the recession and were closer in time to the Going Private Merger. The median Revenue multiple generated by these two transactions is 0.94.[72] Instead of acknowledging this upward trend, Fesnak stuck with a multiple of 0.60, the same multiple that his firm had chosen at the time of the fairness opinion, explaining at trial that this lower multiple was

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70 JX-21 at 13.
71 *Id.*
72 *Id.* Ex. 12.

justified because the four transactions included in his valuation report sample that closed after August 2008 generated a median multiple of 0.64.[73] In other words, although Fesnak considered evolving market developments (*i.e.*, the recession) when that benefitted Dimensional and Orchard, he ignored the fact that the multiples generated by his most recent comparable transactions were much higher, and kept his chosen multiple constant at his previously selected level, while evincing a new regard for medians not otherwise reflected in his analysis.[74]

Orchard purports to give two-thirds of the weight of its valuation to comparable or market-based methods of valuation, but it in fact simply gives two-thirds of the weight to multiples chosen by its expert based on his subjective view that Orchard had far worse growth prospects than the companies in his samples and was in fact not at all comparable to them. Fesnak has failed to rationally justify his subjective judgment in this regard because the objective evidence regarding Orchard does not indicate that its performance metrics justify such a total disregard for the sample; indeed, its metrics would seem to suggest that it was relatively strong on overall metrics in comparison to the sample,[75] leaving me no basis to accept Fesnak's downward descent. For all these reasons, Orchard has failed to meet its burden to show that its comparables-based analyses are reliable.[76]

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[73] Tr. 294-95 (Fesnak).
[74] Even then, he shorted the petitioners 0.04.
[75] *See* JX-20 Ex. 6; JX-22 at 15.
[76] *See Gilbert v. M.P.M. Enters., Inc.*, 709 A.2d 663, 671 (Del. 1997) (noting that in an appraisal, "it is [a party's] burden to demonstrate the reasonableness of the comparables selected by its expert in the performance of his analysis.").

2. <u>DCF Analysis Of Orchard</u>

The basic premise underlying the DCF methodology is that the value of a company is equal to the value of its projected future cash flows, discounted at the opportunity cost of capital.[77] Put simply, the DCF method involves three basic components: (i) cash flow projections; (ii) a terminal value; and (iii) a discount rate.[78] The experts in this case relied on various conflicting inputs and assumptions in performing their respective DCF analyses. They used different sets of projections prepared by Orchard management in advance of the Going Private Merger (to which they each made a few modifications over which they predictably quibble), and assigned different weights to management's "base case" and "aggressive case" predictions of future cash flows. Fesnak's and Meinhart's approaches to calculating Orchard's cost of capital were largely similar, but they disagreed on certain inputs. I now address the experts' technical disputes, starting with their dispute over the cash flow projections.

a. <u>Cash Flow Projections</u>

The experts had access to two different versions of three sets of financial projections for the fiscal years 2010 through 2014 prepared by Orchard's management before the Merger, each of which represented a "worst case," a "base case" and an

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[77] *See* Richard A. Brealey, Stewart C. Myers & Franklin Allen, *Principles of Corporate Finance* 102 (9th ed. 2008); Cornell, *supra* note 55, at 102; *see also* R. Franklin Balotti & Jesse A. Finkelstein, 1 *The Delaware Law of Corporations & Business Organizations* § 9.45[B][1], at 9-134 (3d ed. 2009).

[78] *See Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *9 (Del. Ch. Aug. 19, 2005). For the standard description of a DCF analysis, see Brealey, Myers & Allen, *supra* note 77, at 102-06.

"aggressive case" scenario.[79] These management projections were presented in Orchard's Proxy Statement, which noted that they had been provided to Fesnak and Associates in its capacity as the special committee's financial advisor, and that Fesnak had updated the projections "with management input."[80] The Proxy Statement went on to state that the management projections it contained "may not be the same as the cash flow projections utilized by Fesnak [and Associates] and included in their materials presented to the special committee in connection with [Fesnak's fairness opinion], which are filed as an exhibit to the Transaction Statement on Schedule 13E-3 filed with the SEC with respect to the [Going Private Merger]."[81] Oddly, the Proxy Statement was filed after the Schedule 13E, but did not contain the most up-to-date version of the management projections.

Going into trial, it appeared that the parties agreed on the use of the same management projections, but disagreed on the weight to assign to management's base case and aggressive case scenarios. Meinhart gave 50% weight to the base case and 50% weight to the aggressive case, whereas Fesnak gave 90% weight to the base case and 10% weight to the aggressive case. This remains the most important dispute with respect to the financial projections, but after post-trial oral argument three additional issues were

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[79] This court has expressed a preference for valuations "based on contemporaneously prepared management projections" because a company's management "ordinarily has the best first-hand knowledge of a company's operations." *Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004).

[80] JX-9 at 48.

[81] *Id.*

raised by the parties, which I address before turning to the appropriate weighting of the projections.

First, it emerged clear late in the game that Meinhart and Fesnak had in fact relied on different projections. Meinhart used the earlier-prepared projections contained in the Proxy Statement.[82] Fesnak used the same projections that were modified "with management input,"[83] used in the fairness opinion his firm provided to the special committee, and included in Orchard's Schedule 13E.[84] It is unclear why Meinhart relied on the Proxy Statement projections when the fairness opinion projections reflected the more up-to-date knowledge of Orchard management, and even more unclear why this issue did not arise earlier in the case. I adopt the fairness opinion projections because they were prepared closest to the Going Private Merger and they are therefore the best indicator of Orchard management's then-current estimates and judgments. Moreover, the petitioners were on notice of the existence of these more up-to-date projections. The projections were publicly available, referenced in the Proxy Statement, and clearly used by Fesnak in his expert report, in response to which Meinhart submitted a rebuttal report. The petitioners' failure to inquire about these updates in discovery is one of their own making, having tactically decided to concentrate on other issues. There is no basis in the record to question the good faith of these adjusted projections and they reflect the best estimate of Orchard's future cash flows as of the Merger date.

[82] *See* JX-20 Ex. 7.
[83] JX-9 at 48.
[84] *See* JX-21 Ex. 13.

Second, the experts made different adjustments to their respective sets of management projections based on the net operating loss carryforwards ("NOLs") that they concluded were available to Orchard. Meinhart started with the assumption, based on Orchard's 2009 10-K and internal company correspondence, that Orchard had $19.7 million of usable NOLs going forward.[85] Based on this assumption, he concluded that under the aggressive case scenario, Orchard would not pay income taxes in the years 2010, 2011, or 2012, and that Orchard would then be taxed $25,000 in 2013 and $3,388 in 2014. Under the base case scenario, Orchard would pay no taxes until 2014, when it would be taxed $480,000. Under either scenario, Orchard would use up its NOLs by 2014 and would therefore have no NOLs beyond the terminal year.[86]

In a letter submitted to the court after the post-trial argument in this case, Orchard criticizes Meinhart's calculation of the NOLs for failing to take into account a tax memorandum dated March 4, 2010 in which the company analyzed the effects of § 382 of the Internal Revenue Code on Orchard's ability to use the full amount of its NOLs.[87] The tax memorandum was submitted as a trial exhibit, but was never mentioned by Orchard at trial or in its papers, and was not referenced in Fesnak's expert report. According to Orchard, Fesnak "relied upon" this memo "in making his NOL adjustment to the cash flows,"[88] and thus Fesnak's calculation of Orchard's NOLs is more up-to-date and accurate than Meinhart's. The import of the tax memorandum, according to Orchard,

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[85] JX-20 at 27.
[86] *Id.* Exs. 10b, 11.
[87] Letter to the Court from Resp. Counsel (May 30, 2012) at 4.
[88] *Id.* at 5.

is that "Orchard cannot accelerate the use of certain of its NOLs regardless of how much pre-tax income it generates, which results in a reduction to its cash flow."[89] Also relevant to this dispute is the fact that Orchard's fairness opinion – which was finalized after this supposedly "smoking gun" tax memorandum was disseminated – includes a different set of NOL calculations than those that Fesnak uses in his expert report.

For the following reasons, I reject both Meinhart's and Fesnak's approaches to calculating NOLs as offered in their expert reports in favor of the NOL calculations underlying the fairness opinion prepared by Fesnak and Associates in advance of the Going Private Merger. One key reason for my decision is Orchard's failure to explain why its expert's approach to the NOLs has changed from the date of the fairness opinion to the present. The fairness opinion was delivered to the special committee on March 15, 2010 – more than a week after the date of the tax memorandum that Orchard now points to as support for a more restrictive approach to using the NOLs. Orchard management presumably had time to incorporate any new information provided by the tax memorandum into their projections, and Fesnak's own firm was involved in preparing the projections used in the fairness opinion. Yet Fesnak – without offering any specific and clear explanation – valued Orchard's NOLs differently in his expert report than he did in the fairness opinion.

Also underlying my skepticism to the NOL calculations included in Fesnak's expert report is the unidirectional nature of Fesnak's changes in favor of his client. Specifically, the aggressive case projections used in the fairness opinion forecasted

[89] *Id.* at 5 n.6; *see also* JX-74 (2009 IRC 382 NOL Study).

$65.57 million of pretax income in 2013 and no income taxes.[90] In the projections used in his expert report, Fesnak changed the taxes for 2013 from $0 to $1.31 million.[91] Likewise, he changed the taxes in the base case scenario projections from $0 in 2014 to $1.67 million.[92] As mentioned, all of these changes helped to generate a lower valuation for Orchard by (i) decreasing the value of the NOLs, (ii) thereby increasing Orchard's tax liability, (iii) which in turn decreased Orchard's net cash flows used for valuation purposes.

Without offering any explanation, but presumably for the same reasons that he changed the tax adjustments to the fairness opinion projections in his expert report, Fesnak changed the present value of the NOLs available to Orchard after 2014. In the DCF valuation supplementing its fairness opinion, Fesnak's firm calculated the present value of the leftover NOLs to be $792,000 for both the base case and the aggressive case, using a discount rate of 20%.[93] Fesnak increased this value to $869,000 in his expert report, again using a 20% discount rate.[94]

The fact that Orchard has not offered any straightforward explanation of why Fesnak's alterations to his model in between the fairness opinion and the valuation report make any sense, coupled with the fact that these unexplained alterations had the effect of benefiting Orchard's litigation position, precludes me from finding that Fesnak's most recent NOL adjustments are warranted. As between Meinhart's NOL calculations and

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[90] JX-8 (Fairness Opinion) Ex. 4.
[91] JX-21 Ex. 13.
[92] *Compare* JX-8 Ex. 4 *with* JX-21 Ex. 13.
[93] JX-8 Ex. 8.
[94] JX-21 Ex. 14.

those prepared for the fairness opinion, I choose to accept the latter. Because I am accepting the projections prepared for the fairness opinion as the most accurate reflection of Orchard management's knowledge at the relevant time, I adopt the tax adjustments made in those projections by that same logic. Meinhart has not offered any reason to doubt the reliability of these tax adjustments, and therefore I do not see a reason to depart from management's view of what NOLs would be available to Orchard. I also accept the value conclusion regarding leftover NOLs that Fesnak and Associates came to at the time of the fairness opinion, discounted at the court's chosen rate of 15.3% instead of Fesnak's 20%. This produces a present value for the residual NOL tax benefit of $824,000.[95]

The expert's third, and final, post-post-trial dispute regards the appropriate terminal value. The petitioners contend that Fesnak included "excess depreciation and amortization expenses in his calculation of [Orchard's] terminal value."[96] In 2014, the year that Fesnak used as the basis for determining Orchard's terminal year cash flow, Fesnak reduced Orchard's projected pre-tax income for both the aggressive and base cases by $654,993 in depreciation expenses and $875,942 in amortization expenses, but assumed capital expenditures for that year of only $500,000.[97] According to the

[95] Because parties did not focus on this issue, the record does not allow me to calculate the present value of the residual NOL tax benefit with great precision. Fesnak failed to explain in his report (i) what value he was discounting the present value of the tax benefit back from and (ii) over what time period the leftover NOLs would accrue. I therefore took the figure Fesnak had derived by applying a 20% discount rate, $792,000, and grossed it up by 20%, turning $792,000 into $950,400. I then discounted that new figure by 15.3%, producing a present value of $824,280, which I rounded down to $824,000 for simplicity. The effect of this adjustment is to increase my calculation of Orchard's per common share value by one penny, when rounded to the nearest hundredth ($4.66 to $4.67).
[96] Letter to the Court from Pet. Counsel (May 30, 2012) at 3.
[97] JX-21 Ex. 13.

petitioners, depreciation and amortization expenses that are three times Orchard's capital expenditures are not sustainable on a normalized basis. In other words, going into perpetuity, capital expenditures and depreciation and amortization expenses must match up. As a solution, the petitioners suggest that the difference between $1.57 million in amortization and depreciation expenses and $500,000 in capital expenditures ($1.03 million) be added to Fesnak's projected cash flow for the terminal period.[98]

The petitioners' challenge is grounded in the sound valuation principle that because the terminal value is meant to capture the present value of all future cash flows of the company, typically the net cash flow figure used to generate the terminal value should be normalized, rather than "unrealistically extrapolate[] [a company's] short run circumstances into perpetuity."[99] The Gordon growth model indicates the equity value of a firm assuming full distribution of its net earnings.[100] One of the important implications of this assumption is that "[c]apital expenditures are equal to depreciation."[101]

Although the petitioners' analytical premise is sound, a closer look at Fesnak's model reveals that the petitioners' challenge has no factual premise. The Excel workbook of Fesnak's model submitted by Orchard shows that Fesnak generated a terminal value using the company's projected pre-tax income for 2014, not the company's projected net cash flow. In other words, Fesnak predicted that Orchard would

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[98] Letter to the Court from Pet. Counsel (May 30, 2012) at 3.
[99] *Kleinwort Benson Ltd. v. Silgan Corp.*, 1995 WL 376911, at *8 (Del. Ch. June 15, 1995).
[100] Z. Christopher Mercer, *The Integrated Theory of Business Valuation* 15 (2004).
[101] *Id.*; *see also Kleinwort Benson Ltd.*, 1995 WL 376911, at *8 ("Kovacs correctly recognized the need for an adjustment in the data so that capital investment relates to growth and depreciation in a sustainable manner.").

spend $500,000 on capital expenditures and would incur $654,993 in depreciation expenses and $875,942 in amortization expenses in 2014, but he did not import these assumptions into his calculation of a terminal value.[102] Thus, Fesnak, like Meinhart, assumed that capital expenditures and depreciation and amortization expenses would equal out in perpetuity by not adjusting Orchard's pre-tax income for these factors.[103] By doing so, Fesnak used a figure of $6.15 million for annual cash flow to calculate his terminal value in the base case scenario, a figure lower than his projected base case 2014 cash flow of $5.43 million, which took into account Orchard's projected income taxes, capital expenditures, depreciation and amortization expenses, and changes to working capital. I therefore reject the petitioners' challenge to Fesnak's terminal value calculation.

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[102] Fesnak's use of Orchard's pre-tax income as the basis for his calculation of terminal value also means that he did not take into account projected changes to Orchard's working capital in 2014. The petitioners, however, do not raise this issue, and because the numbers are relatively small – $88,602 in the aggressive case and $83,293 in the base case – I do not find it necessary to make further changes to Fesnak's model.

[103] Meinhart's approach to calculating a terminal value differed from Fesnak's in that Meinhart used a normalized net cash flow for the residual year as the basis for his calculation, using the projected numbers for 2014 but assuming depreciation and amortization expenses of $0 and capital expenditures of $0, instead of his projected 2014 depreciation expenses of $655,000, amortization expenses of $876,000, and capital expenditures of $500,000, which were nearly identical to Fesnak's. *See* JX-20 Ex. 10a. Meinhart then added back on a value of $304,000 to Orchard's terminal value, which represented the present value (calculated at Meinhart's chosen discount rate of 16%) of Orchard's depreciation and amortization income tax benefit beyond the terminal year. *Id.* Ex. 10b. Orchard indicated in its post-post trial argument letter submission that it also added back on a depreciation and amortization tax benefit beyond the terminal year, but that value was included in its NOL tax benefit calculation. Letter to the Court from Resp. Counsel (May 30, 2012) at 5 n.8 ("The other portion of the tax benefit calculation is the depreciation and amortization tax benefit beyond the terminal year. Mr. Fesnak used approximately $378,000, whereas Mr. Meinhart used $304,000."). The upshot of all this is that, despite their disagreement, Fesnak and Meinhart took similar approaches to calculating Orchard's terminal value. The issue that the parties created post-post-trial is not much of an economic issue.

Having resolved the parties' belated disputes over adjustments to the projections, I turn to the issue of how to appropriately weigh Orchard management's base case and aggressive case projections. As mentioned, Meinhart took a 50-50 approach, while Fesnak gave 90% weight to the base case and 10% to the aggressive case.

In support of giving equal weight to the base case and aggressive case scenarios, the petitioners latched on to language in the Proxy Statement disclosing that before the Merger "[a] sensitivity analysis was [] performed using management's [base case], worst case and aggressive case scenarios" and that "Fesnak assigned the following weighted probability values to each scenario – [base case], 50%, aggressive case, 50%, and worst case, 0%."[104] The petitioners treat this language as proving the point, but there is no there there. The language relied on by the petitioners merely discloses that Fesnak and Associates made a presentation to the special committee in which it gave 50% weight to the aggressive case and 50% weight to the base case. Importantly, the language does not indicate that Orchard management thought at the time of the Merger that the base case and aggressive case scenarios had an equal likelihood of occurring. It is also worth noting that in the context of preparing a fairness opinion, Fesnak and Associates was stress testing, not making a probability decision for valuation purposes.

Moreover, the record directly contradicts the petitioners' contention that Orchard management considered a 50-50 weighting most appropriate at the time of the Merger. Specifically, in a March 15, 2010 letter sent by the special committee to Fesnak and Associates in connection with Fesnak's preparation of the fairness opinion, the special

[104] JX-9 at 40.

committee represented that "the base case scenario is considered by management to be the most likely scenario."[105]

The special committee's representation that the base case was the most likely to occur is supported by Orchard's actual financial results for the last twelve months ("LTM") ended June 30, 2010, which are much closer to the base case projections than they are to the aggressive case projections. Orchard's revenues for 2010 in the base case projections used by Fesnak were forecasted to be $72.57 million; the actual LTM revenues as of June 30, 2010 were $67.12 million.[106] Orchard's LTM EBITDA was $2.15 million; the base case projections used by Fesnak forecasted EBITDA of $2.9 million. Thus, Orchard's actual financial results were not even between the base and aggressive case projections – they were *less* than the base case projections. For these reasons, I adopt Fesnak's approach and give 90% weight to the base case management projections and 10% weight to the aggressive case projections that were used in the fairness opinion and disclosed in Orchard's Schedule 13E.

b. <u>Discount Rate</u>

Both experts calculated a cost of equity for Orchard using three different methods: CAPM, the build-up rate model, and the Duff & Phelps Risk Premium Report model. The latter two methods are related, with the Duff & Phelps model being a variation of the build-up rate model.

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[105] JX-29 (Letter dated March 15, 2010) at SC0003082.

[106] *See* JX-20 Exs. 3, 5; JX-8 Ex. 4; Letter to the Court from Resp. Counsel (May 30, 2012) Ex. A (comparing petitioners' actual LTM data, adjusted to add back Merger expenses, to management's projections).

I am uncomfortable using the latter two methods for a few reasons. I begin with the important one that the build-up model is not, in my view, well accepted by mainstream corporate finance theory as a proper way to come up with a discount rate.[107] Indeed, its components involve a great deal of subjectivity and expressly incorporate company-specific risk as a component of the discount rate. This is at odds with the CAPM, which excludes company-specific risk from inclusion in the discount rate, on the grounds that only market risk should be taken into account because investors can diversify away company-specific risk.[108] Relatedly, corporate finance theory suggests that concern about the achievability of the company's business plan and thus its generation of cash flows should be taken into account by adjustments to the cash flow projections, and not by adjusting the discount rate.[109] The build-up model, however, allows for a variety of risks to be poured into the discount rate, including so-called projection risk and other factors.

Because of these factors, this court has been at best ambivalent about indulging the use of the build-up method, and has preferred the more academically and empirically-

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[107] For example, one of the leading corporate finance textbooks does not even mention the build-up method when discussing accepted ways to estimate the cost of equity, and instead focuses on CAPM and two alternatives to CAPM, the arbitrage pricing theory and the Fama-French three-factor model, which is a variation of the basic CAPM. *See* Brealey, Myers & Allen, *supra* note 77, at 213-27; *see also* William J. Carney, *Corporate Finance: Principles and Practice* 105-17 (2005) (no discussion of the build-up model); Cornell, *supra* note 55, at 205 (also failing to mention the build-up method in his explanation of ways to arrive at the cost of equity).

[108] *See, e.g.*, Cornell, *supra* note 55, at 205 ("The [CAPM], which is the model most widely used in appraisal practice, *is based on the distinction between diversifiable and non-diversifiable risk*. … CAPM states that the risk premium, defined to be the difference between the expected return on a security and the risk-free rate, is proportional to that security's *nondiversifiable risk* as measured by the security's beta.") (emphasis added).

[109] *See* Brealey, Myers & Allen, *supra* note 77, at 247.

driven CAPM model when that can be applied responsibly.[110] In contrast to the build-up model, which has not gained acceptance among distinguished academicians in the area of corporate finance, the CAPM method is generally accepted, involves less (but still more than comfortable) amounts of subjectivity, and should be used where it can be deployed responsibly.[111] In deploying that method, this court has taken into account, as it will here, evolving views of the academy and market players regarding its appropriate application. For example, both parties here accept the evolving view that the returns to the firm are influenced by size and that a size premium is therefore appropriate to take into account in calculating the discount rate.[112] This court has done so on prior occasions too, and will do so here.

There is another reason I choose not to deploy the two versions of the build-up method. Ultimately, I am coming up with one cost of capital. Formulas can be useful, but when they are used simply to make a discretionary human judgment about a debatable subject seem to have a false precision, they are obscurantist, obfuscating, and

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[110] *See Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 338-39 (Del. Ch. 2006) (criticizing the inherent subjectivity of the build-up model in favor of CAPM); *Hintmann v. Fred Weber, Inc.*, 1998 WL 83052, at *4 (Del. Ch. Feb. 17, 1998) (adopting CAPM and rejecting the build-up model because CAPM "seem[s] to be more useful" and "offers more complete information"); *see also Cede & Co. v. JRC Acquisition Corp.*, 2004 WL 286963, at *8 (Del. Ch. Feb. 10, 2004) ("A standard method of ascertaining the cost of equity is CAPM.").

[111] *See generally* Brealey, Myers & Allen, *supra* note 77, at 217-18 (discussing broad acceptance of CAPM); Koller, Goedhart & Wessels, *supra* note 60, at 235 (stating authors' opinion that "CAPM remains the best model for estimating cost of equity.").

[112] *See* Brealey, Myers & Allen, *supra* note 77, at 220-21, 363-64 (discussing the academic debate about the empirical evidence regarding the relationship of stock returns, firm size, and book-to-market ratio on the proper way to calculate cost of capital); *see also* Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital: Applications and Examples* 109-10 (4th ed. 2010) (explaining that "[m]any empirical studies performed since CAPM was originally developed have found that realized total returns on smaller companies have been substantially greater over a long period of time than the original formulation of the CAPM … would have predicted.").

less of an aid to clear thinking than a way of dissembling about what the real reason for the outcome is. For example, in this case, Meinhart came up with a 15.3% discount rate using the CAPM method, a 16.5% discount rate using the Duff & Phelps method, and a 16.1% discount rate using the build-up method, and then chose a discount rate of 16% for use in his DCF analysis. Meanwhile, Fesnak came up with a 17.8% discount rate using the CAPM method, a 19.5% discount rate using the Duff & Phelps method, and a 21.1% discount rate using the build-up method, and then chose a discount rate of 20% for use in his DCF analysis. In each case, why did the experts choose their ultimate discount rates? I still don't really know and I have read the reports and listened to the testimony.

As a law-trained judge who has to come up with a valuation deploying the learning of the field of corporate finance, I choose to deploy one accepted method as well as I am able, given the record before me and my own abilities. Even if one were to conclude that there are multiple ways to come up with a discount rate, that does not mean that one should use them all at one time and then blend them together. Marc Vetri, Mario Batali, and Lidia Bastianich all make a mean marinara sauce. Is the best way to serve a good meal to your guest to cook up each chef's recipe and then pour them into a single huge pot? Or is it to make the hard choice among the recipes and follow the chosen one as faithfully as a home cook can? This home cook will follow the one recipe approach and use the recipe endorsed by Brealey, Myers and Allen and the mainstream of corporate finance theory taught in our leading academic institutions, *i.e.*, the CAPM method.[113]

Under CAPM, the cost of equity is calculated as follows:

Cost of Equity = $r_f + \beta * (r_m - r_f)$, where r_f is the risk-free rate of return, β is the beta of the company, which measures the risk and volatility of the company's securities relative to the overall market portfolio, and $r_m - r_f$ is the equity risk premium, or risk differential between investment in a particular company and investment in a diversified stock portfolio.[114] A size premium is a generally acceptable addition to the CAPM formula in the valuation of smaller companies to account for the higher rate of return that investors demand as compensation for the greater risk associated with small company equity.[115] As noted, both parties agree that a size factor should be considered in applying the CAPM method to Orchard, based on empirical evidence regarding the performance of stocks of different market capitalizations.

Because the experts largely agree on the components of their CAPM estimates of the discount rate,[116] I focus only on the areas of disagreement, which are: (i) whether a

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[113] *See* Brealey, Myers & Allen, *supra* note 77, at 217-22; *see also* Cornell, *supra* note 55, at 205 (describing CAPM as "the model most widely used in appraisal practice").
[114] *See* Brealey, Myers & Allen, *supra* note 77, at 214.
[115] *See Gearreald v. Just Care, Inc.*, 2012 WL 1569818, at *10 (Del. Ch. Apr. 30, 2012) (explaining that "an equity size premium generally is added to the company's cost of equity in the valuation of smaller companies to account for the higher rate of return demanded by investors to compensate for the greater risk associated with small company equity."); *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1159 (Del. Ch. 2006) (noting that the size premium for small companies "is a generally accepted premise of both financial analyses and of this court's valuation opinions.") (citing cases); *see also* Brealey & Myers, *supra* note 77, at 221 (discussing relationship between size and a company's returns).
[116] The experts agree that the appropriate risk-free rate of return at the time of the Merger was 3.9%. They also agree on an industry beta of 1.0, determined by reference to their respective

historical or supply-side equity risk premium should be used; (ii) whether a 1% company-specific risk premium should be added to the CAPM; and (iii) whether the 6.3% size premium added to the CAPM by both experts should be adjusted if the supply-side equity risk premium is used instead of the historical equity risk premium.

I address these issues in turn.

i. Equity Risk Premium

Fesnak calculated a discount rate under a modified CAPM using the historical equity risk premium of 6.7% published in the 2010 Ibbotson SBBI Valuation Yearbook (the "Ibbotson Yearbook").[117] Meinhart relied on the Ibbotson Yearbook's supply-side equity risk premium of 5.2%.[118] Ibbotson's historical equity risk premium is generated using historical market returns from 1926 to the relevant valuation date.[119] Ibbotson's supply-side equity risk premium uses the same historical data, but separates the components of the equity risk premium into those attributable to a stock's price-to-earnings ratio and those attributable to a stock's expected earnings growth, excluding the former and including the latter.[120] This is because the supply-side premium assumes that actual equity returns will track real earnings growth, not the growth reflected in the price-to-earnings ratio.[121]

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chosen comparables and to the median unlevered beta published for companies in SIC 7379 in the 2010 Ibbotson Cost of Capital Yearbook.

[117] JX-21 at 18.

[118] JX-20 at 28.

[119] *See* Roger G. Ibbotson, *The Equity Risk Premium*, *in* RETHINKING THE EQUITY RISK PREMIUM 18, 19 (P. Brett Hammond, Jr., Martin L. Leibowitz, & Laurence B. Siegel eds., 2011).

[120] *See* Magdalena Mroczek, *Unraveling the Supply-Side Equity Risk Premium*, THE VALUE EXAMINER 19, 20-22 (Jan./Feb. 2012).

[121] *See id.*

Meinhart's use of a 5.2% equity risk premium has substantial support in professional and academic valuation literature.[122] I recently reviewed this literature and addressed the choice between the historical equity risk premium and the supply-side equity risk premium in *Global GT LP v. Golden Telecom, Inc.*[123] In *Golden Telecom*, although recognizing that the historical equity risk premium is the more traditional estimate, I concluded that the academic community has shifted toward greater support for equity risk premium estimates that are closer to the supply-side rate published by Ibbotson. I therefore determined that using an equity risk premium based on Ibbotson's supply-side rate in my DCF valuation of the subject company was appropriate.[124] I noted that when academics and experts have "mined additional data and pondered the reliability

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[122] *See, e.g.*, Aswath Damodaran, *Equity Risk Premiums (ERP): Determinants, Estimation and Implications – A Post-Crisis Update* 68 (Stern School of Business, Working Paper, Feb. 2010), *available at* http://ssrn.com/abstract=1492717 ("[M]y valuations in 2010 will be based upon equity risk premiums of 4.5-5%."); Koller, Goedhart & Wessels, *supra* note 60, at 244-45 (recommending an equity risk premium of 4.5% to 5.5%); Bradford Cornell, *Equity Risk Premium: The Long-Run Future of the Stock Market* 201 (1999) (concluding that "reasonable forward-looking ranges for the future equity risk premiums in the long run are 3.5% to 5.5% over treasury bonds."); *see also* Robert G. Ibbotson & Peng Chen, *Long-Run Stock Returns: Participating in the Real Economy*, 59 FIN. ANALYSTS J. 88, 94 (Jan./Feb. 2003) ("[I]nvestors' expectations for long-term equity performance should be based on the supply of equity returns produced by corporations" because "[t]he supply of stock market returns is generated by the productivity of the corporations in the real economy."); *Ibbotson SBBI 2010 Valuation Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation 1926-2009* 64 ("[O]ver the long run, equity returns should be close to the long-run supply estimate.").

It is also worth noting that corporate finance scholars have conducted studies of long-term equity returns for longer periods than the 1926-present period that the Ibbotson Yearbook uses to generate a historical equity risk premium, and have come up with equity risk premium estimates that are closer to the Ibbotson Yearbook's supply-side equity risk premium than they are to Ibbotson's historical equity risk premium. *See, e.g.*, Jeremy J. Siegel, *Perspectives on the Equity Risk Premium*, 61 FIN. ANALYSTS J. 61, 63 (Nov./Dec. 2005) (examining the period from 1802 to 2004 and coming up with an equity risk premium of 5.36%); Eugene F. Fama & Kenneth R. French, *The Equity Premium*, 57 J. OF FIN 637, 638 (Apr. 2002) (considering the period from 1872 to 2000 and calculating an average equity risk premium of 5.57%).

[123] 993 A.2d 497 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010).

[124] *See id.* at 514-16.

of past practice and come, by a healthy weight of reasoned opinion, to believe that a different practice should become the norm, this court's duty is to recognize that practice if, in the court's lay estimate, the practice is the most reliable available for use in an appraisal."[125]

Golden Telecom's default acceptance of the supply-side equity risk premium was recently embraced by this court in *Gearreald v. Just Care, Inc.*[126] In that appraisal action, Vice Chancellor Parsons rejected the respondent's use of a historical equity risk premium under *Golden Telecom*, finding that the expert had provided "no persuasive substantive financial reason as to why the application of a supply side equity risk premium would be inappropriate."[127] Like the respondent in *Just Care*, Orchard has not provided me with a persuasive reason to revisit the supply-side versus historical equity risk premium debate. I therefore find that the Ibbotson Yearbook's supply-side equity risk premium of 5.2% is an appropriate metric to be applied in valuing Orchard under the CAPM.

ii. Company-Specific Risk Premium

Fesnak included a 1% company-specific risk premium in his calculation of the discount rate under the CAPM "to account for the specific risks facing Orchard that were not otherwise captured within the other components of the cost of capital."[128] Although Meinhart indicated in his report that a company-specific risk premium, if appropriate, is part of a modified CAPM, he concluded that addition of this factor is inappropriate

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[125] *Id.* at 517.
[126] 2012 WL 1569818 (Del. Ch. Apr. 30, 2012).
[127] *Id.* at *10.
[128] Resp. Post-Tr. Ans. Br. at 36.

here.[129] I do not believe that a company-specific risk premium should be used in a CAPM calculation of a discount rate, especially in a case like this.

A company-specific risk premium is not an addition to the CAPM that is accepted by corporate finance scholars,[130] but is sometimes added to the discount rate by practitioners valuing a company to reflect that the company has risk factors that they believe have not already been captured by the equity risk premium as modified by beta and (if applicable) the small company size premium.[131] "Pure proponents of the CAPM argue that only systemic risk as measured by beta is relevant to the cost of capital and that company-specific risks should be addressed by appropriate revisions in cash-flow estimates."[132]

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[129] *See* JX-20 at 28-29.

[130] *See generally* Brealey, Myers & Allen, *supra* note 77, at 217-18; *see also* Eugene F. Fama & James D. MacBeth, *Risk and Return: Some Empirical Tests*, 81 J. POL. ECON. 607 (1973) (concluding that the empirical evidence did not support the existence of a company-specific risk premium); Aswath Damodaran, *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance* (2d ed. 2011) (explaining that firm-specific risk should average to zero). Professor Macey explains in simple terms why any reward for bearing firm-specific risk (*i.e.*, unsystematic risk) would quickly be diminished to zero. "The reason investors will not be compensated for bearing diversifiable risk is arbitrage. If portfolio 1 securities promised higher returns than portfolio 2 securities, then '[i]nvestors would snap at the chance to have these higher returns, bidding up the prices of stocks with the unsystematic risk and selling stocks with equivalent betas but lower unsystematic risk. This process would continue until the prospective returns of stocks with the same betas were equalized and no risk premium could be obtained for bearing unsystematic risk.'" Jonathan R. Macey, *An Introduction to Modern Financial Theory* 34-35 (1998) (citing Burton Malkiel, *A Random Walk Down Wall Street* 205 (4th ed. 1985)).

[131] *See Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1157-58 (Del. Ch. 2006).

[132] *Union Ill. 1995 Inv. LP v. Union Financial Group Ltd.*, 847 A.2d 340, 354 n.28 (Del. Ch. 2003); *see also Del. Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 339 (Del. Ch. 2006) ("To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients' objectives, when other valuation inputs fail to do the trick."); *Solar Cells Inc.v. True N. Partners LLC*, 2002 WL 749163, at *6 n.11 (Del. Ch. Apr. 25, 2011) ("This court has been … suspicious of expert valuations offered at trial that incorporate subjective measures of company specific risk premia, as subjective measures may

More generally, for a corporation that operates primarily in the United States and where there are sound projections, the calculation of a CAPM discount rate should not include company-specific risk for the obvious reason that it is inconsistent with the very theory on which the model is based.[133] If there are concerns about projection risk because the projections were generated by an inexperienced management team, the company's track record is such that estimating future performance is difficult even for an experienced management team, or projections seems to be infected with a bias, it would be better for the expert to directly express his skepticism by adjusting the available projections directly in some way, to make plain his reasoning.[134] Admittedly, this would involve as much subjectivity as heaping on to the discount rate, but it would also force more rigor and clarity about the expert's concern. Here, where management under the control of Dimensional came up with various scenarios and Orchard's expert gave overwhelming weight to management's base case scenario, no extra discounting is warranted and the CAPM method should be applied on its own terms, and not be infected by an ingredient from the build-up method.

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easily be employed as a means to smuggle improper risk assumptions into the discount rate so as to affect dramatically the expert's ultimate opinion of value.").

[133] *See* Carney, *supra* note 107, at 106 (explaining that "the risk associated with individual firms can be nearly completely eliminated" by portfolio diversification, and that CAPM is instead concerned with "systemic risk because it is associated with the economic system" and thus "cannot be eliminated through diversification."); Pratt & Grabowski, *supra* note 112, at 105 ("A fundamental assumption of the CAPM is that the risk premium portion of a security's expected return is a function of that security's market risk. That is because capital market theory assumes that investors hold, or have the ability to hold, common stocks in large, well-diversified portfolios. Under that assumption, investors will not require compensations (i.e., a higher return) for the unsystematic risk because they can easily diversify it away. Therefore, the only risk pertinent to a study of capital asset pricing theory is market risk.").

[134] *See Union Ill. 1995 Inv. LP*, 847 A.2d at 354 n.28.

Moreover, this is not an appraisal action in which the respondent's expert is given management-prepared projections that he believes are inaccurate. Fesnak, whose firm was hired by the special committee as its financial advisor in the Going Private Merger, had his hands deep in the dough of the projections used in the fairness opinion and then in his valuation report, and I accept his 90-10 weighting of the base case and aggressive case scenarios. Fesnak gave the following reasons for his addition of a company-specific risk premium: (i) Orchard's "ability to achieve revenue levels and profitability as forecasted;" (ii) Orchard's "ability to capitalize on its business strategy;" and (iii) "the impact on [Orchard] of the general economic recession."[135] These are risk factors that Orchard management presumably considered at the time of the Merger, with Fesnak's participation, and thus Fesnak's argument that the cash flow projections must be further adjusted by an addition to the discount rate is even weaker than it might be had he had no access to management at the time the projections were made.

In terms of projection risk, I suppose I can see the rough utility of "stress testing" projections when they are from an unreliable source. No doubt private equity and venture capital firms use hurdle rates to see how far off the projections of unproven managers can be for an investment to still make sense. Having no way to directly adjust the cash flows in the manner that some standard valuation treatises suggest is proper (but do not explain how to do), some market participants no doubt use the discount rate as a crude way of applying a doubt factor to the projections. In this way, they are

[135] JX-21 at 14.

"discounting", but not coming up with a discount rate in a way consistent with CAPM. Rather, they are conflating what is being discounted with the discount rate.

Although I have some sympathy with this short-cut (*i.e.*, a "heuristic" to academics), there is no justification for it here. Orchard had experienced management who were under the control of Dimensional. There is no reason to think the projections used by Fesnak biased, except in a way that favors his client. Fesnak chose to give almost no weight to the aggressive case, and 90% weight to the base case. Fesnak therefore dealt with projection risk already through weighting the projections. As the petitioners' expert Meinhart pointed out at trial, the addition of a 1% company-specific risk premium to Fesnak's CAPM analysis double counts Orchard's risks of failing to achieve projections that are already included in Fesnak's probability weighting of the different scenarios, and the appropriate way to deal with company-specific risk would be to weight the cash flows differently.[136] Fesnak's larding onto the discount rate was simply a form of additional discounting that he did not justify as warranted.[137]

Furthermore, Fesnak explained in his expert report that his addition of the company-specific risk premium was in part attributable to the "company-specific" risk factor for the state of the general economy.[138] How this general risk has a worse effect on Orchard than on all other market participants is not clear to me and provides no basis in

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[136] Tr. 84 (Meinhart).

[137] *See* Pratt, *Valuing a Business*, *supra* note 56, at 213-14 ("The analyst must be especially careful to avoid undue double counting, such as reflecting a negative factor fully by a reduction in the economic income projection, and then magnifying the effect by an increase in the discount rate for the negative factor.").

[138] JX-21 at 14.

my view for an addition to the discount rate.[139] More fundamentally, this is again a risk that should be reflected in the estimated cash flows, not heaped into a CAPM discount rate. It has no place there.

For these reasons, Orchard has failed to convince me of the appropriateness of the company-specific risk premium used by Fesnak in his valuation of the company.[140] I therefore reject Fesnak's addition of 1% to the discount rate under the CAPM.

iii. Size Premium

Meinhart and Fesnak relied upon the same size premium of 6.3% in their respective CAPM calculations of Orchard's cost of capital, which is the size premium for the broader 10th decile published in the 2010 Ibbotson Yearbook.[141] A size premium is an accepted part of CAPM because there is evidence in empirical returns that investors demand a premium for the extra risk of smaller companies.[142] The petitioners describe the 6.3% premium as, if anything, too high,[143] and Orchard argues it is conservative and

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[139] *Cf. ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 920 (Del. Ch. 1999) ("I do not believe all of these [risks] are particularly specific to the [company], especially the ones relating to competition, dependence on a single location, and risk of obsolescence. Such 'company specific' risks apply to nearly all companies in the entire United States economy, and as such they are already factored into the S&P 500 premium.").

[140] *See Hintmann v. Weber*, 1998 WL 83052, at *4 (Del. Ch. Feb. 17, 1998) ("As with all aspects of a party's valuation for purposes of Section 262, the proponent of a company-specific premium bears the burden of convincing the court of the premium's appropriateness.").

[141] JX-20 at 29; JX-21 at 20.

[142] *See, e.g.*, *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 338 (Del. Ch. 2006); *Gearreald v. Just Care, Inc.*, 2012 WL 1569818, at *10 (Del. Ch. Apr. 30, 2012); *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1159 (Del. Ch. 2006).

[143] Tr. 95 (Meinhart) ("I'm very comfortable with the 6.3 size premium that both Mr. Fesnak and I used in this analysis as being appropriate. If there's any criticism of that, I think the criticism would be maybe it's a little high.").

is not justified if other inputs to the CAPM are modified, such as the equity risk premium.[144]

The Ibbotson Yearbook divides the stock returns of public companies into deciles by size, measured by the aggregate market value of the companies' common equity. The smaller the company, the greater the excess return over the basic realized returns.[145] The 10th decile encompasses companies with a market capitalization of approximately $1 million to $214 million, and is further broken down into sub deciles.[146] The parties agree that Orchard technically falls into sub decile 10z, which includes companies with a market capitalization of $1 to $76.1 million.[147] The Ibbotson Yearbook size premium for sub decile 10z is 12.06%, which is nearly twice the size premium chosen by the parties' experts.[148]

But, a rote application of the 12.06% premium to Orchard is improper because the 10z sub decile includes troubled companies to which Orchard, which is debt free, is not truly comparable. The Ibbotson Yearbook does not exclude speculative or distressed companies whose market capitalization is small because they are speculative or distressed.[149] Before one uses the size premium data for 10z, one needs to determine if the mix of companies that comprise that sub decile are in fact comparable to the subject

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[144] *See* Resp. Post-Tr. Ans. Br. at 40
[145] Pratt & Grabowski, *supra* note 112, at 233.
[146] JX-39 (Excerpt from 2010 Ibbotson Yearbook).
[147] Tr. 178 (Meinhart – Cross); Tr. 320 (Fesnak)
[148] JX-39.
[149] Pratt & Grabowski, *supra* note 112, at 265.

company.[150] Both Meinhart and Fesnak concluded that a size premium as high as 12.06% was inappropriate for Orchard. Meinhart explained at trial that he was cautious to use the 10z sub decile because doing so would "run the risk of including companies in there that may be going through financial distress or other situations that may, in fact, skew [the] size premium numbers."[151]

Rather than making the argument that Orchard's cost of capital should include an adjustment to the size premium for the broader 10th decile to account for Orchard's being among the smallest companies in that decile, Orchard merely asserts that the size premium of 6.3%, albeit adopted by Fesnak, should be increased in the event that the court does not adopt the rest of Fesnak's inputs to the CAPM. Specifically, Orchard uses Fesnak's application of a conservative size premium as a back-door way to argue in favor of using a historical, rather than supply-side, equity risk premium. Orchard claims that using the supply-side equity risk premium with the Ibbotson Yearbook's size premium understates the cost of capital, and a supply-side equity risk premium must therefore "be offset by [] a higher size premium."[152] In support of this argument, Orchard cites to an article by James Hitchner which suggests that use of the Ibbotson Yearbook's supply-side equity risk premium mandates an upward adjustment to the size premium employed in valuation. Specifically, Hitchner writes:

> [The Ibbotson Yearbook's] size premiums … take the actual return of that decile over a period …, and then they subtract the expected return calculated using the [CAPM] …. However, … [Ibbotson's] size premium

[150] *Id.* at 268.
[151] Tr. 179 (Meinhart – Cross).
[152] JX-21 at 18; *see also* Resp. Post-Tr. Ans. Br. at 31.

data is not calculated using the supply side equity risk premium. It's calculated using the [historical] equity risk premium, so you have a little bit of 'apples and oranges.' It would be nice if [Ibbotson] could start publishing supply side size premiums, but currently, they don't. If the expected return using supply side is less, which it would be when using a smaller equity risk premium, mathematics would dictate that the size premium itself would go up because the 'in excess' of CAPM would be higher. As such, much of the decrease in the return due to using the [supply side equity risk premium] would be offset by a higher size premium.[153]

Orchard's citation to this article fails to convince me that the size premium must be adjusted if a supply-side, rather than historical equity risk premium is used, for reasons explained in a source cited by the petitioners. Shannon Pratt and Roger Grabowski explain in their valuation treatise *Cost of Capital: Applications and Examples* that the Ibbotson size premium data should not be adjusted if the supply-side equity risk premium is used because "[i]f one believes that economic factors not expected to recur caused the returns on the broad market to be higher than one would have expected, then the returns of stocks comprising all deciles were probably influenced by the same factors."[154] The use of a size premium with the CAPM model is already a nod in Orchards direction, and Orchard has not persuaded me that simply because I use the supply-side equity risk premium, I should add more to the size premium.[155] By adding a hefty 6.3% into the CAPM formula for size, Orchard is treated fairly in my view, even though I acknowledge

[153] James R. Hitchner, *Cost of Capital Insights*, FINANCIAL VALUATION AND LITIGATION EXPERT, Issue 12, Apr./May 2008).
[154] Pratt & Grabowski, *supra* note 112, at 239.
[155] It is conceivable that I might have added 1% to the size premium because of where Orchard falls in the broader 10th decile. An addition of 1% to the size premium for the broader 10th decile might have been a justifiable way to account for Orchard's small size without equating the company with the distressed and speculative companies in the 10z category. But, Fesnak did not argue that this factor justified his addition for company-specific risk in his report, which is where it should have been.

that academic and practitioner thinking this area seems to be in a period of active evolution.[156]

IV. Conclusion

For the reasons I have explained, I accept the financial projections used in Fesnak's fairness opinion and disclosed in Orchard's Schedule 13E, without the changes to the tax rate proposed by Fesnak in his valuation report. Like Fesnak, I give 90% weight to the base case and 10% weight to the aggressive case. After modifying these inputs to Fesnak's model, I applied a discount rate of 15.3% and arrived at a value of $4.67 per share for Orchard as of the date of the Going Private Merger. Because the parties failed to engage on several issues until the unhelpful stage of post-post-trial oral argument letters, I harbor some doubt that I have split the pennies with complete precision. The parties should confer and make sure that I adjusted Fesnak's model correctly. Assuming that I did, they should present a final judgment using an amount of $4.67, plus interest from July 29, 2010 to the date of payment at the statutory rate, compounded quarterly. If the dollar figure is different, they should explain why they use the different figure and submit the corrected amount. The parties shall submit an order within seven days.

IT IS SO ORDERED.

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[156] *See generally* Brealey, Myers & Allen, *supra* note 77, at 220-21 (describing the effect of company size on returns and noting that "it is hard to judge how seriously the CAPM is damaged by this finding" and that "data and statistics are unlikely to give final answers.").