### HIGHLIGHTS

- Court adopts a broad rationale for applying enhanced scrutiny to mergers
- "Fair value," as applied to reverse stock splits under DGCL 155, has the same meaning as fair price/fair value in entire fairness and appraisal cases
- Court applies a bifurcated analysis to the fair price prong of entire fairness, first determining if deal price is within a fair *range,* and then fixing a point-value for damages only if price and process are not entirely fair
- "Normalizing adjustments" to earnings are proper to account for expenses reflecting controlling shareholder self-dealing
- Book value is an appropriate measure of value for businesses that rely heavily on physical assets, but tends to undervalue a business as a going concern

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# *Reis v. Hazelett Strip-Casting Corp.* – Delaware Chancery Addresses Valuation in a Reverse Stock Split; Adopts Bifurcated Analysis on Fair Price; Applies "Normalizing Adjustments" to Account for Private Benefit Extraction

## Summary

Vice Chancellor Laster's maiden valuation opinion, *Reis v. Hazelett Strip-Casting Corp.,*[1] provides important guidance for litigating price claims in Delaware. In Reis, the controlling shareholder of a small, family-owned corporation squeezed out the minority via a reverse stock split. Before the squeeze-out, the company's stock was unequally divided between the controlling shareholder and his brother. When the brother died, he bequeathed his shares to over 100 individuals, mostly past and present company employees. The controlling shareholder opposed the dispersed ownership, and attempted to negotiate a purchase of the shares directly from his brother's estate. After the executors pressed for a higher price, he elected to force a sale through a reverse stock split. The all-insider board approved the transaction, and no majority-of-the-minority vote or other minority protections were adopted. The board then engaged a valuation firm to price the company, and paid the estate the value it determined.

The Court ruled the transaction subject to entire fairness review, noted the absence of procedural protections and some strong-arming by the controlling shareholder, and concluded that fair dealing had not occurred.[2] Turning to price, the Court used a combination of capitalized earnings and book value to arrive at a valuation nearly 2½ times the amount that the company had paid the estate.[3]

## Discussion

Vice Chancellor Laster began his analysis by offering a rationale for broadly applying enhanced scrutiny to corporate sale transactions, stating that because they are "[f]inal stage transactions," they "give rise to what economists refer to as the last period problem," namely, that a player who cheats during the "last period" does not suffer the same penalties faced during earlier periods. In the case of corporations, the constraints insiders face from "a range of markets, including the product markets, capital markets, employment markets, and

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[1] C.A. No. 3552-VCL, 2011 WL 303207 (Del. Ch. Jan. 21, 2011).

[2] *Id.* at *14.

[3] *Id.* at *28

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the market for corporate control"[4] have "less traction" in final stage transactions, justifying heightened judicial scrutiny. Because "[a] reverse split in which stockholders receive cash in lieu of fractional interests is an end stage transaction for those stockholders being cashed out of the enterprise," it follows that "[a] disinterested and independent board's decision to pay cash in lieu of fractional shares therefore should be subject to enhanced scrutiny."[5]

Turning to the facts of the case at bar, the Vice Chancellor readily concluded that the highest level of scrutiny – entire fairness – applied:

> When a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, the transaction will be reviewed for entire fairness with the burden of proof on the defendant fiduciaries. . . . A reverse split under those circumstances is the "functional equivalent" of a cash-out merger. If the controlling stockholder permits the board to form a duly empowered and properly functioning special committee, or if the transaction is conditioned on a correctly formulated majority-of-the-minority vote, then the burden could shift to the plaintiff to prove that the transaction was unfair. If the controlling stockholder permits the use of both protective devices, then the transaction could avoid entire fairness review.[6]

The absence of any independent committee process or minority stockholder vote thus mandated entire fairness review, with the burden on defendants.

Evaluating fair dealing on the facts at bar, the Court cited the absence of procedural protections and the controlling shareholder's threats that no dividends would be paid, that the company would never pay a higher price for the minority shares, and that the pending offer might be reduced or made available only to selected minority stockholders in future. Based on these factors, the Court found "no dealing in this case that could be called 'fair.'"[7]

Turning to the applicable valuation standard, the Court first acknowledged that the Delaware Supreme Court has held "fair value" under DGCL 155 (governing payment for fractional shares, such as those resulting from a reverse stock split) to have "'a meaning independent of the definition of "fair value" in [DGCL 262 (governing appraisal proceedings)].'"[8] However, "[g]iven that the Delaware Supreme Court has long equated the fair price and fair value inquiries,"[9] and in light of the substantial academic support for the pro-rata-share-of-going-concern fair price/fair value standard, the Vice Chancellor concluded that "[t]he fair value standard is therefore economically efficient and should be applied consistently to freeze-outs, regardless of form."[10]

To evaluate fair price/fair value, the Vice Chancellor then articulated a new, bifurcated analysis that first analyzes whether the deal price would support a fairness determination, and only then, if the transaction is found

[4] *Id.* at *9.

[5] *Id.* at *10.

[6] *Id.* at *10 (citations omitted).

[7] *Id.*

[8] *Id.* at *11 (quoting *Applebaum v. Avaya, Inc.,* 812 A.2d 880, 892 (Del. 2002)).

[9] *Id.* at *13.

[10] *Id.* at *14.

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not to be entirely fair, separately determines what price constitutes the proper measure of damages as a remedy for breach. Explaining this two-step analysis, Vice Chancellor Laster observed that because a fair price is one "'within a range that reasonable men and women with access to relevant information might accept,'. . . [a] court readily could conclude that a price fell within the range of fairness and would not support fiduciary liability, and yet the point calculation demanded by the appraisal statute could yield an award in excess of the merger price."[11] He cautioned, however, that while the range of fairness concept "permits a court to give some degree of deference to fiduciaries who have acted properly[,] it is not a rigid rule that permits controllers to impose barely fair transactions."[12] Rather, "the range of fairness concept has most salience when the controller has established a process that simulates arm's-length bargaining, supported by appropriate procedural protections."[13]

The Court's conclusion that an appraisal petitioner could receive a bump at the same time as a class asserting fiduciary claims would get nothing, is not a welcome one for shareholder plaintiffs. The bifurcated approach does make analytical sense, however, given the reality, noted by the Court, that fixing a point-valuation for a company is an artifact of the need to determine a specific appraisal award or damages, rather than a finding that any lower value is necessarily unfair. The Court also suggests that this reality swings both ways: where significant process flaws exist, the Court of Chancery has broad authority to resolve doubts "'against the wrongdoer.'"[14]

After articulating its two-step approach, the Court explained that bifurcation is not always productive, and need not be performed in "cases like this one, where the fair price analysis and remedial determination coincide . . . ."[15]

Turning to the valuation exercise itself, the Vice Chancellor applied the capitalized earnings method advanced by both sides, supplemented with the book value approach offered by the plaintiff.

Importantly, the Court devoted careful attention to the need for "normalizing adjustments" to earnings designed to prevent value extraction by the controlling shareholder. While use of a capitalized earnings approach meant that these adjustments were applied to historical earnings in *Reis*, they would appear to apply equally to forward-looking management projections in the more commonly-used discounted cash flow analysis.

As the Vice Chancellor explained, Delaware law allows a court to "make normalizing adjustments to account for expenses that reflect controller self-dealing when the plaintiff/petitioner provides an adequate evidentiary basis for the adjustment."[16] Applying these principles, the Court, first, rejected the plaintiffs' argument that the company's high R&D cost, resulting from a policy of assigning employees to R&D

[11] *Id.* at *15 (quoting *Kahn v. Tremont Corp.,* C.A. No. 12339, 1996 WL 145452, at *1 (Del. Ch. Mar.21, 1996), *rev'd on other grounds,* 694 A.2d 422 (Del. 1997)).

[12] *Id.* at *16.

[13] *Id.* at *17.

[14] *Id.* at *16 (quoting *Thorpe v. CERBCO, Inc.,* C.A. No. 11713, 1993 WL 443406, at * 12 (Del. Ch. Oct.29, 1993).

[15] *Id.* at *17.

[16] *Id.* at *21.

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rather than laying them off during slow periods should be adjusted, holding that "[t]he company's hiring and retention policies are issues where the controller's interests align with the minority's. Both want to maximize the value of the firm. How a company treats its line employees is not a self-interested transaction that the controller could use to divert returns that otherwise would inure proportionately to all equity holders."[17]

Turning to the company's money-losing "marine division," however, the Vice Chancellor found that it was a way for the controlling shareholder "to indulge his love of sailing," and he therefore excluded losses from the division. The Vice Chancellor also indicated that he would have made adjustments for excessive salary and certain related-party transactions if appropriate evidence had been presented.[18]

Turning the book value, the Court endorsed its use for valuation of "a business that derives significant value from its physical assets," while cautioning that "[b]ook value tends to undervalue a business as a going concern because it does not fully account for intangible value attributable to the operations."[19] Here, book value reflected a far higher value than capitalized earnings, and therefore "reinforce[d] [the Court's] concern that the company's earnings have been depressed because the owners have taken their returns in the form of compensation and equipment lease payments, thereby suppressing an income-based valuation."[20]

The Court then determined fair price to be $3,845 per share, nearly 2½ times the $1,595.17 per share paid by the company. [21]

[17] *Id.* at *19.

[8] *Id.* at *21.

[19] *Id.* at *25.

[20] *Id.* at *27.

[21] *Id.* at *28.



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