

## ***'9/11 Defense' Fails to Justify Unfair Merger***

***Gesoff v. IIC Industries Inc., et al., 2006 Del. Ch. LEXIS (May 18, 2006)***

Undoubtedly, the trauma of 9/11 impacted many businesses, with economic ripple effects continuing to this day. But in this case, a company may have taken unfair advantage of the disaster to defend a merger process that was “marked with grave examples of unfairness,” according to the Delaware Chancery Court, including a “plainly unfair price” for its minority stockholders.

### **Specific and small-company risk premia also highlighted**

Although the legal issues focused primarily on fairness, the damages portion of the opinion prompted another thoughtful, authoritative discussion on valuation issues by the Chancery Court (Vice Chancellor Lamb); in particular, on the derivation and application of specific and small company risks in the domestic as well as foreign arena.

In this case, a foreign holding company (CP Holdings, Ltd.) owned 78% of a publicly-traded U.S. subsidiary (IIC), which controlled various companies doing business worldwide: a Hungarian hotel operation; a Hungarian agricultural producer; an Israeli heavy machine and equipment manufacturer; and an East African equipment distributor.

To simplify its cost structure, the parent company (CP) sought to remove the subsidiary's minority stockholders (IIC) in a going-private transaction. By early 2001, the CFO had located a small investment bank (Jesup & Lamont, NYC) “that would be willing to do the company valuation necessary to support the tender offer.”

The CP board authorized a bid at \$13 per share, based on what the company was paying for IIC market shares as of May 2001. The board approved funds for a fairness opinion and a special committee. All good so far: But then the CFO invited only one IIC director to the special committee, allowing him no authority to choose an attorney other than the one who already represented CP and IIC. Likewise, the Jesup firm was chosen as financial advisor for the special committee despite its prior relationship with CP.

The negotiations that followed were “entirely inadequate.” An internal email between the CFO and the attorney dictated that CP would make a “lowish” bid to the IIC board, which would hire Jesup to evaluate the bid. The bankers would then recommend a “slightly higher” bid, which CP would meet, the bankers approve, and “the door would then be open for CP to make its tender offer for the shares of IIC.”

CP adhered to the plan by dropping the initial offer to \$10 per share. Jesup & Lamont conducted its appraisal—but sent drafts with valuation ranges to the parent CFO without the special committee's knowledge. On September 10, 2001—the day before the disaster—the CFO and special committee member agreed on \$10.50 per share for the tender offer, presenting it to the IIC board with the fairness opinion that same day.

### **September 11 intervenes**

Tragic events “understandably delayed” the process—but did not obviate the unfair dealing. By October 2001, the tender offer had increased CP’s holdings to only 84.1%, still below the 90% necessary for a short-form merger. CP immediately launched a long-form merger with IIC at the same \$10.50 per share, which the special committee ratified without further research or fairness evaluations. Minority shareholders brought a class action, alleging unfair dealing and pricing, and seeking a statutory appraisal action.

CP (and other named defendants) countered that the merger process was fair; and any “irregularities” failed to affect the price, which was “more than fair,” given the intervention of September 11. But the Court made short shrift of those “irregularities”:

[T]he defendants unilaterally imposed on the minority a price of the parent’s own choosing, established a deceptive negotiation between the parties, and left the minority’s putative special committee almost entirely powerless against its parent. This muddled, dishonest process is emphatically not what the Supreme Court meant by ‘fair dealing,’ ...and will not be tolerated here.

Particularly troubling was the free flow of “private” valuation information between the appraisers and CP. This “sieve-like” separation contributed to a process so “transparently corrupt,” according to the Court, that it could serve as a collective lesson to transactional planners and practitioners of how *not* to conduct a similar merger “by orchestrating a stylized mockery of arms’-length negotiations.”

The Vice Chancellor also dispensed with defendants’ so-called “9/11 defense”:

As a logical matter, the defendants are right to note that if \$10.50 was even in the vicinity of a fair price on September 10, and if the defendants had shown that IIC was affected to the same extent as many American companies on September 11, then the fair price on September 12 would be somewhat below \$10.50. Neither of these assumptions coincide[s] with the evidence presented in this case.

Given its far-flung holdings, IIC was already exposed to terrorism and other sovereign risks in Israel and Africa; its Hungarian hotel operations were largely unaffected by attacks on America. The 9/11 tragedy had no material impact on IIC’s intrinsic value—but it did add a layer of difficulty to an already difficult calculation of damages.

### **Plaintiffs’ valuation succumbs to numerous errors**

To calculate damages, the Court reviewed both parties’ expert reports to conduct its own DCF analysis, and tested the results against the facts to ensure that its valuation was equal to if not higher than a formal appraisal. It considered plaintiff’s report first, by David Fuller, CFA, ASA (Value Incorporated; Irving, TX), which necessarily relied on appraisals of IIC’s eight hotels in Budapest; and of its Israeli land holdings.

The hotel appraisal by Russell Kett, FHCIMA, FBHA (HVS International, London) suffered from three significant errors:

1. *Franchise fee.* Under a franchise agreement with Hilton Hotels, one of the hotels paid a fee that comprised 7.7% of total revenues in 2001—but Kett omitted this expense from his initial calculations, and failed to correct it in subsequent revisions.
2. *Mistake in sale price.* Kett also mistakenly underestimated the sale value of the Budapest Hilton by nearly 16%. (The court did not explain the basis for this underestimation.)
3. *After-the-fact revisions.* When given the opportunity at trial to recess and then explain his mistakes, Kett offered new and “novel rationalizations,” which failed to restore the Court’s faith in his conclusions.

Similarly, the Court lost faith in the underlying appraisal of Israeli real estate, which depended on documents that could not be found or timely produced at trial, and which was admittedly a “short version” valuation by an appraiser who did not visit the property.

Finally, in his overall valuation, Fuller had relied on subjective financial forecasts that differed markedly from management’s. He also used country-specific risk premia that were too low, incorrectly applied a control premia to DCF analysis, and overlooked a small-stock risk premium—such that the Court could not adopt his fair value conclusion of \$20.17 per share for IIC.

#### **Defendants’ valuation offers better framework**

In contrast, the Court adopted the general framework provided by defendants’ expert, Neil Beaton, CPA/ABV, ASA, CFA (Grant Thornton, LLP), which posited a fair price of \$9.60 for IIC shares on the merger date. Specifically, Beaton’s “scenario analysis,” averaging conservative and optimistic possibilities, was more appropriate given the inherent difficulties of valuing IIC; and even plaintiffs’ expert had adopted Beaton’s DCF analysis, conceding its superiority to subjective valuations. However, Beaton’s analysis was still subject to several “material adjustments” in four areas:

1. *Specific Company Risk Premium (SCRIP).* Beaton applied a “conservative” and “optimistic” SCRIP to all constituent parts of IIC; for example, 3% and 2%, respectively, to its Hungarian hotels. But—while the Court recognized the subjective component of the calculations, it declined to apply SCRIP without sufficient factual support, including “specific financial analyses.”
2. *Small-company risk premia.* Beaton also applied a small-company risk premium to IIC’s constituents, relying on Ibbotson’s guidelines (*Size Premium in Excess of CAPM*). Specifically, he added a 5.33% small-size premium to the WACC of all IIC companies—including its hotel holdings—arguing that they all fell within Ibbotson’s 10th Decile. But the Court questioned whether size risk premia developed for the U.S. market applies to foreign corporations:

In other words, Beaton’s valuation calls on the court to decide whether there is something inherently risky about the stock of companies that are small compared to their global competitors, or whether the small-stock premium arises only when a company is small in relation to the market on which it trades.

A review of relevant scholarship suggested that a small-size premium “might well” apply to foreign companies in more highly developed markets, but would not apply at all (or to the same extent) to those in emerging markets. Accordingly, the Court declined to apply a small-stock premium to IIC’s African holdings, but did apply the Ibbotson Decile 10 small-size risk premium of 5.33% in deriving the WACC of its Israeli and smaller Hungarian operations.

However, as the Ibbotson data suggest that the hotel industry may be less subject to the size premium, and IIC’s Hungarian hotels form part of the index for the Budapest Stock exchange, these operations warranted a Decile 9 premium of 2.4% in both the optimistic and conservative scenarios.

3. *Real estate value.* Beaton’s did not adjust the book value of the Israeli properties, as they were single-purpose assets built to accommodate the company’s particular operations; and any value derived from their sale over book value would be consumed by tenant improvements. The Court disagreed, giving more weight to the possibility raised by plaintiffs’ experts, that the property buyer would permit the company to remain in return for rental payments, thus adding value above book. However, the Court noted its prior lack of confidence in plaintiffs’ adjusted book value, and applied a 67% discount for its failure to adjust for the time and expense of selling the property.
4. *Management forecasts.* Although Beaton had started with management forecasts for the Israeli holdings, he admitted to adjusting them downward to account for the company’s business situation. Their use would “cut against this court’s belief that management projections are generally preferable to projections by third parties, especially [those] created after-the-fact.”

In sum, the Court accepted Beaton’s valuation with the four substantive changes, deriving conservative/optimistic DCF scenarios for IIC of \$9.55 and \$19.50 per share, respectively, noting the \$14.30 midpoint. As a reality check, the Court referenced CP’s original authorization of \$13 per share, based on the market, thus according its own DCF analysis a 100% weight and awarding plaintiffs \$14.30 per share.

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