The Unfair Value of a Copper Mine in Delaware

By Gavin Meyers

"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."[1] When a merger of a company occurs, the Delaware courts have attempted to provide protection to the minority shareholders by fashioning a remedy that compensates the minority if the deal is one-sided. The remedial effort consists of damages calculated by determining the fair price or fair value[2] of the company's shares as of the date of the transaction.

The Delaware courts have been attempting to determine fair value for over 70 years[3] but, as will be shown, have continued to show a fundamental misunderstanding of the concept of a going concern by including elements outside of the going concern. Since 1983, the Delaware courts recognized the expertise in valuation methods that had been developed by the financial community, and realized that hanging on to archaic methods would be a detriment to the legal

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[1] Robert G. Hagstrom, *The Warren Buffett Way*, 23 (2nd ed., John Wiley & Sons 2005) [hereinafter *The Warren Buffett Way*] (quoting Warren Buffett). In the financial community, Warren Buffett is regarded as one of the most successful investors in the world over the past 40 years, and his investment philosophies have become principles from which all investors can live by. *Id*. at 19. Buffett developed his investment approach from the teachings preeminent investment philosophers including: Benjamin Graham, Philip Fisher, John Burr Williams, and Charles Munger. *Id*. Maybe the most important of Buffett's investment tenets is that "[t]he stock market is there to serve you, not instruct you." *Id*. at 121 (quoting Warren Buffett). Importantly, in Part II of this paper, this investment tenet will become an important aspect of the concept of "going concern value".

[2] This article will use "fair price" and "fair value" interchangeably as their meaning in this setting is identical. See *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 463-64 (Del. Ch. 2011) ("[T]he Delaware Supreme Court has long equated the fair price and fair value inquiries.")

[3] *Chicago Corp. v. Munds*, 172 A. 452, 455 (Del. Ch. 1934).

system.[4] As such, Delaware opened the door to a more flexible approach to fair price valuations in court proceedings that has continued to evolve over the past 28 years.

Determining a fair price generally requires the use of several financial valuation methods but, since 1983, the most widely used is the Discounted Cash Flow ("DCF") method.[5] As will be shown, the DCF method incorporates all of the aspects of fair value that the courts consider important.[6] Its adaptability to most situations creates consistency and the ability for the courts to develop reasonable guidelines for its application. However, DCF, like any valuation model, can only produce results based on the information presented. Moreover, the model can result in drastically different results from even the slightest manipulation. Because of these reasons, the courts have failure to develop additional guidance in these areas have led to incorrect and inequitable results.

This article will discuss the issue that resulted from the recent decision in *In re Southern Peru Copper Corp.*[7]("*Southern Peru*") when the court applied many of the developed concepts of fair value through the use of a DCF analysis, but failed to provide an equitable result due to the lack of a proper standard for applying the

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[4] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983).

[5] See Lawrence A. Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. Corp. L. 119, 124 (2005) [hereinafter *Fair Value of Cornfields*].

[6] Fair value is forward looking because it depends on future value. *Id*. at 126. The DCF method projects future value thereby incorporating the forward looking concept of fair value. *Id*. at 137.

[7] *In re S. Peru Copper Corp.*, CIV.A. 961-CS, 2011 WL 4907799 (Del. Ch. 2011).

fair value remedy. This article will further provide a practical approach that will both resolve the erred approach taken in *Southern Peru* and provide an equitable standard by which future cases can achieve a fair result.

Part I of this article will provide a brief recanting of the facts in *Southern Peru* that will articulate the conservative approach taken by the court. Part II will review the origins of fair value through the concept of going concern value. This section will also provide the support for the use of more relevant valuation models than the outdated method used by the courts for over 50 years. Part III will explain and discuss the DCF method and briefly cover some aspects of alternative valuation methods. Through this discussion, the reader will be able to see how the DCF method can help mold the proper application of going concern value. In addition, this section will use a hypothetical illustration to exemplify the impact an incorrect application of the elements of fair value that can have on valuation methods. Part IV will further articulate the errant approach applied in *Southern Peru*, and use the information in the previous sections to explain to postulate the guided approach that properly applies the concept of going concern value that should alleviate inequitable results and lead to the finding of fair value.

I. *In re Southern Peru Copper Corp.* in a Nutshell

Although the facts of *Southern Peru* are lengthy and complex, for purposes of this paper they can be broken down into a few key points. The merger in

Southern Peru was not the typical squeeze-out merger giving rise to appraisal or fair value determinations, but the particular facts provided created a situation that was very similar. Grupo México, S.A.B. de C.V, ("GM") was the majority shareholder of Southern Peru Copper Corp. ("SPC") by owning 54.17% of SPC's outstanding stock with the ability to exercise 63.08% of the voting power of SPC.[8] GM also had a 99.15% ownership in another mining company, Minera ("M"). In 2004, GM approached SPC and essentially imposed its will to force SPC to buy GM's ownership in M through an exchange of stock where SPC would receive GM's shares in M and GM would receive additional shares in SPC.[9] SPC formed a Special Committee ("SC") of disinterested directors to evaluate and negotiate the transaction.[10] The market value of the shares that GM was to receive as of October 21, 2004[11] amounted to $3.1 billion.[12] When the merger closed on April 1, 2005 the value of those shares had risen to $3.75 billion.[13]

The plaintiffs, the minority shareholders of SPC, filed a derivative action against SPC, the GM-affiliated directors of SPC, and the members of the SC, alleging a breach of fiduciary duty alleging the merger was entirely unfair to SPC

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[8] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *3.

[9] *Id*.

[10] *Id*.

[11] The date the merger agreement was executed.

[12] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *3.

[13] *Id*.

and its minority shareholders.[14] The parties agreed to an entire fairness standard of review[15], and subsequent delays, primarily due to the fault of the plaintiffs, amounted to a drawn out litigation process.[16] The decision, issued by Chancellor Strine, held that the merger was entirely unfair to the plaintiffs, but determined that the factors of fair price required a conservative approach in favor of the defendants due to the litigation delays caused by the plaintiffs.[17] After determining the fair value of the exchanged shares, the court awarded the plaintiffs damages of $1.263 billion.[18] It is this approach to the fair value determination where *Southern Peru* went awry, but to understand why requires an understanding of the concept of "fair value" itself.

II. Fair Value

A. The Origins of Fair Value

Fair value derives its original definition from Delaware's appraisal statute. Originally, the statute awarded the "value" of a shareholder's interest but amended the statute to award the "fair value" of a shareholder's interest in 1976.[19] In line with the case law interpretations of the old statute, the statute was amended to its

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[14] *Id*.

[15] See *supra* n. 19.

[16] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *4 n. 7.

[17] *Id*. at *43

[18] *Id*.

[19] Del. St. Ti. 8, §262(f) (1976).

current form in 1981 to include "all relevant factors" in the valuation excluding "any element of value arising from the accomplishment or expectation of the merger."[20] Interestingly, the adoption of the "fair" and "all relevant factors" language had a major impact on interpretation because the statue now mandated what the courts had essentially already been considering.[21] Although "fair value" finds its derivation from the Delaware appraisal statute, its use has been expanded outside of the appraisal process to breach of fiduciary duty cases that have invoked the "entire fairness standard."

The "entire fairness standard" was adopted in 1983 when Justice Moore issued his decision in *Weinberger v. UOP, Inc.*[22] Under this standard, there are two elements: (1) fair dealing and (2) fair price.[23] In a nutshell, if the majority shareholder fails to prove that the merger was accomplished by fair dealing, this factor is contemplated when determining fair price.[24] If there was fair dealing, then the only remaining determination is fair price which is identical to the appraisal process. Thus, it can be implied that the appraisal process has presumed fair dealing because the only consideration in appraisal is fair price. Regardless of

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[20] Del. St. Ti. 8, §262(h) (1981).

[21] *Weinberger*, 457 A.2d at 713 (It is significant that section 262 now mandates the determination of 'fair' value based upon 'all relevant factors'.")

[22] *Id*. at 710 (the court adopted the entire fairness standard of review for cases where a controlling or majority shareholder essentially stands on both sides of the transaction).

[23] *Id*. at 711 ("The concept of fairness has two basic aspects: fair dealing and fair price."); *Reis*, 28 A.3d at 462 (citing *Weinberger*, 457 A.2d at 711 (Del. 1983)).

[24] See *Weinberger*, 457 A.2d at 711 (the test for entire fairness is not bifurcated between fair dealing and fair price, but rather all aspects are examined as a whole).

which cause of action is filed, both actions have exclusively used the “fair value” definition and its court interpretations to determine the fair price of a dissenting shareholder’s interest.

B. The Delaware Interpretations Leading to Going Concern Value

Very early on in the fair value interpretations, Delaware stated that awarding fair value requires a shareholder “to be paid for that which has been taken from him, viz., his proportionate interest in a going concern.”[25] A going concern is a business that is expected to continue operating as it was prior to the merger.[26] To receive “going concern value”, the court must consider all relevant factors excluding only those speculative elements that may arise from the accomplishment or expectation of the merger.[27] Generally, the elements of a going concern that may be considered are those elements that may arise from a business plan that has been implemented prior to the merger.[28]

A common analogy used to explain the going concern value concept is that of warts and diamonds.[29] In general, going concern value means a company

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[25] *Tri-Contl. Corp. v. Battye*, 31 Del. Ch. 523, 526 (1950).

[26] See *Cede & Co. v. Technicolor, Inc.*, CIV.A. 7129, 1990 WL 161084, *17 (Del. Ch. 1990) (financial experts valued a going concern as an operating business).

[27] *Weinberger*, 457 A.2d at 713.

[28] See for example, *Cede & Co. v. Technicolor, Inc.* where the bidder accomplished a two-step merger, but before completing the second step (the actual merger) the bidder had implemented his plans for the business. 684 A.2d 289, 293 (Del. 1996). The court held that these elements became a part of the going concern because they had been implemented prior to the actual merger date. *Id*. at 298. Essentially, if the bidder had waited to implement his plan until after the merger date, the shareholders would not have been entitled to any value arising from the plan because it would then have been a speculative element.

[29] *Fair Value of Cornfields* at 143-44.

should be valued considering the value of all its warts and diamonds.[30] In general, the warts and diamonds consist of the company's assets, market value, earnings, future prospects, and any other elements that can affect a company's stock.[31] A going concern's warts and diamonds are not necessarily fixed assets or definite quantitative factors, but are also the current executives and reinvestment opportunities that the company's implemented business plan would reasonably consider.[32] Moreover, warts must be valued as warts and diamonds valued as diamonds; a minority shareholder cannot claim the warts could be diamonds and, vice versa, a bidder cannot claim the diamonds are actually warts.[33]

Another important aspect related to going concern value is that the court will not adjust the concept even when the company is likely to cease operation absent the merger. When the risk of bankruptcy has increased, going concern value is of little use.[34] Of course, in such a situation it is unlikely a shareholder would dissent from receiving something over the high risk of receiving nothing,[35] but such

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[30] *Id*. at 143.

[31] *Weinberger*, 457 A.2d at 711 (The aspect of fair price "relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.")

[32] *Fair Value of Cornfields* at 143-44.

[33] *Id*.

[34] *S. Muoio & Co. LLC v. Hallmark Ent. Investments Co.*, CIV.A. 4729-CC, 2011 WL 863007, *16 (Del. Ch. 2011) ("[W]hen a company's going concern value comes close to its liquidation value (with the increasing risk of bankruptcy) its equity value may approach zero.")

[35] As implied in *S. Muoio & Co. LLC*, generally a company's stock becomes worthless upon bankruptcy because no reasonable investors will buy into a bankrupt company. Thus, because there are no buyers, there is no one to sell to and the stock is effectively worthless.

situations have occurred.[36] Even in such dire situations, the court has resolved itself to award going concern and not liquidation value to the dissenting shareholders.[37] Such a result is consistent with the warts and diamonds analogy because bankruptcy is the result of the current management's implemented business plan for using its warts and diamonds. When the company would have headed into bankruptcy but for the offer from another company, then bankruptcy is the result of the pre-merger management of the company's warts; if the shareholder receives an offer at all he should consider himself lucky.[38] Thus, going concern will only be calculated, and should only be calculated, when there is an operative reality that the company could continue absent the merger, otherwise fair value has the potential to become just a "nuisance" to the courts.

The going concern value concept is consistent with the principles of the financial community that believe an investor who purchases shares of a company is effectually buying a business.[39] Accordingly, when a shareholder dissents from the merger, it is assumed the shareholder would have continued his ownership of the

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[36] See *S. Muoio & Co. LLC v. Hallmark Ent. Investments Co.*, CIV.A. 4729-CC, 2011 WL 863007 (Del. Ch. 2011); *Hanover Direct, Inc. Shareholders Litig.*, CIV.A. 1969-CC, 2010 WL 3959399 (Del. Ch. 2010) *judgment entered sub nom. In re Hanover Direct, Inc.*, 1969-CC, 2010 WL 5058556 (Del. Ch. 2010); *Application of Vision Hardware Group, Inc.*, 669 A.2d 671, 677 (Del. Ch. 1995) *aff'd sub nom. Young v. Vision Hardware Group, Inc.*, 676 A.2d 909 (Del. 1996).

[37] *S. Muoio & Co. LLC*, 2011 WL 863007 at *16.

[38] See *Application of Vision Hardware Group, Inc.*, 669 A.2d 671, 679 (Del. Ch. 1995) *aff'd sub nom. Young v. Vision Hardware Group, Inc.*, 676 A.2d 909 (Del. 1996) (the court held that the dissenting shareholders' shares had only "nuisance value" but for the value they received from the acquirer).

[39] Warren Buffett believes that, for the investor, there is no fundamental difference between actually buying a business and buying the stock of a business. Robert G. Hagstrom, *The Warren Buffett Way* at 41. In other words, "[b]uying stocks means buying a business." *Id*.

going concern had the merger not occurred.[40] Based on the shareholder's dissent from the merger, in both appraisal and entire fairness proceedings, it is presumed that the shareholder would have preferred to continue on as a shareholder of the company than to receive the merger price.[41] Similarly, in *Southern Peru* the dissenting minority shareholders are presumed to have preferred to not take ownership of M rather than dilute the value of their shares in SPC.

To compensate the dissenting shareholders, the courts have used the fair value remedy afforded by Delaware's appraisal statute by applying going concern value to determine whether the merger price was a fair value.[42] For some time, Delaware had exclusively relied upon a "block method" of valuation which chose elements of value, "i.e. assets, market price, earnings, etc.," assigned weights to each and the result was fair value.[43] Finally, in 1983, Delaware abolished the use of the block method as the exclusive method to determine fair value[44] and adopted a more liberal approach that permits the courts to consider the generally acceptable

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[40] *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996) ("The underlying assumption in an appraisal valuation is that the dissenting shareholders would be willing to maintain their investment position had the merger not occurred.")

[41] *Fair Value of Cornfields* at 137.

[42] It should be noted that fair value is "not a single point on a line, but a range of reasonable values . . ." *Reis*, 28 A.3d at 466 (quoting *Cede & Co. v. Technicolor, Inc.*, CIV.A. 7129, 2003 WL 23700218, *2 (Del. Ch. 2003)) (internal quotations omitted).

[43] *Weinberger*, 457 A.2d at 712.

[44] *Id*. at 712-13 ("the standard 'Delaware block' or weighted average method of valuation, formerly employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings.") Interestingly, one of the reasons the block method seemed outdated could relate to the investment tenets of Warren Buffett mentioned earlier. See *supra* n. 1.

methods of valuation in the financial community.[45] Although the courts are permitted to use any valuation method generally accepted in the financial community, they have shown the most favor to the Discounted Cash Flow ("DCF") method.[46] *Southern Peru* applied the DCF method in its fair price valuation and the sensitivity of the model will show case the importance of applying a different approach to choosing the elements of value than the "conservative" approach[47] applied in *Southern Peru*.

III. The Discounted Cash Flow Method and Other Valuation Concepts

A. The Discounted Cash Flow Model

The DCF method relies primarily on the expectations of the business rather than on the market or historical earnings, and provides a value of the business that reflects both equity and debt.[48] Moreover, the method incorporates the ability to reflect the value of all the relevant factors of a company, including both the quantitative and qualitative elements discussed above.

The DCF method essentially asserts that the value of a going concern is the present value of its expected future operating cash flows.[49] The analysis begins by

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[45] *Id*. at 713 (Fair value "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community").

[46] *Fair Value of Cornfields* at 125.

[47] See *supra* n. 112.

[48] Frank K. Kelly & Keith C. Brown, *Investment Analysis and Portfolio Management*, 378 (8th ed., Thomson South-Western 2006) [hereinafter *Investment Analysis*].

[49] *Id*. at 371.

calculating the company's free cash flow, projecting that amount out into the future, discounting the result to return the net present value of the company, then subtracting debt to return the value of the shareholder's interest.[50] Thus, in the simplest terms, there are three functioning numbers in the DCF method that require particular attention: (1) Free Cash Flow; (2) Growth Rate; and (3) Discount Rate.[51] The importance of these inputs cannot be overstated, the models rely extensively on these inputs and even the slightest changes can lead to substantively different results. Accordingly, using unreasonable elements will lead to unreasonable results; "GIGO: garbage in, garbage out!"[52]

i. **Free Cash Flow**

Free Cash Flow[53] ("FCF") is essentially the cash flow available to all providers of capital (equity and debt) that is available to either be reinvested in the company, pay down debt, or distributed to the shareholders.[54] This element is essential to going concern value because it reflects the ability the company would have had to continue its pre-merger business plan and to take advantage of reinvestment opportunities.

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[50] *Id*. at 378.

[51] *Id*.

[52] *Id*. at 370.

[53] Warren Buffett generally uses what he calls "owner's earnings" which is nearly identical. *The Warren Buffett Way* at 114.

[54] *Investment Analysis* at 306.

FCF is generally calculated as equal to the firm's operating income plus depreciation and amortization expenses less capital expenditures and the net change in working capital over the year.[55] Although, FCF is not, admittedly, a precise measure due to the requirement of estimating capital expenditures, a valuation "would rather be vaguely right than precisely wrong."[56] Operating income encompasses earnings prior to the deduction of taxes and interest.[57] The deductions from operating income usually indicate the amount of cash the company has used to purchase assets over the year. These deductions are important because they can be analyzed for estimates about investments the company may make in the future. Adding back depreciation and amortization is necessary to account for the cash flow used in the current year and not to reflect prior year expenses.[58] Upon calculating FCF, the next step in the analysis is to determine the proper growth rate used to estimate future values of FCF.

ii. Growth Rates

Growth rates will generally reflect the estimated value that the management will derive from the warts and diamonds of the going concern. As such, they are

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[55] *Id*. at 529.

[56] *The Warren Buffett Way* at 114 (quoting Warren Buffett quoting John Maynard Keynes).

[57] *Investment Analysis* at 302.

[58] "It might seem odd to add back depreciation/amortization since it accounts for capital spending. The reasoning behind the adjustment, however, is that free cash flow is meant to measure money being spent right now, not transactions that happened in the past." Ben McClure, *Free Cash Flow: Free, But Not Always Easy*, , http://www.investopedia.com/articles/fundamental/03/091703.asp#ixzz1di0DP4a9 (last updated Mar. 8, 2010).

an integral factor of both the DCF model and going concern value. Growth rates must generally be broken down into two separate rates: (1) the multiple-year rate, and (2) the infinite or perpetual rate.[59]

1. The Multiple-Year Growth Rate

The multiple-year rate must generally be determined first, and is usually estimated out for a number of years into the future.[60] If the management of the company has made a growth projection, the courts will generally defer to those over an analysts own projections.[61] The use of management's projections, if available and reasonable, is consistent with the concept of going concern value where the valuation must consider the warts and diamonds as they are managed pre-merger.[62] Of course, if management has not made projections or if they are unreasonable, the court should make a reasonable estimate of growth based upon a number of factors including historical performance and future operating opportunities that the company would be reasonably likely to pursue.[63]

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[59] *Investment Analysis* at 374-75.

[60] See *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290, 334 (Del. Ch. 2006) (applying a five-year projection period); *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 501 (Del. Ch. 2010) *aff'd*, 392,2010, 2010 WL 5387589 (Del. 2010) (the corporation operated on a five-year business plan); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 351 (Del. 1993) (same)

[61] *Taylor v. Am. Specialty Retailing Group, Inc.*, CIV.A. 19239, 2003 WL 21753752, *4 (Del. Ch. 2003)

[62] See *infra* Part II.B.

[63] *Delaware Open MRI Radiology Associates, P.A.*, 898 A.2d at 334.

Several methods have been used to determine multiple-year growth rates. One method is based on the company's retention rate[64] multiplied by the company's return on equity.[65] This method is generally the simplest form of estimating a growth rate. Another method is the Compound Annual Growth Rate ("CAGR") which looks at historic amounts and smoothes the annual growth rate out over a number of years.[66] A third, more technical, method is a growth rate derived from a regression analysis.[67] The regression model is a more extensive mathematical equation; it is generally less focused on growth from cash flows and more from a reflection of stock price and earnings per share.[68] For purposes of this paper, it does not matter which growth rate method is used. The most important take away is that there is a multitude of ways to calculate growth, and each method must be based on reasonable estimates.

2. The Perpetual Growth Rate

The perpetual or infinite growth rate is a more difficult number to estimate because it contains the underlying assumption that the company will continue to

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[64] The "retention rate" is dependent on "the amount of resources retained and reinvested" in the company. *Investment Analysis* at 336.

[65] A company's return on equity is based upon the rate of return earned on the funds the company retains in the company. *Id*.

[66] See *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 502 (Del. Ch. 2010).

[67] *Investment Analysis* at 392.

[68] *Id*.

grow at some rate forever.[69] Often, the most reasonable estimates of a perpetual growth rate will consider the economy as a whole, and the industry in which the company operates.[70]

The economy as a whole is generally measured by "gross domestic product" ("GDP"), which "is a measure of aggregate economic output or activity."[71] In general, GDP should be viewed as the base rate and adjusted up or down based on the outlook of the industry in which the company operates.[72] Like the take away from the multiple-year growth rate discussion, the perpetual rate can have a substantial impact on the results of the DCF model. Furthermore, as will be shown, value under the DCF model is more sensitive to changes in the perpetual growth rate than the multiple-year growth rates. It is these sensitivities to changes in the growth rates that will help to make the error in the result of *Southern Peru* even more apparent. Once the growth rates have been estimated, the next step is to look at the company's capital structure to determine a discount rate that will bring the sum of the projected FCF back to present value.

iii. Discount Rates

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[69] *Id*. at 376.

[70] See *Delaware Open MRI Radiology Associates, P.A.*, 898 A.2d at 337.

[71] *Investment Analysis* at 429.

[72] See *Delaware Open MRI Radiology Associates, P.A.*, 898 A.2d at 337 (where the court found a higher perpetual growth rate was reasonable because it was reasonably achievable in the industry).

The discount rate is another important aspect of going concern value because it is a reflection of the risk inherent in the industry and economy that will taper the expectations of growth. Just like the effect on value caused by changes to growth rates, adjustments to the capital structure of a company and thereby adjustments to the discount rate can have a similar impact. Because FCF incorporates both debt and equity, an appropriate discount rate must also reflect both forms of capital.[73] To recognize the capital structure of the company, the DCF model relies upon the Weighted Average Cost of Capital ("WACC").[74] WACC has several interplaying parts that in an actual attempt at valuation would require an in-depth discussion, but for purposes of this paper the focus will be on the weights assigned to the company's capital structure and the cost of each form of capital at a high level.

1. Weighting the Capital Structure

The first consideration is the weight of the company's capital structure. In its simplest form, each form of capital is weighted as a proportion of the total capital of the company.[75] There are two ways to determine the value of capital: market value and book value.[76] Using market value will generally always result in

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[73] *Investment Analysis* at 378.

[74] *Id*.

[75] *Id*. at 531.

[76] *Id*.

a higher WACC than using book value.[77] Thus, it is generally more reasonable to calculate both and average the resulting WACC using both values.[78]

2. The Cost of Equity

The cost of equity can be a paper in and of itself, but at a high level, the most common method used is the Capital Asset Pricing Model ("CAPM").[79] For purposes of this paper, it is enough to understand that CAPM incorporates a cost premium that reflects the risk of investing in the particular company's over the market risk-free rate.[80] In other words, because a company's equity is more risky than say a U.S. Treasury Bond, an investor will expect a higher return on such equity to compensate for the risk undertaken.[81] The cost of equity takes just as much consideration as other elements because estimates of risk can lead to substantially alternate results.[82]

3. The Cost of Debt

The cost of debt is generally easier to estimate than the cost of equity. Usually, a company's debt receives a credit rating similar to that of an individual

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[77] *Id*.

[78] *Id* at 532.

[79] *Id*. at 239.

[80] *Id*.

[81] *Id*.

[82] See *Global GT LP*, 993 A.2d at 511.

person.[83] The credit rating will determine the rate at which a company will be able to issue debt.[84] In essence, the lower a company's credit rating, the higher "yield" a company will have to pay to obtain debt holders.[85] Many financial websites provide composite bond rates for companies that have certain credit ratings and adjustments can be made for companies with worse credit ratings.[86] The cost of debt is generally always lower than the cost of equity.[87] Therefore, the cost of debt will generally decrease WACC leading to a higher valuation of the shares of the going concern.[88]

4. Tying the Underlying Factors Together

Bringing these concepts together, the weights determined by the capital structure of the company are multiplied by the respective costs of capital to return the weighted cost for each form of capital.[89] These weighted costs of capital are then added together to provide the WACC for the company.[90] One thing should be clear at this point: each of these factors discussed require assumptions and

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[83] *Investment Analysis* at 658 (the authors provide a description of the bond ratings for companies applied by different agencies).

[84] See *Id*. at 665.

[85] *Id*.

[86] For example, Yahoo! Finance provides a list of current composite corporate bond rates at http://finance.yahoo.com/bonds/composite_bond_rates.

[87] *Using Capital Cash Flows to Value Dissenters' Shares in Appraisal Proceedings*, 111 Harv. L. Rev. 2099, 2106-07 (1998).

[88] *Id*. at 2107.

[89] *Investment Analysis* at 531.

[90] *Id*.

estimates that could provide vastly different results. As will be shown, even a slight change in WACC can have a significant impact on the results of the DCF model. Again similar to the estimates of growth, the sensitivity to value from changes in the WACC will help shine light on the valuation error in *Southern Peru*.

B. Alternative Valuation Methods

Although *Southern Peru* primarily focused on the DCF method, the court used other valuation methods to check the reliability of the fair price valuations it calculated.[91] One of the more commonly used alternative methods is the comparable companies approach, and, in addition to a DCF analysis, this alternative method was employed in *Southern Peru*.[92] The first criteria in a comparable companies approach is finding comparable public companies that offer products and services that overlap the most with the target company.[93] The analysis then requires calculating a ratio of each company that reflects each company's price divided by some measure of income.[94] The ratios should then be adjusted to reflect the same capital structure as the target company, then averaged and multiplied by the same applied measure of income of the target company.[95]

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[91] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *42.

[92] *Id*.

[93] *Andaloro v. PFPC Worldwide, Inc.*, CIV.A. 20336, 2005 WL 2045640, *16 (Del. Ch. 2005).

[94] *Id*.

[95] *Id*.

The resulting value is the value of the company to the shareholders except for one final adjustment.

The final adjustment is a result of "control premiums" and "minority discounts" that are inherent in this type of valuation context. Generally, the ratios being used to determine valuation reflect an inherent minority trading discount because the shares trading in the public market reflect the price of minority shares; "that is, shares without any accompanying benefit of control."[96] To account for this minority discount under the comparable companies method, the court must add back a premium; the "control" premium.[97] The control premium is not a clear cut calculation, and often is an estimate based on the premiums to trading price applied in other merger transactions from the current or immediately past year.[98] Importantly, the control premium should only be added in the comparable companies analysis, and not in any other valuation method currently used.[99]

As a last note on the comparable companies analysis, parties have argued that a private company should reflect a minority discount due to the lack of marketability of the shares.[100] This argument derives from the fact that private

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[96] *Id*.

[97] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *42.

[98] *Id*. (applying a control premium based on an average premium paid in the year of the merger for other merger transactions); *Andaloro*, 2005 WL 2045640 at *18 (same).

[99] *Berger v. Pubco Corp.*, CIVA3414-CC, 2010 WL 2025483, *1 (Del. Ch. 2010).

[100] See *Borruso v. Commun. Telesystems Intern.*, 753 A.2d 451, 459 (Del. Ch. 1999); *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144 (Del. 1989).

companies do not have as liquid a market to trade their shares as do public companies.[101] However, the Delaware Supreme Court has explicitly disallowed such a discount when it is based solely on the fact that the target company is private as opposed to public and without further support that such a discount is appropriate.[102] The court will not apply a penalty for simply being a minority shareholder.[103] The inclusion of the comparable companies approach is to support the point that whatever valuation method is used, the approach to applying the elements of value that result in the minority shareholder's interest can lead to vastly different results with the slightest variations.

C. A Hypothetical Fair Price Valuation

To help explain the inequity created by the decision of *Southern Peru* and to support the importance of selecting appropriate elements of value, a hypothetical fair price valuation may be helpful. Upon calculating fair value, each party will usually use their own expert investment analyst to create a valuation of the company. For purposes of this paper, we will assume the analysts on both sides have chosen to use the DCF model for their valuations. Some additional assumptions will be pertinent: assume the court found that the merger consisted of

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[101] *Borruso*, 753 A.2d at 459-60.

[102] *Id*. at 460; *Cavalier Oil Corp.*, 564 A.2d at 1145.

[103] *Cavalier Oil Corp.*, 564 A.2d at 1145.

unfair dealing on the part of the defendant corporation. Thus, the court must consider the unfair dealing in its determination of a fair price.[104]

i. **Assumptions and Estimates**

Assume Target Company ("TC") had FCF of $1,000,000; a capital structure of 70/30 ($700,000 equity/$300,000 debt); and 10,000 shares outstanding at the time of the merger. Further assume the plaintiff held 1,000 shares in TC. Under these assumptions, the data can be input into the DCF model, and then determine the value of TC's shares based on estimates of growth rates and WACC.

ii. **Sensitivity Analysis**

Rather than clutter the analysis with a bunch numbers and spreadsheets, it will be easier to examine the effect of the input factors through a few sensitivity analysis tables. Each dollar amount in Tables 1 and 2 are in per share values.

Table 1[105]

WACC

Constant Growth Rate	5.0%	7.5%	10.0%	12.5%	15.0%
1.5%	$4,205.57	$2,403.72	$1,664.12	$1,262.30	$1,010.46
2.0%	$4,836.51	$2,586.44	$1,745.00	$1,305.82	$1,036.69
2.5%	$5,719.82	$2,805.70	$1,836.67	$1,353.70	$1,065.02
3.0%	$7,044.79	$3,073.69	$1,941.43	$1,406.62	$1,095.72
3.5%	$9,253.08	$3,408.68	$2,062.31	$1,465.41	$1,129.08

[104] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *26.

[105] A five-year multiple growth rate of 10% was assumed for this model.

Table 2[106]
Multiple-Year Growth Rate

Constant Growth Rate	5.0%	7.5%	10.0%	12.5%	15.0%
1.5%	$1,352.12	$1,501.38	$1,664.12	$1,841.26	$2,033.78
2.0%	$1,416.21	$1,573.48	$1,745.00	$1,931.77	$2,134.80
2.5%	$1,488.86	$1,655.19	$1,836.67	$2,034.33	$2,249.28
3.0%	$1,571.88	$1,748.58	$1,941.43	$2,151.55	$2,380.12
3.5%	$1,667.67	$1,856.33	$2,062.31	$2,286.81	$2,531.08

What should be immediately apparent from the tables is that even a 50 basis point adjustment in the constant or perpetual growth rate leads to about a $100 different in the per share price. Applying that difference to Pl's shares leads to about a $100,000 difference based on the growth rate used in the model.[107] This sensitivity will become even more dramatic when considering the facts and differences in estimates in *Southern Peru*.

IV. The Errant Approach and Resolution of *Southern Peru*

Based on the facts of *Southern Peru* and consistent with the standards for determining fair value discussed in Part II, *Southern Peru* made an entire fairness

[106] A WACC of 10% was assumed for this model.

[107] For example: using Figure 1 a 2.5% growth rate and 10% WACC would return a total value to Pl of $1,836,670; whereas staying with the same WACC and increasing growth just 50 basis points would return a total value to Pl of $1,941,430. If the court chose the 3% rate over the 2.5% rate due to the unfair dealing, that decision would amount to a $104,760 increase in value to Pl.

review of a deal where the majority shareholder essentially stood on both sides of the merger. In a correct application of those rules, the court found unfair dealing on the part of the defendant even though the discussion was based on an integrated discussion of both fair dealing and fair price.[108]

Southern Peru limited its fair price valuation to a conservative approach[109] that explicitly resulted in determining the essential factors in a light more favorable to the defendant.[110] It is this limitation that seems unnerving from the start. By finding that the defendants had in fact conducted unfair dealing but then resolved all the factors of the DCF model in a light more favorable to the defendant, the plaintiffs seemed to have received the short end of the stick. Moreover, the court stated that the "record could arguably support a damages award of $2 billion *or more*"[111] but ultimately awarded damages over $700 million less than the arguably supported $2 billion amount.[112]

The main reason cited by *Southern Peru* for the approach taken was that the plaintiffs caused "a pattern of litigation delay".[113] The court reasoned that such a

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[108] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *26.

[109] *Id*. at *3.

[110] *Id*. at *41 ("I use the discount rate assumption . . . that is most favorable to the defendants and a long-term copper price assumption that is even more favorable to the defendants . . . ").

[111] *Id*.

[112] *Id*. at *43.

[113] *Id*. at *2.

delay "subjected the controller to lengthy market risk."[114] Understandably, a party should not be able to delay litigation when such a delay will subject another to some substantial risk, but such an issue should not be a factor in going concern value. Whether or not a party causes delays in litigation pertaining to a proceeding considering fair value is irrelevant to determining the actual fair value of the company in question for the following reasons: (1) fair value is determined as of the date of the merger; and (2) it is an element of value arising from the merger which is to be excluded from fair value.

Going concern value must generally only include factors that arise up to the merger date.[115] Delays in litigation cannot possibly occur before the merger because prior to the merger there is nothing to litigate. Furthermore, the delays in litigation are a speculative element of arising from the expectation or accomplishment of the merger for the same reason, i.e. if the merger does not occur, there are no litigation delays. For these reasons, delays in litigation cannot be a factor in going concern value. Thus, when *Southern Peru* considered this factor in determining a fair price for the minority shareholder's interest, it included the type of elements of value specifically excluded from fair value.

A. A New Reasonable, Practical, and Equitable Approach

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[114] *Id*. at *3.

[115] See *supra* n. 26.

To remedy this issue, this paper proposes a solution that will provide guidance for appropriating the factors to the proper party that will result in a more reasonable determination of fair value. First, the court should determine whether or not there has been fair dealing.[116] If there has been fair dealing, the defendant should be given the benefit of having all of the going concern value factors viewed in the light most reasonably favorable to the defendant. If there has not been fair dealing, all of the factors of going concern value should be viewed in the light most reasonably favorable to the plaintiff. Then, if the merger price is below the determined fair price, then the merger price was unfair and the plaintiffs should be awarded the fair price.[117] If the merger price is at or above the determined fair price, then the merger price was within the range of reasonableness and the plaintiffs are not entitled to damages. Finally, to account for any litigation delays, the court may adjust prejudgment interest to reflect the fault of either party in accordance with Delaware law.

B. The Consistency of the Equitable Approach with Fair Value

Following the proposed approach would have several benefits. First, the approach would incentivize fair dealing on the part of the controlling shareholders because the controlling shareholder would undoubtedly prefer the view of factors

[116] For an exclusive appraisal action, this part of the court would presume there was fair dealing, thus creating a benefit for those who wish to solely demand an appraisal.

[117] Or, as was the case of *Southern Peru*, the plaintiffs should be awarded the difference between the merger price and the fair price if they have already received the merger price (or its equivalent).

viewed in a light most reasonable to them. Second, the approach would likely result in more transparent negotiations and possibly higher merger prices. Third, the approach is more equitable because it will recognize when a controlling shareholder has acted fairly and should not be punished. Finally, the approach provides clear guidance to the court that will result in finding proper going concern value and equitable results.

In addition, the approach does not prohibit the court from recognizing delays in litigation. Delaware permits the application of pre-judgment interest to ensure the prevailing party receives the value it would have received had the value awarded been paid when the wrong occurred.[118] The law states that a court *may* but does not have to award pre-judgment interest or it may adjust pre-judgment interest in its discretion.[119] In this manner, *Southern Peru* had the ability to penalize the plaintiffs for the delays in litigation without affecting the determination of fair value. In fact, Chancellor Strine recognized this remedy, and then reduced the possible pre-judgment interest to the plaintiffs as well as awarding them a depressed fair value.[120] Because the court applied the pre-judgment interest rate against this inequitable fair value the error in the award was compounded.

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[118] *Summa Corp. v. Trans World Airlines, Inc.*, 540 A.2d 403, 409 (Del. 1988).

[119] *Id*.

[120] *In re S. Peru Copper Corp.*, 2011 WL 4907799 at *43.

V. Conclusion

In sum, this article has discussed the decision in *Southern Peru* and the conservative approach applied that led to a fundamental misunderstanding of going concern value. To help resolve the issue of a lack of guidance that led to the diminished result in *Southern Peru*, this article has proposed a simple step-by-step analysis that will direct future courts from returning equally unjustifiable results.

To establish this equitable approach, this article discussed the history of fair value and going concern as it has been interpreted by *Weinberger* and its progeny. In addition, this article detailed the proper types of elements that should, and should not, be included in going concern value that are both consistent with the financial community and the Delaware courts. This article then broke down the DCF model part by part to help articulate the reasons why the conservative approach applied in *Southern Peru* was improper. In that discussion, this article explained the importance of recognized the proper elements of fair value due to the sensitivity of valuation methods. In the heart of this article, it was discussed how delays in litigation, although not to be ignored, are not a proper element of fair value. In addition, delays in litigation already have a remedy through pre-judgment interest thereby providing that the proposed equitable approach does not absolve nor prohibit the recognition of improper conduct in any manner.

In the end, the equitable approach will hopefully lead to an increase in fair dealing and a decrease in improper conduct by controlling shareholders. In addition, it will hopefully lead more companies that are run by honest and competent people that are truly looking out for the interests of all of the company's shareholders equally. It should be noted that this article is not intended to admonish the courts for reaching incorrect results in fair value determinations. Understanding a company and being able to determine the actual price of that company is impractical if not impossible. The objective of the court is simply to determine a fair price that is satisfactory to a reasonable person, and not to be forced into determining a price that is superior to the one offered. This objective is important for the court to adhere to, and it would be well within the realm of an intelligent investor.[121]

[121] "To achieve *satisfactory* investment results is easier than most people realize; to achieve *superior* results is harder than it looks." Benjamin Graham, *The Intelligent Investor*, 250 (HarperCollins 1949).