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Case Number 230,2013

IN THE SUPREME COURT OF THE STATE OF DELAWARE

AMERICAN COMMERCIAL LINES, \$ INC., \$ No. 230, 2013

Respondent Below, \$ No. 230, 2013

Respondent Below, \$ On Appeal from C.A. No. 6369 in the Court of Chancery of the State of Delaware

Petitioner Below,

Appellee, Cross-Appellant.

IQ HOLDINGS, INC.'S ANSWERING BRIEF ON APPEAL AND OPENING BRIEF ON CROSS-APPEAL

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NATURE OF PROCEEDINGS

This is an appeal and a cross-appeal from a post-trial decision by the Court of Chancery that appraised 250,000 shares of Appellant and Cross-Appellee American Commercial Lines Inc. ("ACLI") stock held by Appellee and Cross-Appellant IQ Holdings, Inc. ("IQ") as of December 21, 2010 (the "Merger Date").

The Court of Chancery rendered its Post-Trial Order ("PTO") on March 18, 2013. PTO at 1. The Court of Chancery found the discounted cash flow ("DCF") analyses by both parties' experts sufficiently reliable to use to determine fair value. *Id.* at ¶¶ 4, 5, 6. The Court of Chancery used the DCF analysis by ACLI's expert as its basic valuation framework, but made adjustments to it. Over IQ's objection, the Court adopted the views advocated by ACLI's expert on (1) reducing management's pre-dispute cash flow projections, (2) determining the amount of ACLI's debt, and (3) the appropriate beta and small company stock premiums to use. The Court, however, required the DCF analysis to apply the cost of debt advocated by IQ's expert to the amount of debt advocated by ACLI's expert.

ACLI moved for reargument asserting that the Court of Chancery inappropriately determined the cost of ACLI's debt. A-414; A-754. On April 5, 2013, the Court of Chancery denied ACLI's motion by order with explanation. A-1124. Final judgment was entered on April 10, 2013. A-1127.

SUMMARY OF ARGUMENT

Arguments on Appeal

- 1. Denied. The Court of Chancery correctly calculated the yield-to-worst rate of ACLI's Senior Notes (the "Notes") as of the Merger Date, and the Court of Chancery did not misapply 8 *Del. C.* § 262. There is no evidence that the rate was affected by the announcement of the Merger. Moreover, using the 9.6% yield-to-worst rate on the day before the Merger was announced, October 18, 2010 (the "Merger Announcement Date") to establish the <u>cost</u> of debt (as advocated by ACLI and rejected by the Court of Chancery) would be inconsistent with determining the <u>amount</u> of debt by using its market value on the Merger Date (as advocated by ACLI and adopted by the Court of Chancery).
- 2. Denied. The Court of Chancery correctly applied the actual observed (and stipulated) interest rate of ACLI's revolving credit facility (the "Revolver") on the Merger Date. ACLI mischaracterizes the Court of Chancery's decision as making an unsupported assumption about future interest rates. The Court of Chancery made no assumption about how interest rates would change, but only noted that ACLI's expert's opinion that interest rates would increase in the future was not as reliable as the actual cost of debt at the time of the Merger. Accordingly, the Court of Chancery found that the actual cost of the Revolver on the Merger Date, as

agreed to by the parties in the Joint Pretrial Stipulation, was the best indication of the cost of the Revolver on that date.

- 3. Denied. The Court of Chancery correctly adopted the actual market cost of the Notes on the Merger Date rather than ACLI's calculated long-term cost of debt. Contrary to ACLI's assertion that applying a long-term cost of debt is a "well-established valuation principle," both case law and financial literature consistently advise that a company's actual cost of debt is a better measure than a calculated long-term proxy in determining fair value.
- 4. Denied. The Court of Chancery correctly determined that ACLI could have borrowed at a blended interest rate of 5.84%. ACLI's claim on appeal that it could not have borrowed at that rate was never raised below and, in any event, is unsupported by the record. The Court of Chancery's finding of the appropriate interest rate was based upon the observable market rate for ACLI's publically-traded Notes and Revolver on the Merger Date. There was no reason to look to bond ratings, as ACLI now belatedly contends on appeal. Moreover, the Notes' rating suggests that the cost of the Notes should be lower than 7.15%, not higher as ACLI contends.

Arguments on Cross-Appeal

5. The Court of Chancery contravened settled Delaware law by adopting ACLI's expert's post-Merger adjustments to ACLI management's projections.

Delaware law prescribes reliance on the most recently prepared management projections available as of the Merger Date rather than on an expert's post-litigation adjustments to these projections. Even accepting the testimony of all of ACLI's witnesses, none of whom were members of ACLI management that prepared the projections, the adjustments made by ACLI's expert, specifically her reduction of management's projected cost savings by half, were not supported by the record.

- 6. The Court of Chancery erred by arbitrarily, and without any evidentiary support, including the "other non-cash operating activities" line item from ACLI's expert's discounted cash flow analysis in its valuation. The PTO never mentions this line item and never explains why it should be included in valuing ACLI. At trial, ACLI presented no evidence to support what this line item represented or why it should be included in a discounted cash flow analysis.
- 7. The Court of Chancery abused its discretion in using the beta and small cap premium advocated by ACLI's expert. The small cap premium was not supported by the evidence because it did not appropriately reflect the risk of a company the size of ACLI and, when considered with the beta chosen by ACLI's expert, accounted for the same risks twice. Furthermore, the Court's explanation of its decision to apply ACLI's expert's beta and small cap premium actually supports application of the beta and unsystematic risk premium advocated by IQ's expert.

STATEMENT OF FACTS

On the Merger Date (December 21, 2010), ACLI was one of the largest and most diversified inland marine transportation and service companies in the United States. A-1573; A-1774. ACLI let its fleet deteriorate for many years, and it was struggling with cost and revenue pressures that resulted from having one of the oldest fleets in the industry. A-191 at 239:17–242:13; A-238 at 420:14–421:15. In the view of ACLI's CFO, Thomas Pilholski, ACLI's fleet was "probably the oldest fleet of a company of our size in the industry," and in the next four to six years the fleet would require significant reinvestment. B-293 at 33: 18–20.

However, because ACLI owned its own shipbuilding capacity, it could replace its fleet for less than its competitors, and could do so on its own schedule. A-1753; A-1785–86. ACLI had also substantially improved its capital structure and strengthened its balance sheet during 2009 by issuing \$200 million in Notes and entering into a new revolving credit agreement that placed fewer constraints on its operations. A-1322; A-1334.

I. MANAGEMENT PROJECTIONS

In the ordinary course of its strategic planning process in 2010, ACLI's management presented the ACLI Board of Directors with financial projections and a proposed plan going forward in May (the "May Plan") that focused on reinvesting heavily in the aging fleet while continuing to implement a set of

strategic initiatives, some of which dated back to 2005. A-202 at 275:13–276:17; A-1323–26. Management believed that replacing the fleet would remedy many problems associated with years of under-spending on ACLI's fleet, including high costs and inefficiency. A-192 at 241:1–242:13. When ACLI's Board reviewed the May Plan, however, it expressed concern about the increased level of debt that management proposed using to finance the increased capital spending. A-194–95 at 252:16–253:1; A-202 at 276:18–277:2. The Board instructed management to prepare a revised plan that did not require much additional borrowing. A-192 at 243:17–21.

Management revised its plan and gave the Board an updated fleet reinvestment forecast in July 2010 (the "July Projections"). The July Projections reduced capital expenditures, no longer used additional debt to finance capital expenditures, and covered the six-year period from 2011 through 2016. A-202–203 at 277:22–279:21. The July Projections also reduced certain strategic initiative savings included in the forecast. A-203 at 278:15–22; 279:16–20. The July Projections were the last long-term projections ACLI management prepared before the Merger. A-197 at 261:15–262:8; A-207 at 296:23–297:9.

II. THE MERGER

In part because of its long-term focus on reducing costs, ACLI was an attractive investment in 2010. For example, BB&T Capital Markets upgraded its

recommendation on ACLI from "Hold" to "Buy" and set a \$50 target for ACLI's share price in October, 2010, explaining: "with management's recent focus on cost reductions, the [earnings per share] leverage from pricing is even greater. For instance, as the company replaces their fleet, the new barges have significantly lower maintenance cost (plus less down time)." B-188.

Platinum Equity, LLC ("Platinum") also saw ACLI—an established business with a solid market position, fixable cost problems, and its own barge building facilities—as a tremendous opportunity. Through Bank of America Merrill Lynch ("BAML"), Platinum approached ACLI, whose Board of Directors formed a Special Committee to negotiate a transaction. A-1579. The Special Committee retained BAML as its financial advisor. A-1580.

In preparing its fairness opinion, BAML used the July Projections to develop what ACLI referred to as the "Cash Flow Neutral Case" in its proxy statement. A-1596. However, BAML failed to account for changes in deferred income taxes so that BAML's free cash flow calculations were lower than the July Projections. *See* B-236; A-1994 at 74:4–18. BAML also failed to use management's projections for the years 2015 and 2016—years in which ACLI realized the increased revenues and margins generated by increased capital spending on its fleet. B-236. And BAML created (and valued ACLI using) its own "Deferred Investment Case" forecast, which represented the projected effect of a "prolonged period of

economic stagnation whereby fleet renewal is delayed and certain strategic initiatives have approximately one third of the effect as in the cash flow neutral case." A-1597. Relying on an incomplete and inaccurate version of management's projections as well as its own downward-adjusted forecast, BAML advised ACLI that \$33 per share was fair, an opinion not based upon the operative reality of ACLI as of the time of the Merger. Platinum agreed to pay \$33 per share. A-1583.

III. TRIAL AND POST-TRIAL ORDER

IQ owned 250,000 shares of ACLI common stock at the time of the Merger, dissented from the Merger, and perfected its appraisal rights pursuant to 8 *Del. C.* § 262. A-118. IQ filed its petition for appraisal on April 12, 2011. A-126 at ¶37. Trial was held in the Delaware Court of Chancery on October 1 and 2, 2012. Before trial, the parties submitted a Joint Pretrial Stipulation with certain agreed facts, including that the interest rate on ACLI's revolving credit facility "was LIBOR plus 3.75% assuming unused availability of the Revolver greater than \$175 million." A-120 at ¶7. The Court of Chancery entered the PTO on March 18, 2013. PTO at 1.

At trial, both ACLI and IQ presented expert opinions about the fair value of

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¹ Equity Group Investments, LLC ("EGI"), ACLI's largest shareholder group, agreed to take \$31.25 per share. A-1579; A-1583. However, EGI and its affiliates also planned to dispose of all shares before end of 2010 if the Merger was not approved. *See* A-1584. To do so, it would presumably have to discount the price for its large share position.

ACLI on the Merger Date. Both David Fuller (IQ's expert) and Melissa Knoll (ACLI's expert) gave the most weight to their value conclusions based on a DCF analysis. A-2114; A-1910. The most significant difference between the parties' DCF approaches was cash flow projections they used: while Fuller relied on management's most recent projections, Knoll made her own post-Merger adjustments to those projections. A-1899; A-148–49 at 66:5–70:5. In its PTO, the Court of Chancery found that "both experts' discounted cash flow analyses are sufficiently reliable to use in determining fair value." PTO at ¶6.2 However, the Court of Chancery used Knoll's DCF analysis "as the basic valuation framework," subject to the Court's rulings on the parties' disputes over the correct inputs to use for the analysis. Id. And, contrary to Delaware law regarding post-Merger modifications to management projections, the Court of Chancery applied Knoll's modified projections to its DCF analysis to determine fair value. *Id.* at ¶7(b).

In using Knoll's DCF analysis as its framework, the Court of Chancery implicitly included a line item from Knoll's analysis which Knoll titled "other non-cash operating activities." Although a line item of the same title appeared in ACLI management's projections, the value in Knoll's line item did not, and no evidence was presented at trial to support what was actually included in Knoll's line item.

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² Contrary to ACLI's assertion, the Court of Chancery did not find that Fuller was not credible. Indeed, ACLI cites only to its own briefing for this assertion. Appellant's Corrected Opening Brief (hereinafter, "OB") at 12.

A-167–169 at 144:12–150:18. Further, no evidence was presented to explain what was included even in management's line item of the same name, or why something described as "non-cash" should be included in a DCF analysis. *Id.* In advising ACLI's Special Committee on the merger proposal, BAML did not include the line item from management's projections in its DCF analysis, and neither did Fuller. *Id.*; A-372–74. The Court of Chancery made no mention of this line item in its PTO and provided no explanation of whether or why it should be included in the valuation of ACLI.

The parties disagreed at trial on how to determine the amount of ACLI's interest-bearing debt, which included the Notes and the Revolver. B-16–18; A-1794; A-1812. While Fuller valued ACLI's debt by determining how ACLI was most likely to repay its debt, Knoll valued ACLI's debt by looking at its market value. A-2107; A-2132; A-1902; A-1927–29. The parties also disagreed about how to determine the cost of ACLI's debt. A-1946–47. Fuller determined the cost of debt represented by both the Revolver and the Notes, and then used the appropriate weighted average of those costs. A-2124. Knoll, on the other hand, applied the cost of debt represented by the Notes to all of ACLI's debt, and determined the cost of debt for the Notes at a different date than she used to determine the amount of debt for the Notes. A-52; A-249–51 at 465:11–467:6, 471:21–473:12; A-250–51 at 469:5–471:20; A-285–86.

The Court of Chancery determined that ACLI's debt should be valued at market, and used Knoll's market value calculation. PTO at ¶8. However, rather than using Knoll's cost of debt, the Court held that "the cost of debt will be the weighted average of the actual cost of the Notes and [the Revolver] as of the Merger Date." *Id.* at ¶9(a). For the Notes, "[h]aving used the market value of the Notes as of the Merger Date," the Court of Chancery applied "the yield to worst for the Notes as of that date, or 7.15%." *Id.* This finding was consistent with what Fuller asserted was the appropriate cost of debt to use for the Notes if one agreed with Knoll's approach to determining the amount of that debt. A-1946 at ¶15; A-1963; see also A-52; A-285. For the Revolver, the Court of Chancery applied the actual observed cost of the Revolver on the Merger Date as stipulated by the parties. PTO at ¶9(a). The Court also noted that Knoll objected to these figures because she believed interest rates would increase in the future. *Id.* The Court recognized that while interest rates could change, a company's actual cost of debt on the valuation date is the best indication of its cost of debt for fair valuation purposes. Id.

The parties also disagreed at trial on the appropriate beta and small stock or unsystematic risk premiums to apply to ACLI's weighted average cost of capital ("WACC") calculation. Fuller advocated (1) an unlevered beta of 0.73 derived from the Bloomberg adjusted betas of other publicly-traded waterway companies,

and (2) an unsystematic risk premium of 2.5% to account for the company-specific risks faced by other companies of similar size. A-2124; A-2137; A-137 at 22:12–16. Knoll applied MSCI Barra's predicted beta for ACLI of 0.80 and a small stock premium based on Ibbotsen data for the average of the ninth and eighth decile of equity values. A-1896–98. The Court of Chancery adopted Knoll's figures. PTO ¶9(c).

IV. ACLI'S REARGUMENT

Following the Court of Chancery's PTO, ACLI moved for reargument, asserting that the Court inappropriately determined the cost of the Notes and Revolver. A-754. In addition, in demonstrating the effect of the Court of Chancery's rulings ACLI silently changed the rounding convention both experts had used at trial, a change that had the effect of lowering the valuation. A-1105–06.

The Court of Chancery denied ACLI's motion. A-1124. With respect to the cost of the Notes, the Court of Chancery cited Knoll's testimony at trial, which admitted that the cost of debt applied by the Court was the actual market cost of debt tied to Knoll's market value of debt. *Id.* at ¶2. With respect to the cost of the Revolver, the Court of Chancery explained that it used the actual cost as stipulated by the parties, and noted that ACLI's motion for reargument presented a new analysis not presented at trial. *Id*.

Finally, the Court of Chancery found that:

[ACLI's] Motion tacitly introduces a new adjustment to Knoll's model, a change in rounding. The [PTO] stated that "Knoll's discounted cash flow analysis . . . will be used as the valuation framework, subject to the rulings that follow on the disputes over inputs." [PTO] ¶ 6. The [PTO] specifically provided the changes that would be made to Knoll's model. A change to Knoll's rounding approach was not one of them. It is rejected.

A-1125–26. Accordingly, ACLI's assertion that the "Reargument Order requires the parties to round the WACC input to the nearest 0.1%," mischaracterizes the Court of Chancery's holding, which was only that ACLI could not change its (and Knoll's) convention throughout the case of rounding the WACC conclusion to the nearest tenth of a percent in order to arrive at a lower valuation after the Court announced its decision.

ARGUMENT

I. THE COURT OF CHANCERY CORRECTLY ADOPTED THE 7.15% YIELD-TO-WORST COST OF THE NOTES ON THE MERGER DATE.

A. Question Presented

Whether the Court of Chancery correctly adopted the 7.15% yield-to-worst of ACLI's Notes on the Merger Date as the cost of ACLI's debt. A-52; A-1946 at ¶15; A-1963.

B. Standard of Review

While ACLI attempts to frame this issue as a question of law, ACLI actually disagrees with the Court of Chancery's findings of fact. OB at 19–20 (contrasting ACLI's expert's testimony with the Court of Chancery's findings); *id.* at 21 ("The Court of Chancery also ignored the testimony of both experts . . ."). Accordingly, the Court of Chancery's cost of debt finding should be reviewed for abuse of discretion. *M.G. Bancorporation v. Le Beau*, 737 A.2d 513, 526 (Del. 1999). The Court of Chancery abuses its discretion only if its factual findings do not have support in the record or its valuation is not the result of an orderly and logical deductive process. *Id.* This Court defers to the Court of Chancery's factual findings so long as they are supported by the record, even if it might independently reach an opposite conclusion. *Bell v. Kirby Lumber Corp.*, 413 A.2d 137, 142

³ None of the portions of the record to which ACLI cites for where this issue was preserved below, *see* OB at 18, cast the cost of debt calculation as an issue of statutory interpretation. *See* Supr. Ct. R. 8.

(Del. 1980).

C. Merits of Argument

The Court of Chancery properly determined the cost of debt represented by the Notes on the Merger Date by looking to the market price of the Notes on the Merger Date. There is no evidence that this cost of debt was affected by any element of value arising from the expectation of the Merger.

To determine the amount of debt represented by the Notes, Knoll used the market value on the Merger Date. A-1902; A-1927–29. Knoll valued the Notes at 1.175 times par to reflect the market's valuation of ACLI's debt rather than the amount owed by ACLI as reported in its financial statements. *Id.*; A-1946. ACLI never argued at trial, and does not argue now, that the above-par market price of the Notes on the Merger Date was affected by the announcement of the Merger two months earlier. The Court of Chancery found that this market price was reliable and applied Knoll's calculation as the appropriate measure of the amount of debt represented by the Notes. PTO at ¶8.

To determine the cost of debt represented by the Notes, Knoll again used a market value. Knoll looked to the average yield-to-worst for the Notes, which she determined was 9.6%. A-52; A-250–51 at 469:5–471:20; A-285–86.⁴ However, while she derived the <u>amount</u> of debt from the market price of the Notes on the

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⁴ For the Notes, yield-to-worst was yield-to-call, because the market assumed the 12.5% coupon Notes would rationally be called at a premium in July 2013.

Merger Date (117.50), Knoll derived the <u>cost</u> of debt (9.6%) from the lower market price of the Notes two months earlier (110.79). A-52; A-250–51 at 469:5–471:20; A-285–86. Knoll then applied this 9.6% cost of debt for the Notes alone to all of ACLI's debt, including both the Notes and the Revolver. A-52; A-138 at 25:8–26:4; A-249–51 at 465:11–467:6, 471:21–473:12; A-286.

Knoll's cost of debt conclusion was analytically inconsistent with the amount of debt she used. Knoll derived both inputs from the market price for the Notes, but she used the price on one date to derive the cost and the price on a different date to derive the amount. Fuller first identified the inconsistency of Knoll's method in his Rebuttal Report:

Regardless of the amount of debt, Knoll's calculation of the Company's cost of debt is wrong. Knoll applied the cost of debt for the Notes as of October 15, 2010, which was an average yield to worst ("YTW") of 9.6%, and an average price of 110.79 per Note. However, Knoll used a price of the Notes of 117.50. If the notes are priced at that level, then it would make financial sense for the Company to call the Notes in July 2013, and refinance the Notes at an interest rate at least 5.0% less than it was paying. The Note price of 117.50 indicates a YTW of 7.16% based on a call at 106.25 on July 15, 2013.

A-1946 at ¶15; see also A-1963. IQ argued that 7.15% was the appropriate cost of debt to use for the Notes if one used Knoll's market-value calculation of the amount of debt represented by the Notes. See A-52 ("[T]here is no sound justification for deriving the amount of debt represented by the Senior Notes using

the market price at the closing of the transaction, while estimating a cost of debt from the lower market price two months earlier. If, for example, Knoll had figured the cost of debt from the \$117.5 market price of the Senior Notes at December 21, the yield-to-call would have been 7.15%"); A-285. The Court of Chancery found this evidence persuasive, and its conclusion is amply supported by the record.

In an effort to undermine this finding, ACLI argues on appeal that the 7.15% yield-to-worst on the Merger Date was affected by the announcement of the Merger, but ACLI never provided any evidence at trial to support such a claim. To support its argument on appeal, ACLI includes in its brief a chart showing that yield-to-worst for the Notes on the Merger Date was lower than yield-to-worst on the Merger Announcement Date. OB at 9. ACLI first presented this chart to the Court of Chancery after the close of evidence and, accordingly, IQ never had an opportunity to confront and cross-examine Knoll or other ACLI witnesses about it. A-362 at n.1; In re S. Peru Copper Corp., C.A. No. 961-CS, 2011 WL 5176789, at *2 (Del. Ch. Oct. 14, 2011) ("I find that these exhibits are improper summaries to the extent they rely on information beyond what was included in Beaulne's expert report and not testified to by Beaulne at trial. Moreover, to the extent that the plaintiff seeks to offer this evidence as a belated supplement to Beaulne's expert report, it is inadmissible as unfairly raised.") (internal citations omitted). Furthermore, ACLI's chart is not based on anything in the evidence and cannot be

reproduced from any information in evidence, except for the yield-to-worst figures as of the date of the announcement and the date of the merger. *See* B-456 at ¶6. And IQ is unable to tie the chart to Bloomberg data. *Id*.

However, even considering ACLI's improper post-trial chart, there is still no evidence that the decrease in yield-to-worst was because of the announcement of the Merger. According to ACLI's chart, the Merger announcement produced, if anything, an immediate increase in yield. Likewise, according to ACLI's chart, the yield did not drop below the yield on the Merger Announcement Date until almost a month later. The more likely explanation for the decrease in the Notes' yield is that, from the Merger Announcement Date to the Merger Date, ACLI's financial outlook and performance steadily improved. See A-1444-50. Although ACLI suggests that its strong third quarter results were an anomaly, caused by "an accelerated receipt of revenues a quarter early," this explanation for the improved results was not disclosed in ACLI's 2010 Q3 10-Q, and as such the market would not have considered it in its reaction to the improved performance. OB at 20 n.22; *see generally* A-1444–1546.

In fact, Knoll admitted that 7.15% was the realistic cost of the Notes on the Merger Date, even suggesting herself that this was an appropriate value for the long-term cost of the Notes. A-237 at 417:7–17 ("That 7.15 percent yield-to-worst assumes – that's the yield assuming the company refinances in 2013. And when

you look at treasuries at that point in time, treasuries were at .77 percent, meaning you have a default premium over Treasury of 6.38 percent. So in a weighting exercise, the 7.15 percent, rather than, for example, the 12-1/2 percent coupon would be what would be essentially burdening a calculation of long-term cost of debt during the three-year approximately period of time before you would refinance that.") (emphasis added). Indeed, ACLI's argument, if accepted, would render ACLI's market value of the Notes from the Merger Date just as improper as the market cost of the Notes on that same date. In other words, ACLI seeks to benefit from the Court of Chancery's adoption of Knoll's increased market value of debt on the Merger Date, while inconsistently arguing that the market cost of debt on the Merger Date should be higher.

Accordingly, the Court of Chancery correctly used the actual market cost of debt for the Notes as of the Merger Date in its valuation.

II. THE COURT OF CHANCERY PROPERLY APPLIED THE OBSERVED INTEREST RATE OF THE REVOLVER AS AGREED TO BY THE PARTIES.

A. Question Presented

Whether the Court of Chancery's use of ACLI's observed 0.26% one-month LIBOR base rate as a component of ACLI's cost of debt was supported by the record. A-120.

B. Standard of Review

IQ agrees with ACLI that this question presents a challenge to the Court of Chancery's factual findings, to which this Court will defer so long as they are supported by the record, even if it might independently reach an opposite conclusion. *M.G. Bancorporation*, 737 A.2d at 526; *Bell*, 413 A.2d at 142.

C. Merits of Argument

1. The Court Of Chancery Correctly Applied The LIBOR Rate To Which The Parties Stipulated.

ACLI argues that the Court of Chancery's calculation of the LIBOR base rate did not result from any evidence at trial; this is wrong. The Court of Chancery adopted the rate to which ACLI <u>stipulated</u> in the Joint Pretrial Stipulation the Court entered before trial began. A-120. The stipulated rate is also the actual rate that ACLI was paying on the Revolver on the Merger Date. A-1114. Even the entirely new "market evidence regarding long-term expectations for LIBOR rates" on which ACLI now relies actually supports use of a 0.26% LIBOR base rate. OB at

23 & n.26 (relying on evidence not admitted at trial that provides "economic conditions . . . are likely to warrant exceptionally low levels for the federal funds rate for an extended period") (emphasis added). Thus, the Court of Chancery's LIBOR base rate is amply supported by the record and should be affirmed.

2. ACLI's Argument Mischaracterizes The Court Of Chancery's Conclusions And Is Unsupported By The Record.

Furthermore, the entire premise of ACLI's argument—that the Court of Chancery determined "that the Federal Reserve intended to keep LIBOR perpetually at 0.26%," OB at 17—mischaracterizes the Court of Chancery's decision. The Court of Chancery never tried to determine what LIBOR would be in the future. To the contrary, the Court noted that while "interest rates may eventually revert towards the mean, humans cannot predict the future, and deviations from the mean can persist for extended periods." PTO at ¶9(a). The Court concluded: "The actual figures as of the Merger Date reflect the Company's cost of debt at the time of the Merger, are the best indication of its cost of debt, and will be used to determine fair value." Id. The only evidence from trial that ACLI relies on is testimony from Knoll, who opined that interest rates would increase in the long term. OB at 24 n.28. The Court of Chancery acknowledged Knoll's opinion, but determined that Knoll's opinion was not the best indication of ACLI's cost of debt. PTO at ¶9(a).

ACLI also argues that the swap market predicted that LIBOR rates would be higher than 0.26% over the next three years. But this value is irrelevant, as the long-term swap rate reflects how much ACLI would be required to pay in order to protect itself from inflation and future interest rate risk, and this protection was not a feature of ACLI's Revolver financing at the time of the Merger. A-1794; A-1812; see also A-251-52 at 471:21-474:15-23, 477:5-16. Rather, the Revolver was tied to LIBOR, a short-term rate. A-1794; A-1812; see also In re RJR Nabisco, Inc. S'holders Litig., C.A. No. 10389, 1989 WL 7036 at *11 n.9 (Del. Ch. Jan. 31, 1989) (LIBOR is a short term rate); In re Emerging Commc'ns, Inc. S'holders Litig., C.A. No. 16415, 2004 WL 1305745, at *16 (Del. Ch. May 3, 2004) (actual observed cost of debt is more reasonable long-term debt cost assumption than assigned long-term cost of debt based on assumption that company could not borrow indefinitely at current observed cost of debt). There is no dispute that the Court of Chancery selected 0.26% as the LIBOR base rate because this was the rate that ACLI was actually paying on the Revolver on the Merger Date. OB at 6 (citing A-1125 at ¶3).

Similarly, ACLI's argument that the "current yield curve on forward Treasury rates" implies a change in interest rates is inaccurate. OB at 28. In support of this argument, ACLI cites Knoll's rebuttal report, which stated that an "upward sloping" yield curve indicated that future interest rates were expected to

increase. *Id.* at 28 n.36. But ACLI selectively excludes part of Knoll's sentence, which reads: "If the current yield curve is upward sloping (after removing the effect of the horizon premium), that indicates that future interest rates are expected to be higher than current short-term rates." B-378 (emphasis added).⁵ At trial, Knoll admitted that she could not remove the effect of the horizon premium to determine whether or not the yield on Treasury rates was in fact upward sloping. A-253 at 478:3–9.

ACLI misstates the opinion and testimony of Fuller when it suggests that he did not believe the one-month LIBOR rate reflected long-term expectations because his report used one-year LIBOR. Fuller applied one-year LIBOR based on the terms of the Revolver as it was refinanced on the Merger Date. A-137 at 24: 4–12. This rate was 0.78% for one-year LIBOR, plus a 3.00% premium under the terms of the revised Revolver on that date, which resulted in a lower total cost of debt for the Revolver than the 4.01% used by the Court of Chancery. Accordingly, the Court of Chancery's finding of an actual cost of the Revolver as observed on the Merger Date is supported by Fuller's analysis; he absolutely did not suggest that he believed this rate was too low. A-2124; A-2049 at 171:15–172:9.

Finally, ACLI improperly relies on materials never introduced at trial to

⁵ ACLI included the wrong version of Knoll's Second Updated Rebuttal Report in its Appendix. The version included in ACLI's Appendix includes language that was struck by the Court of Chancery when it granted IQ's motion to strike this rebuttal report. A-131 (order granting motion to strike). The correct version of Joint Exhibit JX0072 is included in IO's Appendix at B-363-421.

controvert its own stipulation about the actual cost of the Revolver. OB at 7 n.2 (citing to exhibits attached only to ACLI's motion for reargument and not introduced in evidence at trial). In its effort to push up the cost of the Revolver, ACLI suggests—based on materials never offered at trial—that the Revolver distinguishes "LIBOR Loans" from "Base Rate Loans," and that "[a]t the time of the Merger, LIBOR Loans and Base Rate Loans comprised approximately 88.7% and 11.3%, respectively, of outstanding principal under the Revolver." OB at 7 n.2. The only support ACLI provides for this ratio is a worksheet created by Knoll after trial that ACLI attached to its Motion for Reargument. See A-775–78. The Court of Chancery rejected this approach in its order denying ACLI's motion for reargument. A-1125. In reality, there is no evidence that ACLI's Revolver included any "Base Rate Loans."

ACLI's mischaracterizations about the PTO, its reliance on materials that were not offered in evidence, and its new calculations should not be considered. Rather, the Court's application of LIBOR (one-month LIBOR was .261 on the Merger Date) plus 3.75% is an appropriate and accurate cost of debt for the Revolver on the Merger Date as reflected in the record. *See* A-1114; A-1123.

III. THERE IS NO "WELL-ESTABLISHED VALUATION PRINCIPLE" THAT HOLDS A CALCULATED LONG-TERM COST OF DEBT IS MORE APPROPRIATE THAN AN ACTUAL OBSERVED COST OF DEBT.

A. Question Presented

Whether the Court of Chancery correctly applied ACLI's actual cost of debt on the Merger Date. A-1946–47; A-52; A-250–51 at 469:5–471:20; A-285–86.

B. Standard of Review

Although ACLI asserts that the standard of review is *de novo*, ACLI has pointed to no legal error and instead argues that the Court of Chancery did not agree with ACLI's expert. OB at 32. Accordingly, the standard of review for this challenge to factual findings is abuse of discretion. *See supra* at Section I. B.

C. Merits of Argument

ACLI attempts to reargue Knoll's opinion at trial that 7.15% was lower than she believed the long-term cost of debt should be. *See* A-251 at 470:6–11 ("I wouldn't have looked at the yield-to-worst on December 21st of 2010 and used that as my benchmark, because that number was much lower than what my determination was of what the long-term cost of capital and cost of debt capital were for this company."). Knoll's analysis ignored ACLI's actual market cost of debt in favor of an assigned long-term cost of debt based on her own expectations. A-220 at 348:19–349:1.

The Court of Chancery disagreed with Knoll and ACLI as a matter of fact,

and found that the actual cost of debt as of the Merger Date was the appropriate cost to apply to the market value of debt on that date. The Court of Chancery knew Knoll had a different opinion: "Knoll objected to these figures because they assume that the current interest rate environment will continue." PTO at ¶9(a). In denying ACLI's motion for reargument, the Court of Chancery explained that the 7.15% "yield to worst accurately described the cost of the Notes, which the market rationally expected would be refinanced when optimal for [ACLI] to do so. At trial, respondent had an opportunity to litigate the cost of the Notes and presented a figure which I chose not to adopt." A-1124 (citing Tr. 417, in which Knoll acknowledges 7.15% is the actual cost of the Notes on the Merger Date). There was obviously no misapprehension or misapplication of law or fact in the Court's finding; the Court simply disagreed with Knoll on this point.

Moreover, the Court's decision to apply the actual cost of debt, rather than a cost of debt based on Knoll's prediction about the future, is supported by the record and the law. Delaware courts consistently hold that a company's actual cost of debt is the appropriate measure, rather than a manufactured long-term cost of debt like Knoll used. *See Emerging Commc'ns*, 2004 WL 1305745, at *16 (company's actual observed cost of debt is more reasonable long-term debt cost assumption than assigned long-term cost of debt based on assumption that company could not borrow indefinitely at current observed cost of debt); *Gilbert v*.

M.P.M. Enters., Inc., C.A. No. 14416-NC, 1998 WL 229439, at *2 (Del. Ch. Apr. 24, 1998) ("In keeping with the Court's goal of determining with as much accuracy as possible the fair value of petitioner's shares on the merger date, the parties should use MPM's actual cost of debt when calculating the discount rate."), aff'd, 731 A.2d 790 (Del. 1999); Finkelstein v. Liberty Digital, Inc., C.A. No. 19598, 2005 WL 1074364, at *27 (Del. Ch. Apr. 25, 2005) ("This prong of the analysis is designed to capture Liberty Digital's cost of borrowing, and the petitioners have not shown why their figure better captures that value than Katz's use of the actual debt instruments.").

Fuller's testimony also supports the Court of Chancery's findings. ACLI argues that Fuller concluded that a 7.15% cost of debt for ACLI's Notes was inappropriate. OB at 32. This is not true. ACLI misinterprets Fuller's testimony by referencing his discussion of the cost of debt that should be applied to the lower book value of ACLI's Notes, rather than to the higher market value of the Notes calculated by Knoll and adopted by the Court of Chancery. Fuller specifically identified 7.15% as the actual cost of debt represented by the Notes on the Merger Date if Knoll's calculated market value of the Notes on the Merger Date was used. A-1946 at ¶15. Indeed, Fuller applied a 5.75% weighted cost of debt to Knoll's analysis, which was lower than the Court of Chancery's 5.84% weighted cost of debt determination. *Id*.

Financial literature likewise does not advise looking at long-term rates when determining cost of debt in a fair market valuation. Although ACLI asserts that it "is well established in the financial community that cost of debt . . . should reflect expected average interests rages over a long period of time," the only support for this assertion is a citation to the trial testimony of ACLI's own expert. OB at 31 & n.42. There is no support in the financial literature relied on by either expert in this case that a manufactured long-term cost of debt is more appropriate for valuation purposes than a company's actual cost of debt on the valuation date.

IV. THE 5.84% BLENDED COST OF DEBT ADOPTED BY THE COURT OF CHANCERY IS NOT CLEARLY WRONG.

A. Question Presented

Whether the Court of Chancery correctly determined that ACLI's cost of debt was 5.84%. ACLI did not preserve this question in the trial court, and does not contend otherwise.

B. Standard of Review

This Court adheres to the well-settled rule that precludes a party from attacking a judgment on a theory the party failed to advance before the trial judge. *Riedel v. ICI Ams. Inc.*, 968 A.2d 17, 25 (Del. 2009). ACLI has offered no argument or citation to the record suggesting that this argument was presented to the Court below, *see* OB at 34, nor has ACLI contended that the Court of Chancery committed plain error. Therefore, ACLI waived this argument. *Id.* at 23–25; Del. Supr. Ct. R. 8; *Smith v. Del. St. Univ.*, 47 A.3d 472, 479 (Del. 2012) (holding that an argument not preserved below may be raised on appeal only in the event of plain error "so clearly prejudicial to substantial rights as to jeopardize the fairness and integrity of the trial process.").

Assuming that this question had been preserved for review, it would present at most a challenge to the Court of Chancery's factual findings, which are reviewed for abuse of discretion. *See supra* at Section I. B.

C. Merits of Argument

ACLI waived this argument. It fails on its merits, as well. ACLI argues that the cost of debt adopted by the Court in the PTO is inappropriate in view of ACLI's credit rating. OB at 34. In support of this argument, ACLI relies only on materials that were never offered at trial (the material cited was attached only to ACLI's motion for reargument). *Id.* at 34–35.

Notwithstanding the lack of any evidentiary support, ACLI is wrong. There is no reason to infer a cost of debt from a credit rating when the market has already directly valued the specific debt instrument under consideration. Further, ACLI's argument is inaccurate because ACLI's corporate "B" credit rating does not apply to any of its specific debt instruments. *See* A-727 at ¶9 (Standard & Poor's issuer credit rating "does not apply to any specific financial obligation"). In fact, the credit rating for ACLI's Notes around the Merger Date was actually a B+, which, following ACLI's reasoning, suggests that the cost of debt for the Notes should be lower than 7.15%. A-1110; *see also* A-772. ACLI admits this fact in its brief. OB at 20 n.21. Moreover, if ACLI's Revolver had been rated, which it was not, it would have received an even higher credit rating than ACLI's Notes because it is first lien debt, carrying less risk than the Notes. A-1116; B-16.

V. THE COURT OF CHANCERY'S ADOPTION OF KNOLL'S MODIFICATIONS TO MANAGEMENT'S PROJECTIONS WAS CONTRARY TO DELAWARE LAW.

A. Question Presented

Whether the Court of Chancery's decision to apply an expert's post-litigation modifications to ACLI management projections rather than applying management's most recent projections at the time of the Merger was contrary to law. A-1899; A-1945; A-148–49 at 66:5–70:5.

B. Standard of Review

When the trial court's decision implicates a question of law, this Court reviews such matters *de novo* to determine whether the trial court "erred in formulating or applying legal precepts." *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1142 (Del. 1990).

C. Merits of Argument

1. Contrary to Delaware Law, The Court of Chancery Disregarded Management's Projections.

Throughout the proceedings below, the most significant difference between the parties' DCF valuation approaches was in the projections of future cash flows they used: while Fuller relied on management's projections to prepare his DCF analysis, Knoll made her own post-Merger adjustments to those projections. Specifically, Knoll removed 50% of management's strategic initiative savings from the cash flows projected by ACLI management in the July Projections. A-

1899; A-1945. Knoll did so without speaking to anyone in management involved in forecasting those savings, and her reduction in the forecast was inconsistent with what management and the Board represented in public filings about the reliability of ACLI's forecasts. A-213 at 318:13–21; *see also* A-1978–79 at 13:14–17:7; A-202 at 274:22–275:7; A-205–06 at 289:7–290:5; A-207 at 295:1–4; A-1591. The Court of Chancery, contrary to Delaware law on use of management projections, adopted Knoll's litigation-driven adjustments to the July Projections. PTO at ¶7.

Delaware law is clear that there is a strong preference for using projections prepared by management in the normal course of business. Doft & Co. v. Travelocity.com Inc., C.A. No. 19734, 2004 WL 1152338, at *5 (Del. Ch. May 20, 2004) ("Delaware law clearly prefers valuations based on contemporaneously prepared management projections because management ordinarily has the best first-hand knowledge of a company's operations."). Similarly, there is a wellrecognized skepticism of post-merger adjustments to management projections particularly when they are prepared for litigation, as Knoll's were. "Contemporary pre-merger management projections are particularly useful in the appraisal context because management projections, by definition, are not tainted by post-merger hindsight and are usually created by an impartial body. In stark contrast, post hoc, litigation-driven forecasts have an untenably high probability of containing hindsight bias and other cognitive distortions." Cede & Co. v. Technicolor, Inc.,

C.A. No. 7129, 2003 WL 23700218, at *7 (Del. Ch. Dec. 31, 2003), rev'd in part on other grounds, 884 A.2d 46 (Del. 2005); see also Cede & Co. v. JRC Acquisition Corp., C.A. No. 18648-NC, 2004 WL 286963 at *2 (Del. Ch. Feb. 10, 2004) ("[T]his Court prefers valuations based on management projections available as of the date of the merger and holds a healthy skepticism for post-merger adjustments to management projections or the creation of new projections entirely. Expert valuations that disregard contemporaneous management projections are sometimes completely discounted."); Emerging Commc'ns, 2004 WL 1305745, at *14 ("This Court has consistently expressed a preference for the most recently prepared management projections available as of the merger date. The Court has also been skeptical of ex post adjustments to such projections.").

Contrary to this established law, the Court of Chancery adopted Knoll's adjustments to management's projections. The Court of Chancery cited only one case, *Emerging Commc'ns*, 2004 WL 1305745, at *14, which it characterized as supporting the proposition that "[c]ontemporaneous management projections are often used as the starting point for a discounted cash flow analysis." PTO at ¶7. In so doing, the Court misapplied *Emerging Communications* and thus committed legal error.

Emerging Communications only refers to using management's contemporaneous projections as a "starting point" to explain an argument the Court

rejected (the defendants' argument that management projections should be used as a "starting point" before making adjustments). *Id.* at *14. The Court actually held that management projections without any modifications were the most reliable source of inputs to project future cash flows. *Id.* ("The Court disagrees. It concludes that the June projections, without any modifications, are the most reliable source of inputs to project ECM's future net cash flows."). The Court explained that the adjustments proposed by the defendants essentially substituted their expert's personal judgment for the non-litigation business judgment of the company's management and that the expert's attempt to arrive at a more "realistic" result with a hindsight valuation completely ignored the closest insiders' projections, which was simply inexcusable. *Id.* at *15 (citing Technicolor, 2003 WL 23104613, at *26).

2. The Court of Chancery's Reasons For Disregarding Management's Projections Are Not Persuasive.

Here, the Court of Chancery provided three reasons for its use of Knoll's modified projections, none of which supports deviating from Delaware law to use of Knoll's modified projections over the projections most recently prepared by ACLI management. *See* A-197 at 261:15–262:8; A-207 at 296:23–297:9 (July Projections were last long-term projections prepared before the Merger Date).

First, the Court of Chancery reasoned that the "market check that American conducted shows that actual buyers did not fully credit the undiscounted

projections." PTO at ¶7(a). That observation is speculative because there is no evidence about how potential bidders in the "go-shop" period regarded the financial information provided. It also illogically assumes that potential bidders thought the financial information they were given was inflated (rather than accurate, but insufficiently promising to justify a topping bid). In fact, the evidence at trial showed that the financial information BAML prepared and shared during the go-shop understated management's actual projections in two ways. First, BAML failed to account for changes in deferred income taxes, so that its free cash flow calculations were lower than management's July Projections. See B-236; A-2025 at 74:4–18 (ACLI's expert acknowledging this error). Second. BAML failed to use management's projections for the years 2015 and 2016—years in which ACLI expected to realize the increased revenues and margins generated by increased capital spending on its fleet. B-236. Accordingly, potential buyers never had the opportunity to consider (or fully credit) management's actual July Projections.

Second, the Court of Chancery reasoned that because ACLI's shareholders approved the merger after being shown BAML's adjustments of the management projections and a second (lower) set of projections that only BAML prepared, shareholders must have concluded the BAML-adjusted management projections were not reasonably achievable. PTO at ¶7(b). But that reasoning only

compounds the error of the Court's first inference. That is, not only were shareholders shown a version of management's projections that <u>understated</u> the financial results management expected, they were also shown an <u>even lower</u> set of projections that management had not prepared. Shareholders were not given an opportunity to evaluate management's own actual projections for the future, but were nudged toward accepting the offer on the table by BAML's even lower projections.

Third, the Court of Chancery reasoned that "the evidence at trial established that the full amount of the Strategic Initiative Savings was unlikely to be achieved." PTO at ¶7(c). The Court of Chancery then referenced testimony of two ACLI witnesses, Mark Noltemeyer and Sara Bryant, who both testified about difficulties they saw in the achievability of the projected savings. But neither of these witnesses had anything to do with developing the savings projections. A-202 at 274:22-275:7; A-205-06 at 289:7-290:5; A-207 at 295:1-4. And not only was Bryant not involved in the analysis behind the July Projections, her post-litigation opinions about the reasonableness of that forecast were also based on the asserted inability of ACLI to implement scheduled service after the Merger. A-208 at 298:8–10 ("You know, I think I am considering that the strategic—the scheduled service has not gone anywhere. It's hard to ignore that fact."). This is precisely the sort of post-merger hindsight that should be avoided in an appraisal action. See

Cede & Co., Inc. v. MedPointe Healthcare, Inc., C.A. No. 19354, 2004 WL 2093967, at *16 (Del. Ch. Aug. 16, 2004).

In reality, there is no evidence that anyone in ACLI management who developed the projections believed they were unlikely to be achieved. In seeking shareholder approval for the transaction, ACLI represented to its shareholders, and to the public, that management's forecasts (including the strategic savings) "were reasonably prepared on bases reflecting the best currently available estimates and good faith judgments of the management of the Company" and management was "not aware of any facts or circumstances that would make such information or data inaccurate or misleading in any material respect." A-1591.

Noltemeyer and Bryant, whom the Court of Chancery found to be credible, confirmed the reliability of management's projections. They agreed that the projections were based on the best data available at the time. A-206 at 290:20–23. Noltemeyer testified that the Board believed management's projections were a plausible and practical plan. A-196 at 258:15–259:8; B-251 at 44:15–24. And Bryant testified that the members of management in charge of developing the strategic initiatives, Michael Ryan and Tom Pilholski, were comfortable with the projections. A-207 at 295:22–296:10; B-346 at 29:3–13.

Indeed, Knoll admitted that her work was based on projections she did for the purpose of this litigation, and not on management's best estimates of likely results from operating the Company. When asked how she came to "a better judgment than management had about the achievability of these cost savings," Knoll responded: "I believed that I was engaged to come to a different kind of judgment than what management was coming to. My job was to make a judgment as to what was suitable for valuation purposes, not what was suitable for running a business or any of the other things we've talked about today." A-247 at 456:13–19 (emphasis added). But this misunderstands the question in an appraisal action, which is the value of the corporation "as a going concern based upon the 'operative reality' of the company as of the time of the merger." M.G. Bancorporation, 737 A.2d at 524. The projections used in an appraisal action should be the projections the Company used for running the business, not projections created "for valuation purposes" in the litigation.

Knoll lacked any basis to change management's projections at all. Knoll never spoke to anyone in management who developed the strategic initiative savings. A-240 at 426:8–20. There is no support for the amount of her adjustment either: she merely eliminated 50% of the strategic initiative savings because it was the midpoint between success and failure. A-247 at 455:15–18. Neither Knoll nor ACLI provided any reasoned basis for this arithmetic. *Id.* at 455:6–7 ("The assumption I made had the effect of assuming that 50 percent would be achieved.").

No support exists for relying on an expert's post-litigation modifications to those projections, done "for valuation purposes, not what was suitable for running a business," and based on post-litigation discussions with ACLI employees who did not develop the projections, instead of relying on the projections developed by and publicly endorsed by management before the Merger. *See* A-247 at 456:13–19. ACLI presented no evidence, and the Court of Chancery's decision was based on no evidence, that any information existed before the Merger that would call the July Projections into question or suggest that the July Projections were anything but reasonable when they were developed.

Accordingly, the Court of Chancery erred in not applying Delaware's law in favor of reliance on contemporaneous management projections and instead using an expert's post-Merger and post-litigation modifications to those projections when it adopted Knoll's modifications to the July Projections.

VI. THE COURT OF CHANCERY ERRED BY INCLUDING A LINE ITEM FROM KNOLL'S DISCOUNTED CASH FLOW ANALYSIS THAT WAS NOT SUPPORTED BY THE RECORD.

A. Question Presented

Whether the Court of Chancery abused its discretion by including in its valuation, without any recognition or explanation, a spurious a line item from Knoll's DCF analysis that is unsupported by the record. A-167–169 at 144:12–150:18.

B. Standard of Review

The Court of Chancery abuses its discretion if its factual findings do not have support in the record or its valuation is not the result of an orderly and logical deductive process. *M.G. Bancorporation*, 737 A.2d at 526. The Delaware Supreme Court will defer to the Court of Chancery's factual findings so long as they are supported by the record, even if it might independently reach an opposite conclusion. *Bell*, 413 A.2d at 142.

C. Merits of Argument

In adopting Knoll's DCF analysis as the framework for its findings, the Court of Chancery incidentally applied, without any specific finding or other explanation, an unsupported line item included in Knoll's analysis. Specifically, Knoll included in her DCF analysis a line item titled "Other Non-Cash Operating Activities," which ACLI suggested was taken from a line item included in the July Projections. A-327–29. However, the line item Knoll used actually included

figures that do not appear anywhere in management's projections. A-168 at 145:22–146:12; A-372–74. Although ACLI advanced supposition about the nature of the expenses involved, it provided no evidence of what the amounts in the line item actually were or why they should be included in a DCF analysis. Thus, there was no basis for the Court to include this item in the valuation.

In an effort to explain the components of the line item at trial, ACLI's counsel prepared a chart it derived from ACLI's 2009 10-K and suggested that, in 2009, a line labeled "Other Non-Cash Operating Activities" comprised Debt Retirement Costs, Debt Issuance Cost Amortization, Impairment and Loss on Sale of Summit Contracting, Gain on Property Disposition, Other Operating Activities, and "a portion of" Accounts Receivable Operating Activities line items. A-169 at 151:7–19; A-328. But while ACLI's chart included a line called "Other Operating" Activities/Other Non-Cash Operating Activities," the cited source of that line— ACLI's 2009 10-K—does not include any line item with that name. A-1348; A-372–74. Additionally, ACLI's suggestion that the items shown on the chart were components of the 2009 financial statement entry (which totaled \$22,580) says nothing probative about what was actually included in the "Other Non-Cash Operating Activities" projections created by management, which were (yearly, beginning in 2011): -\$2,007; -\$216; -\$596; -\$1,327; and -\$1,327. See B-452-53; A-372–74. These negative projections bore no apparent relation to the positive

\$22,580 projection for 2009, and no evidence made any connection between them. Moreover, many of the components ACLI suggested were included in the 2009 line item were likely one-time revenues or expenses (for example, "Impairment and Loss on Sale of Summit Contracting" and "Gain on Property Disposition"). A-328; A-372–74. ACLI provided no evidence to show whether these various components were included in the July Projections.

Because no evidence exists that the line item from management's projections was a cash flow item that should be included in a DCF analysis, Fuller did not include this item in his valuation. Indeed, BAML, who worked with ACLI management to apply management's projections to its DCF analysis, also excluded the "Other Non-Cash Operating Activities" line item. A-169 at 149:13–14, 150:4–9 ("I viewed it as an item which wasn't a cash flow item which would be normally picked up in a discounted cash flow analysis, looking at the operating cash flowgenerating ability of the company. And so I felt comfortable excluding it. Again, I noted that [BAML] didn't include it, either.").

The PTO included no mention of this line item, but incidentally included it in its valuation by adopting Knoll's DCF analysis as its framework. Because there was no support in the record for including this line item and the line item was not included as a result of an orderly and logical deductive process, the Court of Chancery abused its discretion by not excluding this line item from its valuation.

VII. THE COURT OF CHANCERY ERRED IN ADOPTING KNOLL'S BETA AND SMALL STOCK PREMIUM VALUES.

A. Question Presented

Whether the Court of Chancery's use of Knoll's beta and small stock premium were supported by the record or were the result of an orderly and logical deductive process. A-2124; A-2137; A-137 at 22:12–16; A-1948 at ¶22; A-254–55 at 484:17–486:7.

B. Standard of Review

The Court of Chancery abuses its discretion if its factual findings do not have support in the record or its valuation is not the result of an orderly and logical deductive process. *M.G. Bancorporation*, 737 A.2d at 526. The Delaware Supreme Court will defer to the Court of Chancery's factual findings so long as they are supported by the record, even if it might independently reach an opposite conclusion. *Bell*, 413 A.2d at 142.

C. Merits of Argument

The Court of Chancery abused its discretion in applying Knoll's beta and small cap premium. Although this looks at first blush to be a dispute about the Court's factual findings, the Court abused its discretion because its reasons for using Knoll's small cap premium and beta rest on a plainly mistaken factual premise, and actually support application of the beta and unsystematic risk premium advocated by IQ. Furthermore, Knoll's small cap premium was not

supported by the evidence because it did not appropriately reflect the risk of a company the size of ACLI and, when considered with her chosen beta, accounted for the same size risks twice. For these reasons, the decision to use Knoll's beta and small cap premium was an abuse of discretion because it was not the result of an orderly and logical deductive process.

In its PTO, the Court of Chancery applied Knoll's beta and small stock premium. On beta, the Court of Chancery reasoned that "Knoll considered several estimates of beta before relying on the Barra predicted beta, which fell at the midpoint of these estimates. Less persuasive was Fuller's reliance on a single beta—an adjusted Bloomberg beta—that assumed mean reversion to the market beta of one." PTO at ¶9(b) (emphasis added). But the Court of Chancery was wrong. Fuller did not rely on a single beta. Fuller applied the average beta from a sample of several "observed betas of publicly traded waterway transportation companies." A-2124. Knoll, on the other hand, simply applied the Barra predicted beta for ACLI, a single beta.

Fuller calculated an unlevered beta of 0.73 using the mean of observed betas of other publicly-traded waterway transportation companies. A-2137. Fuller used Bloomberg adjusted betas, which draw on empirical evidence suggesting that the beta for most companies will, over time, tend to move toward the average beta. See Werner F. M. DeBondt & Richard H. Thaler, Anomalies: A Mean-Reverting

Walk Down Wall Street, 3 J. Econ. Persp. 189, 191 (1989) (discussing empirical evidence for mean reversion). Knoll admitted that Fuller's beta was reasonable. A-254 at 483:21–484:12 ("I don't think that it would be out of the range of reasonableness"). Fuller also applied an unsystematic risk premium of 2.5% "to account for company-specific risks faced by companies of a similar size." A-2124; A-2137; A-137 at 22:12–16.

Knoll, in contrast, applied ACLI's predicted beta of 0.80 as determined by MSCI Barra's proprietary algorithm. A-1896–97. Knoll then applied a small stock premium based on Ibbotson data for the average of "ninth decile (equity values ranging from \$214.2 million to \$431.3 million) and eighth decile (equity values ranging from \$432.2 million to \$684.8 million)," A-1898, even though ACLI's market capitalization on the Valuation Date was in the eighth decile. A-1948 at \$22; B-187; A-2107. For this reason, Knoll's small stock premium inappropriately reflected risk associated with companies smaller than ACLI.

Furthermore, Knoll's use of ACLI's predicted beta already included an adjustment to reflect volatility associated with ACLI's size because measurements of ACLI's size are factors in the Barra algorithm. *See* A-254–55 at 484:17–486:7; *see also Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 520 (Del. Ch. 2010) ("the Barra forecasting model is proprietary, and cannot be reverse-engineered. The Barra predictive beta, which is a forecast of a stock's future

looking beta using past data, is based on a thirteen-factor model, but the weight given to each of the factors is not publicly available. . . . Consistent with these realities, [the expert] himself does not fully understand the details of how the Barra model works and, thus, I cannot rely on his advocacy of it."), aff'd, 11 A.3d 214 (Del. 2010); id. at n.140 (listing thirteen factors included in Barra's model, including size and size nonlinearity). If Knoll had applied the mean or median beta drawn from a sample of other companies, as Fuller did, then a small stock premium could be appropriate to adjust for risks associated with ACLI that ACLI does not share with that sample of other companies. While Fuller's use of the unsystematic risk premium was appropriate because he calculated his beta from other companies in the industry, Knoll's use of both Barra predicted beta and a small cap premium was erroneous because the Barra predicted beta she used already incorporated at least some aspect of the size risk.

ACLI argued that Fuller's use of other companies' historical betas failed to reflect the going-concern value of ACLI. A-343–44. But Fuller's use of Bloomberg adjusted beta actually accounted for this because "[b]etas based on observed historical data are more representative of future expectations when they are adjusted." *See JRC Acquisition Corp.*, 2004 WL 286963, at *10 n.96 ("Petitioner's own expert did not use the raw beta, probably because doing so is inaccurate. Betas based on observed historical data are more representative of

future expectations when they are adjusted."); *see also* Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital* 130 (3d ed. 2008) ("Over time, a company's beta tends toward its industry's average beta").

The Court of Chancery's reason for using of Knoll's small company stock premium is similarly clouded. The Court explained that "[i]n arriving at the small company stock premium, Knoll used an average of the eighth and ninth deciles of the small stock premiums listed in an Ibbotson Associates Report. Her reasons were persuasive. Fuller used stale information and the eighth decile small stock premium based on his own valuation, rather than available market valuation." PTO at ¶9(c). In reality, Fuller's premium was based on the available market valuation of ACLI, which was in the eighth decile on the Merger Date, while Knoll's analysis incorrectly averaged this value with the ninth decile of small stock premium, which carried more risk than a company the size of ACLI. It was Knoll, and not Fuller, who applied a premium based on her own valuation rather than available market valuation. Accordingly, the Court of Chancery's use of Knoll's beta and small stock premium was not the result of a logical deductive process, but was error.

CONCLUSION

IQ respectfully requests that this Court affirm the Court of Chancery's cost of debt findings. Further, IQ requests that this Court reverse (i) the Court of Chancery's use of Knoll's modified cost projections and instruct the Court of Chancery to apply the full strategic initiative savings included in ACLI management's projections; (ii) the Court of Chancery's incidental inclusion of Knoll's unsupported "other non-cash operating activities" line item and instruct the Court of Chancery to exclude this line item from its valuation; and (iii) the Court of Chancery's use of Knoll's beta and small company stock premium and instruct the Court of Chancery to apply Fuller's beta and unsystematic risk premium.

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