IN THE SUPREME COURT OF THE STATE OF DELAWARE

CDX HOLDINGS, INC.
(f/k/a CARIS LIFE SCIENCES, INC.),

Defendant-Below,
Appellant,

v.

KURT FOX,

Plaintiff-Below,
Appellee.

No. 526, 2015
Court Below: Court of Chancery
of the State of Delaware
C.A. No. 8031-VCL

APPELLANT'S OPENING BRIEF

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NATURE OF PROCEEDINGS

Caris is a life sciences company focused on cancer theranostics. As part of a merger-spinoff, Caris elected to cancel certain stock options and pay the holders on an adjusted basis, in accordance with the 2007 Stock Incentive Plan (the "Plan"). Although not required by the Plan, Caris accelerated all unvested stock options. Under the Plan, the Board could elect to cancel the options and pay an amount equal to the difference between (a) the Fair Market Value ("FMV") of the underlying common stock, defined as the value "determined in good faith by the [Board]," and (b) the options' exercise price. Op. 34. Based on a valuation from PricewaterhouseCoopers ("PwC") the Board approved the transactions.

Plaintiff sued on behalf of option holders, arguing that the Board failed to "determine" the FMV of the options "in good faith." A75. On July 30, 2014, the trial court certified a class of former option holders. Op. 45-46.

In December 2014, the case went to trial. In its post-trial Opinion (Ex. A), the trial court held that "the Board did not act" to determine FMV. Op. 52. Instead, the court criticized the conduct of Caris's CFO and CEO as "bad faith" but concluded that those parties were not acting for the Board. Op. 7, 49-50.

Based on those findings, the Court awarded $16,260,332.77 in damages, plus pre- and post-judgment interest, attorneys' fees and expenses, and an incentive payment to the lead Plaintiff (Ex. B). Defendant appeals.

SUMMARY OF ARGUMENT

1. Taking the trial court's factual findings as true, the Opinion fails. Caris vehemently disputes the trial court's facts, which tarnish the reputation of two individuals undeservedly. But those findings are not only wrong but legally irrelevant. The trial court erred by finding Caris liable for breaching two contractual provisions, which placed obligations on the *Board*, based on the alleged "bad faith" of persons the court held were *not* acting for the Board: the CFO, CEO, and Grant Thornton ("GT"). That conduct is legally irrelevant under the Plan. The only "breach" attributed to the "very, very" credible *Board itself* was a quibble with the wording of its resolutions. The trial court found that, while the Board accepted PwC's valuation of TargetNow and Carisome when it authorized the transaction, the Board's resolutions did not rise to the level of "determining" the valuation because the Board did not memorialize the number or include precise calculations in its resolutions. As a matter of law, that is not a breach. Moreover, since the transaction proceeded on PwC's valuation regardless of whether the Board's resolutions recited the number, no damages resulted from any breach.

2. The trial court rewrote the Plan's "good faith" and "arbitrary and capricious" standards, in violation of Delaware Supreme Court precedent. The trial court created a heightened standard for subjective good faith, elevating a subjective rationality test to an objective reasonableness review. The court further

erred by imposing an additional "arbitrary and capricious" test and importing a definition of arbitrary and capricious from federal administrative law.

3. The trial court's "psychological" analysis went beyond permissible fact-finding and constitutes legal error. The trial court disregarded consistent testimony from multiple "very, very" credible directors about their own subjective business judgment by citing two articles on "the psychology literature" of hindsight bias. Both articles encourage fact-finders to monitor their *own* internal thought processes, not to uncover the internal unconscious thought processes of others. Using this theory, the court rejected multiple directors' "honestly believed" testimony on a topic they should be *most* competent to recount—their own subjective business judgment. Directors cannot use later validation to prove that their earlier judgments were right. Trial courts should not be allowed to use that same later validation to prove directors cannot recount their own earlier beliefs.

4. The trial court misinterpreted case-dispositive facts. The trial court's factual findings are clearly erroneous and contrary to the record. The trial court assumes that there *must* be a "Holmesian bad man" and bases its findings on (1) outdated FMV figures that pre-dated the companies' decline in value leading up to the PwC valuation; (2) unsupported inferences regarding the CEO and CFO's motives, and (3) conclusions about methods of valuation that are rebutted by irrefutable contemporaneous evidence.

STATEMENT OF FACTS

A. Preliminary Statement.

The heart of this controversy is the valuation of two closely held, spun-off companies: TargetNow and Carisome (collectively, "SpinCo"). Caris contends a $65 million valuation—consistent with a PwC valuation and higher than a GT valuation—represented a good-faith FMV determination of SpinCo in fall 2011. Plaintiff complains it was too low.

B. Caris Management.

Caris was founded by David Halbert, who is its majority stockholder, CEO, and Chairman of the Board. Op. 2; A684. After his mother died from cancer, Halbert became passionate about improving cancer detection and theranostics. *See* A538-40; A543-44. He founded Caris to pursue this passion. A544-45. As CEO, Halbert receives a salary of one dollar per year. A550.

Gerard Martino joined Caris as CFO in 2009. A211. Before joining Caris, Martino served as CFO for Par Pharmaceutical, where—against the wishes of Par's CEO—he blew the whistle on an asset value overstatement problem, causing Par's board to replace the CEO and issue a restatement. A344-45.

Caris' board of directors (the "Board") consisted at all relevant times of Halbert, Laurie Johansen (President of Caris Diagnostics), Dr. Jonathan Knowles (a professor of medicine), Peter Castleman (a principal at a private equity firm that had invested in Caris), Dr. George Poste (an academic and science/healthcare consultant), and Stephen Green (a retired corporate finance executive). Op. 14.

C. Caris Before 2010.

Caris was initially composed of three businesses: an established and profitable anatomical pathology business ("AP Business"); a cancer theranostic/ diagnostic business called TargetNow; and a startup R&D effort known as Carisome, which was working to develop a blood test to diagnose cancer and other diseases. A357-58. The AP Business' profits kept SpinCo afloat. A358-59.

D. In 2011, Carisome And TargetNow's Prospects Plunge.

In summer 2010, the Board was optimistic about all three companies. A696-97. The AP Business was "growing very well and [was] highly profitable," the Board felt that Carisome "was coming out of R&D and had a commercial product ready to go," and it "believed we had something unique in TargetNow." A697. That optimism declined over the next year and plummeted in the fall of 2011. By August 2011, SpinCo had experienced $35.9 million in year-to-date losses. A379. In fall 2011, the "losses seemed to be accelerating. . ." A748.

Carisome's "product introduction was a disaster." A697. The goal was to detect prostate cancer; instead, it gave "false-negatives, false-positives. . . . It was just a dreadful situation." A697-98. The Board pulled the product from the market, and Carisome was "back to [an] R&D company." A699.

Meanwhile, TargetNow met unexpected resistance from the healthcare industry. The Board thought that oncologists "would be very excited to have this new product that would allow them to . . . figure out an appropriate drug for therapy, based on the unique profile of the tumor." A745. But "oncologists were not interested. . ." *Id.* Providers viewed TargetNow as competition for their labs, and insurers refused reimbursement. *Id*.; A91; Op. 13. TargetNow needed a large sales force "to essentially change the paradigm on how oncologists treat cancer patients." A352. Caris had built such a force in 2010. The resulting costs outstripped TargetNow's revenues, A744, and TargetNow never turned a profit. A92.

E. Caris Sells The AP Business.

In 2011, facing debt covenants it could not meet, the Board explored selling the AP Business and, if possible, TargetNow, to fund Carisome's research. A359-60, A442. The Board engaged Citigroup to market the AP Business or, possibly, TargetNow. A235-236. Martino gave Citigroup optimistic financial assumptions for TargetNow "to make it look . . . as good as it could look to a buyer." A247; *see also* A79. Ultimately, Caris received only one firm bid: a Japanese company, Miraca, agreed to pay $725 million for the AP Business (the "Transaction"). A547.

1. Miraca Seeks A High Valuation For SpinCo.

The parties structured the transaction as a spin-off and merger. A234-235.

SpinCo (TargetNow and Carisome) was spun off and sold to a holding company owned by Caris's stockholders, and Miraca merged with the remaining company—the AP Business. Op. 1-2. The spin-off was treated as a sale under tax law; the remaining company would pay taxes on the amount by which SpinCo's FMV exceeded its basis. *Id.* at 20-21. As the successor by merger, Miraca was responsible for any understated tax from the nominal sale of SpinCo. A373-74. Due to this tax treatment, throughout the Transaction, Miraca and its deal advisors—Skadden and Deloitte—conducted extensive due diligence to ensure SpinCo's valuation was not understated. A374-75, A1034-1147.

With the Transaction, Caris would cash out its option holders, including Plaintiff. A1219 § 2.08(d); A1350-51 § 3.05. Under the Plan, for each share covered by an option, the holder would receive the amount by which the share's FMV exceeded the exercise price. A835-36 § 12.3. The Plan defined FMV as "the value of the Common Stock as determined in good faith by the" Board. A814 § 2.25.

2. The Board Reviews The Valuation And Approves The Transaction.

At the October 5, 2011 meeting, the Board reviewed a report prepared by PwC, which it had "engaged . . . to perform a valuation analysis of" SpinCo.[1]

[1] The Board understood such analysis to provide a fair market valuation of TargetNow and Carisome. A1191; A430; A554; A768; A795.

A1162. At the meeting, PwC presented its $65 million valuation to the Board. A1191. "The Board engaged in discussion with [PwC] to understand the assumptions and the methodology" and approved the Transaction. *Id.* Board members felt the PwC valuation was reasonable if not high:

- Johansen: PwC's valuation was "very fair, . . . fair on the side of being generous because of the losses that we had in Target Now and . . . Carisome. . ." A769.

- Knowles: "I . . . personally thought [the $47.23 million PwC valuation for TargetNow] was high. And the reason I thought it was high is because in my . . . former role in Roche [Life Science], I spent quite a lot of time reviewing acquisition . . . targets." A675.

- Castleman: "[M]y view was you shut Target down and you fire everyone in Carisome except for ten R&D people, and you run this as an R&D company. . . . instead of combining those two companies, which were . . . bleeding 60, $70 million a year of cash." A705.

GT's subsequent FMV valuation (required by Miraca) came in lower at $54.7 million. A1281-82. The Board selected the higher PwC number to benefit option holders. A771. Pursuant to a November 22, 2011 unanimous written consent, the Board authorized the cancellation of the options, with the understanding that the PwC valuation would be used. A1399-1405; A765-67. Based on the $725 million purchase price for the AP Business ($4.46/share) and the $65 million valuation of SpinCo ($0.61/share), the FMV of each option was $5.07.

ARGUMENT

I. EVEN ACCEPTING ITS FACTUAL FINDINGS, THE TRIAL COURT ERRED.

A. Question Presented.

Did the trial court commit legal error by (1) focusing on officers' conduct instead of the Board's, contrary to the contract; (2) finding breach of the contract's subjective good faith standard; and (3) measuring damages by what it decided an objectively reasonable Board would have done? A1580-83; A1596.

B. Scope of Review.

De novo review applies to contractual interpretations and legal conclusions, and clear error review applies to factual findings. *SI Mgmt. L.P. v. Wininger*, 707 A.2d 37, 40 (Del. 1998); *Ivanhoe P'rs v. Newmont Mining Corp.*, 535 A.2d 1334, 1340-41 (Del. 1987). The trial court's interpretation of the contract and misapplication of contract law principles are legal issues.

C. Merits Of Argument

1. The Court's Facts Show No Breach Of The Plan.

Even accepting the trial court's fact findings as true, it erred by holding that Caris breached the Plan. The Plan defined FMV as "the value of the Common Stock as determined in good faith by the Administrator," which is defined as the Board. A814 § 2.25. To breach that term, a majority of the Board must have (a) acted in subjective bad faith or (b) consciously and completely disregarded a known duty to act. *Allen v. Encore Energy P'rs, L.P.*, 72 A.3d 93, 104-06 & n.46

(Del. 2013); *Miramar Firefighters Pension Fund v. AboveNet, Inc.*, 2013 WL 4033905, at *3 (Del. Ch. July 31, 2013) (explaining that "a majority of the directors" must have "acted in bad faith"). The trial court's findings, even accepted as true, cannot sustain a finding of breach under this standard.

a. The Trial Court Scrutinized The Wrong Conduct.

Under the Plan, it is the *Board's* conduct at issue. A811 § 2.2, A814 § 2.25. The trial court conceded that "under the good faith standard, the Administrator must believe subjectively in the Fair Market Value it has selected," and "[t]he Administrator is the Board." Op. 48, 53. Yet the court focused on the conduct of Martino, Halbert, and GT, despite holding that the former two were not acting for the Board and that the Board never saw the latter's report. Op. 7, 49. The court explained: "Martino actually made the determination [of FMV], and Halbert signed off, *so this decision analyzes whether they acted in subjective good faith.*" Op. 55 (emphasis added).[2] That is not the test the Plan establishes.

The trial court spent eleven pages criticizing a non-Board member, Martino, for having "manipulated the valuation process." *Id*. at 60. The trial court also criticized Halbert, a Board member and CEO, for giving "perfunctory signoff" on this work, but it stated he was not acting for the Board. Op. 3, 49. Under

[2] And while the court erred by overlaying an "arbitrary and capricious" standard from another part of the contract, *see infra* § II, that test too applies only to *Board* conduct. Op. 3. Even if the court were correct to overlay that extra standard, its Opinion would thus still be error.

"Evidence of Scienter," the court condemned Martino and Halbert's actions. Op. 64.[3] Absent from the court's discussion of bad faith is a single mention of five of the six directors of a board that acted unanimously. By premising breach of the Board's duty on, at most, the conduct of one of its members, the trial court erred.

Nor do the trial court's findings allow it to impute Martino's, Halbert's, or GT's supposed bad faith on a majority of the Board. Bad faith may be inferred from circumstantial "objective facts" only if "the directors knew of those facts." *Allen*, 72 A.3d at 107. Knowledge of bad faith cannot be imputed from an executive—or even from a director—to an entire board. *Desimone v. Barrows*, 924 A.2d 908, 942-43 (Del. Ch. 2007) (holding, in the demand futility context, that "Delaware law does not permit the wholesale imputation of one director's knowledge to every other"). Likewise, "[i]f the [Board] did not knowingly rely on a flawed opinion, it is not reasonably conceivable that [it] acted in bad faith by accepting the opinion of its outside financial advisor." *DiRienzo v. Lichtenstein*, 2013 WL 5503034, at *15 (Del. Ch. Sept. 30, 2013), *appeal ref'd*, 80 A.3d 959 (Del. 2013). Holding that the Board breached its good faith duty requires "facts *specific to each director*, demonstrating that at least half of them could not have exercised disinterested business judgment. . ." *Desimone*, 924 A.2d at 943.

[3] Paradoxically, the trial court also admits: "My sense is that in reality, the bidder projections were aggressive but provided [by Martino] in good faith." Op. 64-65.

Here, the trial court did not find that a majority of the Board was aware of any bad faith. The court found that Martino improperly influenced the GT valuation, but it specifically concluded that "the Board never saw the [GT] report" and that neither Martino nor Halbert were acting as the Board's agents. Op. 7, 49-50, 70. The court did not find that the Board knew of any flaws in PwC's or GT's analyses; rather the court recognized post-trial that the Board would have lacked knowledge of any purported flaws. *See* A795; A799-800. The Opinion fails because it scrutinizes the wrong conduct under the Plan.

b. The Court's Facts Show No Failure To Act, Let Alone Conscious Disregard Of A Known Duty To Act.

The court did not attribute any bad faith to the Board. Nor did it find that the Board consciously disregarded a known duty to act. In reality, the court's findings show there was no breach as a matter of law.

(i) The Board Determined FMV.

The trial court's findings do not support a holding that Caris breached the contract provision requiring the Board to "determine" FMV. The trial court inspected the Board's resolutions and ultimately concluded that those *resolutions* "did not make an adjustment or determine Fair Market Value." Op. 51-52. The court conceded that these resolutions "noted the need for an adjustment" and directed that the options "shall be" so adjusted, but criticized that "the resolution[s] did not *make* an adjustment." *Id.* (emphasis added); *cf. id*. 74 (noting the options were adjusted).

But the Board need not have adopted a formal resolution expressly calculating or stating the FMV in order to determine FMV under the Plan. The Plan calls for the Board to "determine" FMV, not to "calculate" or "memorialize" it in a resolution. The Board "engaged PwC to perform a valuation analysis of" SpinCo. A1162. At its October 5, 2011 meeting, the Board evaluated a detailed presentation from PwC on the value of SpinCo and, having analyzed this presentation, approved the Transaction. A1191-99. The Board then passed a resolution by unanimous consent that "each Company Option shall be proportionately adjusted" to reflect FMV, with the understanding that the PwC valuation would be used. A1400; A835 § 12.1; A764-67. Boards are permitted to consult with and rely upon qualified financial advisors when determining a company's value.

Indeed, "[t]he business and affairs of every corporation . . . shall be managed by or *under the direction of* a board of directors . . ." 8 *Del. C.* § 141(a) (emphasis added). Further, boards are entitled to rely in good faith upon their corporation's officers and third party advisors. *Id.* § 141(e). "The realities of modern corporate life are such that directors cannot be expected to manage the day-to-day activities of a company." *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 943 (Del. 1985). As such, corporate directors may entrust officers and third-party professional firms to perform calculations embedded in their authorizing resolutions. *See id.* at 942-43.

The Board thus determined FMV under the Plan and Delaware law. The trial court's finding—that the Board did not pass a resolution specifically adopting the PwC valuation or go through the mechanics of the calculation—is insufficient to hold that the Board breached an obligation to determine FMV.

(ii) There Was No Conscious Disregard.

Even if the Board failed to "determine" FMV under the Plan, there was no "conscious disregard" that would meet the high bar for breach of a contractual duty of good faith. To establish that a majority of the Board members acted in bad faith by "consciously disregard[ing] [their] contractual duty to form a subjective belief ... would take an extraordinary set of facts." *Allen*, 72 A.3d at 105-06; *see also Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 240 (Del. 2009).[4] The facts of alleged "inaction" here—whether the Board's resolutions and adoption of PwC's number count as a "determination" under the Plan—are not extraordinary.

The court's own facts do not support a holding that the Board failed to determine FMV in good faith; the court concedes that the Board did *something* and did have subjective beliefs as to value. Even the court's *criticism* of Dr. Knowles negates conscious disregard. Op. 50 (finding Knowles "did not know that . . . the

[4] In *Lyondell*, this Court held that even under the heightened scrutiny of *Revlon*: "Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price." 970 A.2d at 243-44.

Plan required the Board to act."). On Poste and Green, Plaintiff presented no evidence at all, and the record affirmatively shows that the Board did not consciously and completely disregard its duties under the Plan. A766 ("[W]e visited with [Shearman & Sterling] about trying to understand how we discharged our duty of good faith in determining fair market value."). That is not "inaction," and it is certainly not conscious disregard.

2. The Trial Court's Facts Show No Damages.

The trial court's findings establish that Plaintiff suffered no damages. The only conduct that matters under the Plan is the Board's. The only "breaching" conduct assigned to the Board was a purported failure to "determine" FMV. Op. 52. That failure is premised on the Board's reliance on PwC's presentation and report as to the FMV of SpinCo, rather than its active memorializing of that number in a formal resolution.

As a matter of law, the only appropriate damages are ones *caused* by the Board's purported "breaching" act. *Paul v. Deloitte & Touche, LLP*, 974 A.2d 140, 146 (Del. 2009). Taking the court's facts as true, the answer is zero. Had the Board memorialized PwC's number in its resolutions, rather than authorizing the transaction on that basis without explicitly stating the number, the distribution would have been the same. Plaintiff would have received the same payment and, thus, suffered no damages. That may explain why the Opinion spent so much time focusing on non-Board conduct and why its damage analysis requires counterfactuals with no connection to the Board's alleged breach.

Because the Plan required the Board to determine FMV in good faith, "[t]he ultimate inquiry must focus on the subjective belief of the specific directors accused of wrongful conduct," and the trial court must "avoid replacing the actual directors with hypothetical reasonable people when making the inquiry." *Allen*, 72 A.3d at 107. The trial court decidedly did not do this. Rather, it imposed the imagined conduct of a hypothetical board. Without citation to the record, the court predicted: "In my view, had the Board proceeded in good faith, it would have retained GT to determine the fair market value. . ." Op. 78. But the court never found that the Board acted in bad faith by relying on PwC, and thus there is no basis for assuming that fact away.

Likewise, the court imagined what the FMV would have been "[a]bsent Martino's intervention." *Id.* But the court never found the Board acted in bad faith by relying on its CFO to work with its outside accountants. There is no basis to assume that fact away either. Thus, the court's damage award is not only wholly speculative, but punishes the Board for conduct that was not in bad faith and had nothing to do with its alleged "breach." That is legal error, and it is no basis for $16 million in damages or any damages at all. As a matter of law, the trial court's own fact findings fail to support liability or damages. This Court should reverse.

II. THE TRIAL COURT ERRED BY REWRITING THE GOOD FAITH AND ARBITRARY AND CAPRICIOUS STANDARDS.

A. Question Presented.

Did the trial court err by (1) imposing a heightened standard of review on contractual good faith determinations, (2) applying an arbitrary and capricious ("A&C") test on top of the good faith standard, or (3) defining the contract's A&C standard based on the federal Administrative Procedures Act? A146-48; A1578-79 n.11; A1584-86; A1594; A1653-60.

B. Scope Of Review.

De novo review applies to a trial court's standards of review for determining if a party complied with contractual obligations. *See supra* § I.B.

C. Merits Of Argument.

1. The Trial Court Rewrote The Good Faith Standard.

By scrutinizing the reasonableness of subjective beliefs concerning FMV instead of simply determining whether any rational basis supported those beliefs, the trial court adopted a new and heightened standard for reviewing whether a party has satisfied a contractual good faith obligation. Whether applied to Martino and Halbert (as the court did) or to the Board (as it should have done), *see* § I.A above, the trial court erred by creating a heightened standard of good faith.

Where a board is subject to a contractual obligation to make a determination in "good faith," and the contract does not define good faith, the board's "determination will be considered to be in good faith unless [it] went 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on ***any ground*** other than bad faith.'" *DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund*, 75 A.3d 101, 110 (Del. 2013) (emphasis added) (quoting *Brinckerhoff v. Enbridge Energy Co., Inc*., 67 A.3d 369, 373 (Del. 2013)). This "definition of good faith" is a "purely subjective" standard based on the "traditional common law definition of the business judgment rule. . ." *DV Realty*, 75 A.3d at 110. Under this rationality standard, "the board's decision will be upheld unless it cannot be 'attributed to ***any*** rational business purpose.'" *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006) (emphasis added) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).[5]

Under the good faith standard, the court's inquiry should have been limited to assessing whether there was "any ground other than bad faith" (*i.e.*, "any rational" basis) supporting the Board's subjective view of FMV in late 2011. *DV Realty*, 75 A.3d at 101; *Brinckerhoff*, 67 A.3d at 373; *Sinclair*, 280 A.2d at 720. The record, including, *inter alia*, (a) the Board's view of SpinCo's negative financial and scientific results leading up to November 2011 and (b) PwC's

[5] *See also In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 43 (Del. Ch. 2013) (Laster, V.C.) ("Only when a decision lacks any rationally conceivable basis will a court infer bad faith . . . ."); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 Del. J. Corp. Law 859, 868 (2001) [hereinafter *Standards*] (explaining that rational decisions are upheld, even if unreasonable).

presentation studied by the Board at the meeting in which it approved the transaction, shows rational "ground[s] other than bad faith" for the Board's view of FMV. *See supra* Stmt. of Facts § D, E.2; *infra* § IV.C. Thus, the Board satisfied the good faith standard.

But rather than simply inquiring whether "any ground other than bad faith" supported the FMV determination, the Court used witness credibility as *carte blanche* to ignore these good faith bases and second-guess the reasonableness of the FMV determination. *See* Op. 54-65. Under the guise of assessing Martino's and Halbert's credibility, the trial court ignored rational grounds for the FMV valuation, cherry-picked record cites, and concluded that Martino and Halbert could not possibly have believed that SpinCo was worth $0.61/share in November 2011. *Id.* (citing, *inter alia*, documents from a private equity firm that Martino and Halbert never received). And the trial court dismissed the other directors' independent beliefs in that same valuation, and their detailed reasons why, as "hindsight bias" because their judgments later proved true. Op. 5-6; *see infra* § III.

This enhanced scrutiny was legal error under *DV Realty*, *Brinckerhoff*, and the business judgment precedents on which these authorities are based:

> The value of most stocks is highly debatable. What is not debatable here is that a rational mind could have believed [the price was] fair, and that is what is relevant under the business judgment rule, which precludes judicial second-guessing when that is the case.

In re MFW S'holders Litig., 67 A.3d 496, 519-20 (Del. Ch. 2013) (Strine, C.), *aff'd* *sub nom. Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). While objective evidence is relevant to a subjective good faith standard, the trial court cannot transform a subjective rationality test into an objective reasonableness test under the premise of assessing witness credibility—particularly where, as here, the court was assessing the wrong witnesses' subjective beliefs. *Allen*, 72 A.3d at 107.

2. The Trial Court Erred By Using And Redefining The A&C Standard.

a. Good Faith Was The Only Standard.

The trial court erred by imposing an A&C standard on top of the contractual good faith standard. "Under well-settled rules of construction, specific language in a contract controls over general language." *Katell v. Morgan Stanley Grp., Inc.*, 1993 WL 205033, at *4 (Del. Ch. June 8, 1993). Section 2.25 of the Plan defines FMV as "the value of the Common Stock as determined in good faith by the Administrator [the Board]." A814 § 2.25. Separate from this specific contractual standard for FMV determinations, Section 3.4 of the Plan provides a general standard: "[a]ll decisions made by the Administrator pursuant to the provisions of the Plan shall be final and binding . . . unless such decisions are determined to be arbitrary and capricious." A818 § 3.4. The trial court applied both Section 2.25 and 3.4 to the FMV determination, purportedly to avoid rendering Section 3.4 "mere surplusage." Op. 53. But Section 3.4 is not "surplusage" if it applies to all conduct except where the parties specifically agreed to a different standard.

Indeed, it is the *court's* view that creates surplusage, imposing a higher standard where the parties bargained for a lower one. Section 2.25 (good faith) is a specific provision that renders the general standard of Section 3.4 (A&C) inapplicable to the FMV clause.

b. Plaintiff Waived An A&C Standard.

Plaintiff waived any argument to apply the A&C provision, which appears nowhere in Plaintiff's pre-trial brief or the pre-trial order. Indeed, Plaintiff identified the issue to be litigated as whether the Board "exercised good faith in arriving at and paying FMV, as defined in the Plan, in connection with the Option Transaction." A189. The court held that Plaintiff had not waived this argument due to *Defendant's* briefing (where Defendant addressed the standard out of an abundance of caution) and two sentences of the 118-paragraph complaint. *See* Op. 53 n.12. Plaintiff cannot avoid waiver simply by using the term "arbitrary and capricious" in two sentences in an initial pleading without raising the issue again until suggested by the court after trial. *See, e.g., In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *18 (Del. Ch. Aug. 18, 2006) (Strine, V.C.); *Emerald P'rs v. Berlin*, 2003 WL 21003437, at *43 n.144 (Del. Ch.), *aff'd*, 840 A.2d 641 (Del. 2003) ("Issues not briefed are deemed waived."). The court erred by applying the A&C standard in light of Plaintiff's waiver.

c. The Trial Court Erred By Importing An Administrative Law Standard Into The Plan, Violating Supreme Court Precedent.

The court should not have imposed an A&C standard on top of a good faith standard. The trial court applied A&C as a process-based test and good faith as a subjective, substantive test. Op. 53. Because trial was premised on subjective obligations (A189), the court's *sua sponte*, post-trial use of a process-based test requires reversal on that ground alone.

But the trial court erred further by importing its definition of A&C into the contract from the Administrative Procedures Act, with no evidence that such definition was what the parties intended. Op. 65. This Court recently rejected a similar attempt to inject the UCC's definition of "good faith" into a non-UCC contract. *See ev3, Inc. v. Lesh*, 114 A.3d 527, 539 (Del. 2014). The use of administrative law here is even more inappropriate. Under the administrative law standard adopted by the trial court, the proper remedy would be to remand to the Board for a new determination, *not* to award damages. *See, e.g., Fla. Power & Light Co. v. Lorion*, 470 U.S. 729, 744 (1985). But the trial court used this standard to assess over $16 million in damages. This Court should reject the trial court's selective use of administrative law or, alternatively, apply the remedy that goes with that review and permit the Board to re-determine FMV.

The trial court also erred by adopting a heightened standard of review for

A&C conduct. By relying solely on federal and Delaware governmental agency precedents, the trial court ignored the deference afforded to corporate boards that rely in good faith on experts and officers as part of a decision-making process. 8 *Del. C.* § 141(e); *Brehm v. Eisner*, 746 A.2d 244, 261-62 (Del. 2000). Instead, the trial court imposed a strict-liability-like standard for board processes involving reliance on experts. Op. 70 (criticizing the Board's reliance on an expert and stating, "[w]hen an *agency* makes a factual mistake because it relied on incorrect information, it cannot be said to have made a rational decision" (emphasis added)).

Further, although acknowledging that the Board's process need only be "rationally designed," *id.* at 66, the trial court's searching scrutiny of the process was more akin to heightened or entire fairness review. *See Standards*, *supra* note 5, at 872 (criticizing courts that claim to have applied the gross negligence standard in due care claims when, in reality, they tacitly applied heightened scrutiny). As a result, while the trial court purported to rely on the A&C standard, it actually crafted and applied a more onerous standard. *See id.* The trial court thus erred by holding that the Plan created a heightened standard of review which finds no support in the language of the contract.

III. THE TRIAL COURT'S "PSYCHOLOGICAL" ANALYSIS WENT BEYOND PERMISSIBLE FACT-FINDING.

A. Question Presented.

Did the trial court err by disregarding the consistent, "honestly" believed testimony of three directors—whose credibility the court found "very, very strong"—on the content of their own subjective beliefs by citing two articles summarizing "the psychology literature" of "hindsight bias"? Issues raised *sua sponte* may be considered on appeal in the interests of justice. *Reddy v. MBKS Co.*, 945 A.2d 1080, 1086 (Del. 2008).

B. Scope of Review.

This Court has the authority to review the entire record and make its own findings of fact where the trial court's findings are not supported by the record or are not the product of an orderly and logical deductive process. *Levitt v. Bouvier*, 287 A.2d 671, 673 (Del. 1972). Federal courts of appeals further have expressed skepticism about trial courts basing rulings of fact and law upon social science studies. *See Free v. Peters*, 12 F.3d 700, 706 (7th Cir. 1993) (Posner, C.J.) (review of conclusions based on "social scientific or other data . . . is plenary"); *Dunagin v. City of Oxford, Miss.*, 718 F.2d 738, 748 n.8 (5th Cir. 1983) (en banc) (regarding "the 'fact' findings of a trial judge as to the latest truths in the social sciences," a "clearly erroneous standard of review" is "[c]learly not" appropriate.).

C. Merits Of Argument.

1. The Trial Court Discarded Consistent, Honest Testimony.

The directors consistently testified that their subjective beliefs in late 2011 were that the PwC valuation was, if anything, on the high side. *See supra* Stmt. of Facts, at § E.2. Immediately after trial, the court noted that "the credibility of the people on the board who made these decisions" was "very, very strong." A794. And on this issue, the Court found that these directors "testified with conviction" and "seemed honestly to believe when testifying that they thought TargetNow and Carisome had very little value in fall 2011." Op. 5-6.

Nevertheless, the trial court disregarded this testimony, stating: "In my view, this [testimony] was a product of hindsight bias." Op. 5-6. The Court explained, quoting a law review article and citing another: "Hindsight bias has been defined in the psychological literature as the tendency for people with outcome knowledge to believe falsely that they would have predicted the reported outcome of an event." Op. 6 (citations omitted).

The court then attempted to fit the facts to this model. It noted that future events proved the directors right—as if this were a bad thing. *Id.* But a court cannot be free to reject directors' testimony as "hindsight bias" whenever their business judgment proves to be valid. The court then claimed "contemporaneous" evidence showed they did not subjectively believe in a low valuation in late 2011, citing not contemporaneous evidence but sell-side projections from 2010 and "fall 2011" that painted a rosier picture—before the collapsing events of mid- to late-2011. Op. 6-7; *supra* Stmt. of Facts § D; *infra* § IV.C.

2. The Trial Court's Use of the Psychology Literature to Discredit the Honest Testimony of Directors Was Legal Error.

The trial court erred in its psychological approach by going beyond the scope of proper fact-finding, by misreading the articles it relied upon, and by creating inconsistent and troubling precedent.

The cited social science research provides an insufficient basis for the trial court's rejection of honest testimony. While "the law is not blind to the influence of the hindsight bias," Op. 6 (citation omitted), both articles cited by the Court apply the principle of hindsight bias *to the fact-finder*, cautioning the fact-finder to be cognizant of its *own* internal thought processes.[6] Neither article suggests that lay fact-finders are competent to apply this aspect of "the psychology literature" to the internal thought processes of *others*.

The court's approach also sets bad precedent and runs contrary to Delaware

[6] Hal R. Arkes & Cindy A. Schipani, *Medical Malpractice v. the Business Judgment Rule: Differences in Hindsight Bias*, 73 Or. L. Rev. 587, 630 (1994) (noting courts have "deemed retrospective evaluation of business decisions to be inadvisable" and advocating for the same deference for physicians in medical malpractice cases); Jeffrey J. Rachlinski, *A Positive Psychology Theory of Judging in Hindsight*, 65 U. Chi. L. Rev. 571, 574 (1998) (warning of factfinders suffering from hindsight bias and lauding courts for having "developed rules that take advantage of specific opportunities to avoid the bias" like excluding evidence of subsequent remedial measures).

law. In essence, the court is punishing the Board for being right in recognizing the trouble the two companies were in as of late 2011. It would be troubling indeed if honest testimony about directors' own business judgment that proved wrong was more credible than judgment that proved correct. Where directors testify truthfully and their business judgment has proved correct, that should be confirmatory, not an invitation to discard their testimony.

Under the trial court's prior decisions, a director may not use post-decision evidence to substantiate his or her compliance with a subjective good faith test:

> The defendants have cited various after-the-fact developments in an effort to confirm the wisdom of the Conflicts Committee's decision . . . . Under Delaware law, business decisions are not judged by hindsight. The defendants' actions must stand or fall based on what they knew and did at the time.

In re El Paso Pipeline P'rs, L.P. Deriv. Litig., 2014 WL 2768782, at *7 (Del. Ch. June 12, 2014) (Laster, V.C.). By the same token, courts should not be free to use post-decision evidence to *discredit* a director's account of his or her own business judgment. Further, it is "essential to ensure" that "the subjective good faith standard remains distinct from an objective, 'reasonable person' standard." *Allen*, 72 A.3d at 107. By invoking a new hindsight bias approach, whereby testimony on one's subjective views can be rejected by citation to social science literature, that essential protection is eroded.

Without its social science premise, the actual facts do not support the trial court's conclusion. The trial court concedes the live testimony on the directors' subjective views was credible, honest, and made with conviction. And while the court claims that "contemporaneous evidence showed that [the directors] did not" actually have these subjective beliefs, Op. 6, it made no findings as to what contemporaneous evidence supports this conclusion as to five of the six directors, choosing instead to focus on the subjective beliefs of Halbert and Martino. *Supra* § I.C.1.a. Further, the only "contrary" evidence cited by the Court was from an irrelevant time period, and the court ignored the intervening facts that did not fit its "hindsight bias" theory. *See supra* Stmt. of Facts § D; *infra* § IV.C

Under the *de novo* review warranted by the trial court's reliance on unrelated and inapposite journal articles, the fact finding should be rejected. *See supra* § III.B. While it is true that live determinations of credibility garner the strongest deference from this Court, the trial court's live determinations *support* the credibility of the directors' testimony. It is only through the trial court's social science theory that it overrode that live testimony and disregarded supporting evidence, and *those* conclusions warrant plenary review and should be overturned.

And even absent plenary review, the facts simply do not connect in the Court's rendering. They fail the test of being "supported by the record and are the product of an orderly and logical deductive process. . ." *Levitt*, 287 A.2d at 673. In other words, the trial court not only erred in misusing the psychological theory but in using it contrary to the record. Under either standard, this Court should reverse the finding rejecting the directors' honest account of their subjective beliefs.

3. This Error Is Case-Dispositive.

This Court should accept the credible, honest testimony of the directors on their own subjective, good faith understanding of the companies' valuation. The trial court likely knew the importance of the hindsight bias theory to its rejection of otherwise credible testimony: it placed the theory before the facts and dedicated more space to the journals than to the record on point. Reversal here is proper.

And reversing this factual finding supports rendition of a take-nothing judgment. The court notes that the measure of damages in Plaintiff's case is what the Board, in good faith, believed the FMV to be, over and above the FMV that was actually used in the distribution. Op. 78-79.

But the directors believed that the value actually used was reasonable if a little high. That means the delta between what they *did* and what they *believed* was either zero or negative. Because the Board agreed with the value used as fair but high, the option holders were paid an amount the Board believed was fair but high. The measure of damages under the Plan is zero. In no instance does the damage model—or the Plan—support a $16 million award.

IV. WHILE THIS COURT SHOULD REVERSE AND RENDER ON THE LEGAL ERRORS ABOVE, THE TRIAL COURT'S CORE FACT FINDINGS ARE ERROR.

A. Question Presented.

Did the trial court err in (1) valuing SpinCo based on outdated data; (2) concluding that the underlying motivation in valuing SpinCo was to achieve zero taxes by using projections that were "falsely low"; or (3) calculating damages without making a determination as to the goodwill associated with SpinCo? A1572-73; A1586-88; A1607-09.

B. Scope Of Review.

This Court will make its own findings of fact unless the trial court's findings are supported by the record and are the product of an orderly and logical deductive process. *Levitt*, 287 A.2d at 673. Findings of fact should be overturned when they are "clearly wrong and justice so requires." *In re Walt Disney*, 906 A.2d at 48.

C. Merits Of Argument.

1. The Trial Court Ignored The Reality That SpinCo's Value Had Collapsed By November 2011.

The trial court made a fundamental error by using outdated valuations of SpinCo to calculate FMV and turning a blind eye to their operative reality in fall 2011. Despite noting that the directors credibly testified that SpinCo had little value in fall 2011, Op. 5, the trial court ignored that by fall 2011, SpinCo's value had dropped drastically from earlier that year: TargetNow's business model was flawed and it would not become profitable, and Carisome's only product had failed and been permanently pulled from the market. A533; A545-46; A657; A664-65; A697-98; A760.[7] Yet the court used selective, outdated information to reach its FMV and ignored the realities driving down SpinCo's value in 2011:

- Mar. 2010: Promising Carisome lab results. A843; A849-63.
- Mar. 2010: Valuation date of report #1 cited by the Court. Op. Ex. A.
- June 2010: Valuation date of report #2 cited by the Court. Op. Ex. A.
- Oct. 2010: Valuation date of report #3 cited by the Court. Op. Ex. A.
- Dec. 2010: Valuation date of report #4 cited by the Court. Op. Ex. A.
- Early 2011: Carisome trial halted. A362; A655-56.
- Mar. 2011: Valuation date of report #5 cited by the Court. Op. Ex. A.
- Apr. 2011: TargetNow forecasts downgraded. A224.
- Summer 2011: TargetNow revenues begin to decline; never recover. A1563-65; A84.
- Sept. 2011: TargetNow forecasts downgraded again; Caris scraps idea of sale. A1004-05; A1009; A1030-33; A246.
- Fall 2011: Data renders Carisome's product non-viable. A533; A657; A664; A697-98; A704; A760-61.
- Nov. 22, 2011: Valuation date for options.

[7] The expert report of Harvard Business School Professor Paul Gompers corroborates the directors' testimony. *See* Expert Report of Dr. Paul Gompers, A1521-22 (concluding that PwC's valuation "likely exceeded the fair market value" of TargetNow and Carisome). The trial court committed clear error by ignoring Professor Gompers' unimpeached report. *See Benton v. Blair*, 228 F.2d 55, 61 (5th Cir. 1955); *Bazydlo v. Volant*, 647 N.E.2d 273, 277 (Ill. 1995).

The trial court simply assumed that there was no difference in the value of SpinCo between 2010 and November 2011. It similarly ignored that GT modified its entire methodology for valuing Carisome due to these updated circumstances—rendering its previous reports obsolete. A97-99. The Court's reliance on stale and irrelevant data to calculate SpinCo's FMV was clear error.[8]

2. The Conclusion That "Zero Tax" Motivated The Valuation Of SpinCo Is Not Supported By The Record.

The trial court also erred by premising its finding of bad faith on the illogical theory that Halbert and Martino were driven to eliminate spinoff taxes when calculating SpinCo's value.[9] *See, e.g.*, Op. 4, 7, 9, 60, 65, 67. This finds no support in the structure of the Transaction or in the record. The Court appears to base this theory on one email from Martino to PwC in which he notes that "[a] real point of issue for the buyer is getting comfortable with the tax liability at closing" and requests that PwC "prepare something in draft based on a 40 million or so valuation." *See* Op. 26, 60.[10] The email provides no indication that Martino was

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[8] The court also based its FMV on "strong indications of interest in TargetNow from multiple bidders," including Danaher, Op. 55, but it ignored that (1) Caris attempted to sell TargetNow in 2011 and 2012 without success (A541-42); and (2) Danaher had no serious interest and never submitted a formal bid. A1001-03; A723-24; A759-60; A87-88; A81-82; A203.

[9] The trial court makes no attempt to link its zero-tax valuation theory to the Board or to show that the Board was motivated to drive down the valuation of SpinCo.

[10] The court also states that when faced with a "choice" between a "realistic valuation" and the "zero-tax valuation," Halbert chose the latter. Op. 9. The court offers no support for this idea, and there is none.

pushing PwC toward a certain valuation or angling for zero tax.[11] Martino asked PwC use $40 million merely as "a placeholder." A254; A271. As that email's recipient testified, "[Martino was] was not asking for a $40 million valuation. He's asking for us to run calculations based on an assumed $40 million valuation . . . . that's a universe apart, right?" A105. There is no record evidence whatsoever that, once NOLs were taken into account, a $40 million valuation for SpinCo. was at the top of the range for valuations that would have resulted in zero tax.

A zero-tax valuation was never the motivation for valuing SpinCo. Instead, the structure of the transaction and the record establishes (1) that only Miraca was concerned about the tax implications associated with the Transaction and wanted a *higher* valuation for SpinCo, and (2) that Caris was highly motivated to close its deal with Miraca and thus also wanted a higher valuation for SpinCo. Any tax liability resulting from the undervaluing of SpinCo would accrue to the parent entity that Miraca was acquiring. Therefore, as recognized by the trial court,[12] Miraca's concern was that if the companies were valued too low in the transaction, the IRS would investigate and require Miraca to pay additional taxes and penalties.

[11] The trial court's zero-tax motive theory leads it to conclude that Martino provided "falsely low" projections to PWC to ensure that the posited zero-tax goal was achieved. Op. 7, 61. However, contemporaneous financial results actually establish that those were overly optimistic, not falsely low. A1004-05; A1011; A1017; A1030-33; A1445; A1450; A1455-56.

[12] At the end of trial, the court noted: "I agree that the buyer had an interest in not having too low a valuation. They didn't want to get so low that the IRS caused problems." A806.

See Op. 21; A373-75; A1028-29; A1034-38; A1039. Caris undisputedly desired to close the transaction quickly to avoid looming debt covenants and to capitalize on the high relative value of the yen. There is no evidence that Halbert, who stood to receive nearly $500 million in the Transaction, would imperil that transaction by pushing for a low valuation to potentially save a small amount of taxes, when those valuations had to pass muster with Miraca and its advisors, Deloitte and Skadden Arps. *See* A549; A385; A547. And no evidence established what, if any, tax would be due at any valuation given the company's NOL position.

The court's zero-tax theory is not "supported by the record [or] the product of an orderly and logical deductive process." *Levitt*, 287 A.2d at 673. Trial courts may of course make credibility determinations, but they cannot—based on a single, misinterpreted email—ignore the uncontroverted testimony of every witness who spoke on the subject and all corroborating evidence that achieving zero tax was not the motivation behind valuing SpinCo. A85; A385-86; A101-03; A94-96; *see* A1028-29; A1034-38. The trial court appears to press the theory that there is always a "Holmesian bad man" waiting to be discovered[13]—contrary to Delaware's presumption of good faith. That model finds no support in this record.

[13] In *Treppel v. Cohen*, C.A. No. 9962-VCL, at 43-44 (Del. Ch. Sept. 8, 2015) (TRANSCRIPT), the Vice Chancellor stated that in controller cases "you have to use the Holmesian bad man Rubric and think 'How would a bad man look at the law? How would somebody who wants to extract benefits do it?'"

3. The Trial Court Erred In Concluding That The Transfer Tax Valuation And FMV Determination Would Differ.

The court took issue with Caris' reliance on the PwC valuation, holding that it was a transfer tax valuation instead of a "good faith determination of Fair Market Value" and therefore should not have been used to value SpinCo. Op. 4; *see also* Op. 7, 25-28, 35-36, 43, 67-70. But, for SpinCo, the FMV and the transfer tax value were identical in November 2011. The court had no basis to conclude otherwise. Both methods used a DCF model. *Cf*. A801-02. As conceded by the trial court, the only difference between a tax transfer valuation and FMV is the value of goodwill. Op. 68-69. Yet Plaintiff presented no evidence, and the court made no finding, that Carisome and TargetNow had *any* goodwill in late 2011. The record shows the opposite: one company's only product had failed and the other was viewed by its target customers as competition. *See supra* Stmt. of Facts § D. The court had no basis to conclude there was any difference between the tax transfer valuation and the FMV. Absent a difference, there are no damages.

CONCLUSION

For these reasons, this Court should reverse and render judgment for Caris.

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