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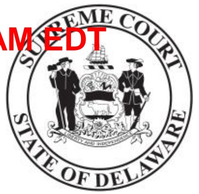

IN THE SUPREME COURT OF THE STATE OF DELAWARE

ISN SOFTWARE CORPORATION, Respondent-Below, Appellant, v. AD-VENTURE CAPITAL PARTNERS, L.P., POLARIS VENTURE PARTNERS FOUNDERS' FUND VI, L.P. and POLARIS VENTURE PARTNERS VI, L.P., Petitioners-Below, Appellees.	)	No. 43, 2017 On Appeal from the Court of Chancery of the State of Delaware, Consolidated C.A. No. 8388-VCG PUBLIC VERSION-- FILED: March 21, 2017

APPELLANT'S OPENING BRIEF

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NATURE OF PROCEEDINGS

After over three years of litigation and a five-day trial in this appraisal action, the Court of Chancery (the "Trial Court") issued an 18-page letter opinion on August 11, 2016 (the "Opinion"), determining that the fair value of respondent ISN Software Corporation ("ISN" or the "Company") was $357 million or $98,783 per share as of January 9, 2013 (the "Valuation Date" or the "Merger Date"). The Opinion relied solely on the discounted cash flow ("DCF") methodology to value ISN.

The assumptions utilized by the Trial Court in its DCF calculation have the effect of forecasting that ISN would be stripped of all of its operating cash within ten years of the Valuation Date. The Trial Court's DCF also forecasts that the Company's shareholder's equity will drop from ***positive*** $23,995,904 at the end of 2012 (nine days before the Valuation Date), to ***negative*** $68,216,437, only five years later in the residual year of the forecast period. The economic effect of the Trial Court's erroneous DCF assumptions transformed a healthy, solvent corporation into an insolvent one with liabilities far greater than its assets. The Trial Court's DCF conclusion, therefore, results in a valuation of ISN that disregards the Company's operative reality, thereby running directly contrary to the core going concern principle of Delaware appraisal law.

ISN has appealed the Trial Court's appraisal award and the award of interest to petitioner Ad-Venture Capital Partners, L.P. ("Ad-Venture"). For the reasons described below, certain elements of the Trial Court's judgment should be reversed, and the case should be remanded. This is ISN's opening brief in support of its appeal.

SUMMARY OF ARGUMENT

1. The Trial Court misapplied settled Delaware law by failing to value ISN as a going concern based on the Company's operative reality as of the Valuation Date. The Trial Court properly considered all three valuation experts' DCF analyses, and ultimately adopted the DCF analysis (and most of the associated inputs), performed by ISN's expert, Daniel Beaulne of Duff & Phelps. The Trial Court made, however, significant -- and improper -- adjustments to Mr. Beaulne's DCF analysis, including adjustments to working capital that transformed ISN from a solvent company with positive working capital on the Valuation Date to an insolvent company with negative working capital at the end of the projection period and into perpetuity. In making such adjustments, the Trial Court reversibly erred because Delaware law required the Trial Court to value ISN as a growing, profitable company with positive working capital (*i.e.*, ISN's operative reality on the Valuation Date) -- not a company that would have depleted its working capital and run itself out of business. The Trial Court's inexplicable decision to deplete ISN's working capital is inconsistent with the Company's operative reality on the Valuation Date, contrary to what Delaware law requires.

2. The Trial Court reversibly erred in calculating ISN's cost of equity in two separate respects. First, the Trial Court relied on the Capital Asset Pricing Model ("CAPM"), which is dependent on an analysis of comparable companies to

calculate beta. But the Trial Court expressly rejected any reliance on comparable companies not once, but twice. This internal inconsistency demonstrates the Opinion's erroneous approach to calculating ISN's cost of equity. Second, if utilizing CAPM is appropriate, the Trial Court selected the wrong size premium in its cost of equity calculation. Under Delaware case law, the Trial Court was required to use an iterative process to select an appropriate size premium in calculating the Company's cost of equity. In selecting its size premium, the Trial Court chose Ibbotson's 8th decile, which is comprised of companies with market capitalizations ranging from $514,459,000 to $818,065,000. Yet, the Trial Court's ultimate valuation of $357 million fell substantially below that range, making the Trial Court's choice of size premium clear legal error.

3. By failing to give any weight to a significant transaction in ISN's stock that preceded the Merger by fewer than 90 days, the Trial Court failed to comply with the statutory mandate set forth in 8 *Del. C.* § 262 ("Section 262") to consider "all relevant factors." 8 *Del. C.* § 262(h). The transaction between Ad-Venture and Polaris Venture Partners Founders' Fund VI, L.P. and Polaris Venture Partners VI, L.P. (together, "Polaris" and with Ad-Venture, the "Petitioners"), to which ISN was not a party, involved a transaction valued at approximately $34,000 per share -- far less than the Trial Court's $98,783 per share valuation. Despite this clear indicator of value, which was knowable as of the Merger Date, the Trial

Court erroneously concluded that the transaction should not be considered in valuing ISN.

4. The Trial Court improperly interpreted the appraisal statute by awarding Ad-Venture interest running from the date of Ad-Venture's appraisal demand. Where, as here, the dissenting stockholder (Ad-Venture) was not involuntarily forced to exchange its equity interest for the right to receive cash, the correct interpretation of Section 262 is for interest to run from the date of judgment or (at the earliest) the date of the opinion determining fair value. Here, Ad-Venture remained an ISN stockholder, but elected voluntarily to surrender that right in exchange for a yet-to-be-determined cash fair value. Consequently, Ad-Venture was not entitled to payment until a judgment or (at the earliest a fair value opinion) was entered in this appraisal action. By awarding Ad-Venture interest from the date of its appraisal demand, the Trial Court committed reversible error.

STATEMENT OF FACTS

A. The Merger

On January 9, 2013, William Addy and Joe Eastin, who constituted the members of ISN's board of directors (the "Board") and who owned a majority of ISN's outstanding stock, approved and adopted the Agreement and Plan of Merger between ISN and 2013 Sub Inc. (the "Merger Agreement"). A79-80; A288 at 767:8-14. The Merger was designed to move ISN closer to its goal of converting from a C corporation to an S corporation. A279 at 732:2-23; A538. The Merger did not involve an acquisition of new operations, contemplate new management or change the operative reality of ISN.

Pursuant to the Merger Agreement, 2013 Sub Inc. merged with and into ISN, resulting in 356 shares of ISN being converted into the right to receive $38,317 per share in cash. A574-80. The remaining 2,706 shares outstanding (including Ad-Venture's shares), plus 552 vested but unexercised options, continued to remain outstanding. *See* A576. Accordingly, Ad-Venture remained a stockholder of ISN following the Merger.

ISN's Board did not retain a financial advisor or obtain a fairness opinion in fixing the terms of the Merger. A80; Opinion at 4. Instead, the Board determined

the per share price by making adjustments to a valuation of ISN that had been performed in 2011.[1] *See* Opinion at 4-5.

B. ISN'S Operative Reality as of the Merger Date

1. ISN's Business

ISN, founded in 2000, is a privately-held company headquartered in Dallas, Texas. A78. The Company provides an online, subscription-based contractor management service called ISNetworld. A78; A277 at 723:2-724:11. ISN assists subscribers in meeting internal and governmental record keeping and compliance requirements. *See* A277 at 723:2-11. As of the Valuation Date, ISN employed approximately 287 employees and had offices in the United States, Canada, the United Kingdom and Australia. A78-79; A352 at 1022:13-19; A277 at 723:2-724:11. For the 2012 fiscal year, which ended nine days before the Valuation Date, ISN had $78.3 million in revenue, $15.7 million in EBITDA, $10.4 million in net income and $13.6 million in retained earnings. A277 at 724:12-17.

2. ISN's Working Capital

ISN is an annual subscription model business where customers pay their annual subscription fees in advance of receiving services. A78-79. These prepayments give rise to significant current assets (including cash balances) on

[1] Petitioners did not assert any breach of fiduciary duty claims against ISN's directors, nor did ISN rely on the Merger price before the Trial Court. Accordingly, the sole issue before the Trial Court was the fair value of ISN as of the Valuation Date.

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ISN's balance sheet. A783. Offsetting ISN's current assets are current liabilities, the largest of which is deferred revenue. *See id.*

Working capital is defined as current assets minus current liabilities.[2] At the end of 2011 and 2012, ISN had current assets greater than its current liabilities, *i.e.*, positive working capital. *Id.* In those two years immediately preceding the Merger, ISN had working capital equal to 10% and 18% of total revenue. *See id.* Thus, ISN's operative reality involved positive working capital equal to $5.5 million and $13.8 million at the end of 2011 and 2012, respectively.[3]

C. Two Significant Transactions in ISN Stock Closed Within 90 Days of the Merger

Ad-Venture made three separate investments in ISN totaling $1 million between 2001 and 2003 to acquire 900 shares of ISN common stock (an average price of $1,111 per share). *See* A785; A470. In 2011, Ad-Venture made a demand pursuant to Section 220 of the Delaware General Corporation Law for purposes of valuing ISN's shares in order to complete a sale to Polaris. A453-60; A463-64. In 2012, following a Section 220 trial conducted before Vice Chancellor Glasscock,

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[2] *Merion Capital, L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896, at *13 (Del. Ch. July 8, 2013) ("Working capital is derived by subtracting current liabilities from current assets and represents the capital the business has at its disposal to fund operations."(citation omitted)).

[3] In the four years immediately preceding the Merger, ISN's working capital averaged 2% of total revenue. *See* A783.

ISN was ordered to produce specific financial information sufficient to allow Ad-Venture to value its shares. *See* A471-84.

In 2012, Ad-Venture notified ISN that it was proceeding to sell some or all of its stock and began contacting potential buyers. A787-88. Four buyers expressed interest, and ISN provided access to its confidential books and records with the two potential buyers that executed the confidentiality agreement approved by the Court of Chancery. *See, e.g.*, A506.

1. The Polaris Transaction

In an all cash transaction, on October 10, 2012, Ad-Venture sold 201 shares (plus other consideration) to Polaris for $29,783.30 per share. A488-505. In the agreement, Ad-Venture provided certain inducements, including a call option, a put option and other consideration. The call option was for Polaris to purchase 76 additional shares for up to one year after the date of the Polaris Transaction for $29,783.30 per share. A488. The put option allowed Polaris to require Ad-Venture to repurchase the shares at 80% of the purchase price for up to 15 years. A493-94. Other inducements provided by Ad-Venture included an escrow account, a personal guarantee and a right of co-sale. A491-97.

2. The Gallagher Industries Transaction

On December 20, 2012, approximately three weeks before the Valuation Date, Ad-Venture exchanged 155 shares of ISN stock plus a put option with

Gallagher Industries LLC ("Gallagher Industries") for certain ranch properties valued at approximately $4.04 million. A514-37. In addition, Gallagher Industries agreed to pay up to $460,000 of Ad-Venture's ranch association fees, for a total purchase price of $4.5 million or approximately $29,032 per ISN share. A514-15; A68-69.

* * *

At the end of the sale process, Ad-Venture had sold 356 of its 900 ISN shares or 39.6% of its holdings. If the additional 76 shares subject to the Polaris call option are counted, Ad-Venture entered into transactions for the sale of 48% of its ISN shares.

D. The Appraisal Demands

On January 16, 2013, Ad-Venture, Polaris and Gallagher Industries received notice of the Merger. A80. Pursuant to the Merger Agreement, Polaris and Gallagher Industries received checks in the amount of $38,317 per share for their respective blocks of ISN shares. *See* A80; A551. Just one day after receiving the notice, Gallagher Industries deposited the check. *See* A586. On January 31, 2013, Polaris demanded appraisal and filed its verified petition for appraisal on April 22, 2013. A81; A587.

After the January 9, 2013 Merger, Ad-Venture remained as an ISN stockholder. A574-76. On January 31, 2013, however, it elected voluntarily to

forfeit its 544 remaining shares and seek appraisal. A81. Ad-Venture demanded appraisal and filed its verified petition for appraisal on March 7, 2013. A81.

E. The Opinion's DCF Adjustments

The Trial Court issued its Opinion on August 11, 2016. The Trial Court relied exclusively on the DCF method to reach its valuation conclusion. Opinion at 11-12. In doing so, the Trial Court relied on Mr. Beaulne's DCF model and inputs "as the best indication of ISN's value." *Id.* at 13. Nonetheless, the Trial Court then made three significant adjustments: (i) the Trial Court removed Mr. "Beaulne's annual cash flow adjustment for incremental working capital" (*id.* at 14); (ii) the Trial Court used "a cost of equity of 10.46% based solely on the capital asset pricing model" (*id.* at 15); and (iii) the Trial Court used "a size premium of 2.46%, based on Ibbotson's 8th decile, to calculate the Company's cost of equity" (*id.*).[4]

The Trial Court's $357 million valuation implied facially implausible multiples of 22.7 times actual 2012 EBITDA and 34.3 times actual 2012 net income. When combined, the Opinion's adjustments to ISN's working capital and

[4] The Trial Court also added (i) "an annual cash flow adjustment for the change in deferred revenue, calculated using Beaulne's projected deferred revenue balances at the end of each year"; (ii) "a cash flow adjustment in 2014 of $16.5 million to account for an expected tax refund"; and (iii) "approximately $34 million to the sum of ISN's discounted cash flows for the balance of the 'Buyout and Litigation Reserve' account." *See* Opinion at 14-15.

to ISN's cost of equity account for $257 million or 72% of the Opinion's $357 million "fair value" determination.

ARGUMENT

I. THE TRIAL COURT BASED ITS VALUATION OF ISN UPON A WORKING CAPITAL ADJUSTMENT THAT IGNORED ISN'S OPERATIVE REALITY AS OF THE VALUATION DATE

A. Question Presented

Whether the Trial Court committed legal error by making working capital adjustments to ISN that ignored its operative reality as of the Valuation Date?

This argument was preserved in the Trial Court at A831-38; A894-905; A1020-23; A1076-88.

B. Scope of Review

"The interpretation and application of the mandates in Section 262 to this appraisal proceeding presents a question of law." *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 524 (Del. 1999). "Therefore, the Court of Chancery's construction of Section 262 must be reviewed *de novo* on appeal." *Id.*; *see also Golden Telecom, Inc. v. Glob. GT LP*, 11 A.3d 214, 216-17 (Del. 2010) (holding that this Court's "review is *de novo* to the extent a trial court decision implicates the statutory construction of DGCL § 262").

Moreover, the Trial Court 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." *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 35 (Del. 2005).

C. Merits Of The Argument

It is settled Delaware law that "[t]he dissenting stockholder is entitled to receive the intrinsic value of his share in a going concern[,]" which "can mean only that he is entitled to receive that sum which represents the amount he would have received as a stockholder in one way or another as long as the company continued in business." *Tri-Continental Corp. v. Battye*, 74 A.2d 71, 76 (Del. 1950). Of critical importance here, "the corporation must be valued 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 525. Contrary to this legal mandate, the Trial Court's valuation methodology contemplated that ISN will run itself out of business within ten years. The reason for this anomaly is that in every year from 2013 through the terminal year, the free cash flow forecasted by the Trial Court significantly exceeds net operating profit after tax forecasted by the Trial Court as displayed below.

	2013	2014	2015	2016	2017	Residual Year
Net Operating Profit After Tax	$ 12,181,476	$ 12,843,038	$ 13,759,766	$ 14,443,392	$ 14,461,570	$ 14,365,860
Free Cash Flow (Opinion)	$ 54,489,062	$ 34,295,702	$ 22,268,019	$ 19,025,899	$ 18,456,499	$ 25,732,262
Difference	$ (42,307,586)	$ (21,452,664)	$ (8,508,253)	$ (4,582,507)	$ (3,994,929)	$ (11,366,402)

See Exhibit 2, lines H and I.

Free cash flow is cash that can be distributed to stockholders. The forecast utilized by the Trial Court effectively distributes more cash to stockholders than the Company is projected to earn for each and every year during the projection period, and importantly, into perpetuity. That result -- which would deplete ISN's

working capital for the projection period and into perpetuity -- runs contrary to well-established Delaware law requiring that a company be valued as a going concern based upon its operative reality as of the merger date. *M.G. Bancorporation*, 737 A.2d at 525.

The Trial Court selected Mr. Beaulne's original DCF analysis, which resulted in a valuation conclusion of $100 million, as its starting point. *See* Opinion at 13. Mr. Beaulne's DCF set a 12% of revenue working capital requirement for his DCF based on objective benchmarks from public companies in the information technology services industry with significant deferred revenue balances like ISN (and therefore similar billing and cash management characteristics from an operations standpoint). A631-32. The Opinion's DCF resulted in a valuation of $357 million -- approximately 3.5 times Mr. Beaulne's valuation.[5] *See* Opinion at 15. The Trial Court removed Mr. Beaulne's 12% of revenue working capital requirement because it concluded that there were no companies comparable to ISN.[6] *See* Opinion at 14 & n.47.

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[5] While the Opinion did not show its actual calculations, Mr. Beaulne recreated them in Exhibits 1 and 2. *See* Exhibit 1; Exhibit 2; *see also* A1104-15.

[6] *See* Opinion at 14 n.47 ("Beaulne estimated that ISN's working capital requirements equal 12% of its projected revenue. He made that determination based on the working capital needs of a set of guideline companies in the information technology services industry with supposedly similar subscription billing characteristics. I reject Beaulne's approach for the same reasons I previously rejected the GPC valuation method: ISN has no direct public

Although the Trial Court removed Mr. Beaulne's working capital conclusion, it did not adopt any replacement. *Id.* That is, the Opinion set *no* working capital requirement for its DCF analysis -- even though the Trial Court concluded that "[t]he nature of ISN's business indicates that its need for additional working capital would be small (although not nonexistent)." *See id.* Under Delaware law, "it is vitally important to account for working capital requirements and fixed capital investment (net of depreciation) in determining the free cash flow that will be discounted back to present value." *See Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *18 (Del. Ch. July 9, 2004), *aff'd in part, rev'd in part*, 884 A.2d 26 (Del. 2005). The failure to adopt a working capital requirement is the critical error in the Opinion.

A working capital requirement determines how much cash (and other current assets) to retain in the business to foster growth, maintain operations and pay for current liabilities. By not setting a working capital requirement, the Trial Court arrived at a valuation in which ISN would not maintain sufficient cash to sustain operations, not to mention sufficient cash to support the significant growth forecasted. As shown below, rather than *adding* a small amount of working capital every year, the Opinion *subtracts* large amounts of working capital, thereby greatly *increasing* the amount projected to be distributed as net cash flow.

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competitors, nor are there many companies that provide similar software applications.").

	2013	2014	2015	2016	2017	Residual Year
[J] Net Operating Profit After Tax	**12,181,476**	**12,843,038**	**13,759,766**	**14,443,392**	**14,461,570**	**14,365,860**
[K] Cash Flow Adjustments:						
[L] Add: Depreciation & Amortization	1,175,135	1,317,256	1,481,930	1,664,156	1,845,588	2,895,259
[M] Add: Incremental Working Capital	5,669,207	22,052,447	9,203,208	5,351,542	4,760,606	11,366,402
[N] Less: Capital Expenditures	1,719,428	1,917,040	2,176,885	2,433,191	2,611,265	2,895,259
[O] Net Cash Flow	**17,306,390**	**34,295,702**	**22,268,019**	**19,025,899**	**18,456,499**	**25,732,262**

Exhibit 1, line M (reflecting the Opinion's depletion of ISN's working capital; note that a positive number in this line indicates a subtraction from working capital); *see also* A1109. Subtracting working capital is inconsistent with the Trial Court's factual determination that ISN will need additional working capital, *see* Opinion at 14 n.47 (concluding that ISN would need additional working capital). Subtracting working capital is also inconsistent with the mandate that the Company should be valued based on its operative reality on the Valuation Date.

Contrary to ISN's operative reality, and as set forth below, the Trial Court's valuation results in significantly negative working capital (*see* line E) and significantly negative shareholder's equity (*see* line J) for every year including the residual year.

	2013	2014	2015	2016	2017	Residual Year
[E] Ending Working Capital Balance	**$ (28,276,191)**	**$ (50,328,638)**	**$ (59,531,846)**	**$ (64,883,389)**	**$ (69,643,995)**	**$ (81,010,397)**
[F] Ending Working Capital Balance (% of Revenue)	**-29%**	**-46%**	**-48%**	**-47%**	**-47%**	**-49%**

Opinion's Shareholder's Equity Conclusion	2013	2014	2015	2016	2017	Residual Year
[G] Beginning Shareholder's Equity	**$ 23,995,904**	**$ (18,311,681)**	**$ (39,764,345)**	**$ (48,272,598)**	**$ (52,855,105)**	**$ (56,850,034)**
[H] Add: Net Operating Profit After Tax	$ 12,181,476	$ 12,843,038	$ 13,759,766	$ 14,443,392	$ 14,461,570	$ 14,365,860
[I] Less: Net Cash Flow (Distributions to Shareholders)	$ 54,489,062	$ 34,295,702	$ 22,268,019	$ 19,025,899	$ 18,456,499	$ 25,732,262
[J] Ending Shareholder's Equity	**$ (18,311,681)**	**$ (39,764,345)**	**$ (48,272,598)**	**$ (52,855,105)**	**$ (56,850,034)**	**$ (68,216,437)**

See Exhibit 2; *see also* A1109. Specifically, the Opinion's DCF analysis forecasts

ISN to be insolvent with negative working capital of $81,010,397 and negative shareholder equity of $68,216,437 at the end of the five-year projection period and into perpetuity.[7] *See* Exhibit 3. The Trial Court concluded that ISN needed additional working capital, *see* Opinion at 14 n.47, yet the Trial Court increased cash flows without reducing them to account for working capital needs.

The Opinion adopts Mr. Beaulne's forecast that ISN will grow its net cash flow at 3.2% annually in the residual period and into perpetuity. *See* Opinion 13 n.46 ("Notably, I adopt Beaulne's assumptions regarding ISN's future cash collections, EBITDA, and the Company's long-term growth rate. I find these conservative assumptions more likely than the bolder growth assumed by the Petitioners' experts."). Exhibit 4, however, calculates what happens to ISN's working capital one, two and three years beyond the residual year. *See* Exhibit 4. The Opinion exhausts *all* of ISN's current assets (*including all cash*) by year three following the residual year (*see* Line P). With no cash, ISN cannot possibly

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[7] As a noted commentator has observed:

> A negative change in working capital creates a cash inflow, and while this may, in fact, be viable for a firm in the short term, it is dangerous to assume it in perpetuity. Carried to its logical extreme, this will push net working capital to a very large (potentially infinite) negative number.

Aswath Damodaran, *Damodaran on Valuation* 194-95 & n.1 (2d ed. 2006).

operate into perpetuity and deliver the net cash flow necessary to support the Opinion's valuation conclusion.

The Trial Court's explanation for making these erroneous adjustments is itself erroneous. The Trial Court found that the parties did not provide the Trial Court with any way to calculate an additional working capital requirement. *See* Opinion at 14 n.47 ("[T]he parties have given me no adequate way to compute that small amount."). That finding, insofar as it is factual, is clearly wrong. As set forth below, the evidence presented at trial established that a working capital requirement in the range of 2% to 18% of revenue is appropriate for ISN.

ISN's average working capital level during the period 2009 through 2012 was 2% of revenue. A783. The average working capital for the oil and gas industry was 6% of revenue, and the oil and gas industry represents approximately 87% of ISN's owner clients and 90% of ISN's contractor clients. A631. The service industry average is 12% of revenue, and ISN is a service business. *Id.* And ISN's actual working capital on the date of the Merger -- the operative reality -- was 18% of revenue. A783. Exhibits 5 and 6 show that by setting a working capital requirement as low as 2% of revenue, the Opinion's DCF valuation would result in positive working capital of $3,288,228 and positive shareholder's equity of $15,864,872 (*see* Exhibit 5, lines E and J; Exhibit 6, lines B and D). Positive

working capital and positive shareholder's equity were consistent with the operative reality of ISN on the Merger Date -- a solvent, going concern.

* * *

For the foregoing reasons, the Trial Court erred as a matter of law by (i) removing Mr. Beaulne's 12% of revenue working capital requirement; (ii) failing to replace it with *any* working capital requirement; and (iii) *depleting* ISN's working capital balances every year, including the residual year and into perpetuity. The Opinion's depletion of working capital added $119 million or $32,927 per share to the Opinion's DCF valuation conclusion, representing 33% of the Opinion's total $357 million valuation. On this basis alone, the judgment must be reversed and the case remanded with instructions to redetermine ISN's fair value using a working capital requirement that reflects ISN's operative reality on the Merger Date and allows ISN to remain a going concern.

II. THE TRIAL COURT ERRONEOUSLY DETERMINED ISN'S COST OF EQUITY AND THEREFORE EMPLOYED AN IMPROPER DISCOUNT RATE IN ITS DCF ANALYSIS

A. The Trial Court Improperly Applied the CAPM

1. Question Presented

Whether the Trial Court misapplied the CAPM to calculate ISN's cost of equity when it also rejected the use of any comparable companies analysis?

This argument was preserved in the Trial Court at A838-44; A911-15; A1023-24; A1070-76.

2. Scope of Review

"This Court reviews appraisal valuations pursuant to the abuse of discretion standard, so long as the Court of Chancery has committed no legal error." *Cede*, 884 A.2d at 35. The Trial Court 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." *Id.*

3. Merits Of The Argument

In calculating ISN's cost of equity, the Trial Court employed CAPM. Opinion at 15. CAPM requires the appraiser to calculate beta for the company being valued.[8] In determining the beta for a privately-held company such as ISN,

[8] *In re Appraisal of DFC Glob. Corp.*, 2016 WL 3753123, at *7 (Del. Ch. July 8, 2016) ("Market or systematic risk is measured . . . by beta. Beta is a function of the expected relationship between the return on an individual security . . . and the return on the market. Beta is used together with the equity risk

it is typical to examine the betas of guideline public companies. *See* Duff & Phelps, *2014 Valuation Handbook -- Guide to Cost of Capital* at 5-1 (2014) ("Beta estimates are generally derived from returns data of publicly traded securities. If one is valuing a closely held business or a nonpublic division or reporting unit, for example, one likely will be using the beta estimate of publicly traded securities as a proxy for the nonpublic business."); *see also Gearreald v. Just Care, Inc.*, 2012 WL 1569818, at *9 (Del. Ch. Apr. 30, 2012) (approving the expert's decision to analyze the betas of comparable publicly-traded companies when valuing a private company).

The Trial Court, however, concluded that there were no companies comparable to ISN and rejected use of comparable companies in its analysis. *See, e.g.*, Opinion at 9 (rejecting the guideline public companies analysis because "ISN has no public competitors"); *id.* at 14 n.47 ("I reject Beaulne's approach [for determining a 12% working capital requirement] for the same reasons I previously rejected the GPC valuation method: ISN has no direct public competitors, nor are there many companies that provide similar software applications."). By rejecting data based on comparable companies yet relying on a comparable-company-

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premium to estimate the expected risk premium for the subject company as a component of its cost of capital. A relatively small change in beta can substantially affect the WACC and, consequently, the outcome of a discounted cash flow model.") (internal quotations and citations omitted).

derived beta in its CAPM to calculate ISN's cost of equity, the Court's analysis is internally inconsistent and illogical.

Mr. Beaulne calculated a 16.4% blended cost of equity for ISN by using the comparable-company-dependent CAPM (16.9%), together with two different build-up methods (16.3% and 16.1%) that do not rely on comparable company metrics. A639-47. The Opinion adopted Mr. Beaulne's 16.9% CAPM cost of equity exclusively as a starting point, but excluded the two build-up methods. *See* Opinion at 15. After making certain adjustments to Mr. Beaulne's CAPM cost of equity, the Trial Court utilized a CAPM cost of equity of 10.46%. Opinion at 15.

The Opinion does not explain why it excluded Mr. Beaulne's two build-up methodologies. The build-up method is a widely-accepted method to calculate a company's cost of equity. It can be used in the absence of guideline public companies, and the Court of Chancery has so recognized. *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 475 (Del. Ch. 2011) ("The build-up method is commonly employed by professional appraisers and has been used by this Court.").[9] The Trial Court's reliance solely on CAPM cannot be squared with its

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[9] *Del. Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 338 (Del. Ch. 2006) ("Situations like this one inspire even less confidence, when experts are required to calculate a cost of capital for a very small, non-public company, for which neither of the experts has identified reliable public comparables. In this context, the ability of the experts or the court to hew literally to the teaching of the high church of academic corporate finance is essentially non-existent. At best, the experts and the court can express their reverence by trying to

conclusion that ISN has no comparable companies. This internal inconsistency led to a flawed determination of ISN's cost of capital, requiring that the judgment of the Trial Court be reversed and the case remanded to the Trial Court with instructions to calculate a DCF value utilizing a build-up method cost of equity of 16.1% or 16.3%, or an average of the two -- metrics that do not require reliance on comparable companies.

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come up with a proxy that takes into account concerns addressed by CAPM and ECMH."); *Laidler v. Hesco Bastion Envtl., Inc.*, 2014 WL 1877536, at *12-13 (Del. Ch. May 12, 2014).

B. The Trial Court Selected an Erroneous Size Premium in Determining ISN's Cost of Equity.

1. Question Presented

Whether the Trial Court committed legal error by selecting an inappropriate CAPM size premium in its cost of equity calculation?

This argument was preserved in the Trial Court at A838-44; A911-15; A1024-25; A1070-76.

2. Scope of Review

The Trial Court abuses its discretion "if [the Trial Court's] factual findings do not have support in the record or its valuation is not the result of an orderly and logical deductive process." *Cede*, 884 A.2d at 35.

3. Merits Of The Argument

If use of the CAPM in this case is permissible, the Trial Court reversibly erred by selecting a size premium inconsistent with Delaware law. Without explanation, the Opinion changed Mr. Beaulne's CAPM size premium from 8.9% (Ibbotson Decile 10y) to 2.46% (Ibbotson Decile 8). Opinion at 15. The 8th decile, however, comprises companies with market capitalizations between $514,459,000 and $818,065,000. *See* A791. Even if one were to accept the Trial Court's valuation conclusion of $357 million, ISN does not fall within that range.

As the Court of Chancery has recognized, selection of an Ibbotson size decile -- particularly for a private company -- is a circular calculation. *See, e.g.*,

DFC Glob., 2016 WL 3753123, at *13 ("Practitioners are advised to use an iterative process for closely held companies because, in the absence of a publicly known market capitalization, the analyst does not know the value of the company until she has completed the valuation."). Therefore, the Trial Court, when valuing a private company such as ISN, must ensure that its selection of a size premium matches its overall valuation conclusion. *See, e.g.*, *Just Care*, 2012 WL 1569818, at *11-12 (declining "to reduce the Company's size premium to less than what is implied by its actual size").

The analysis required to be employed was succinctly set forth in *In re Sunbelt Beverage Corp. Shareholder Litigation*, where the Court of Chancery observed that:

> [t]he Ibbotson table assumes one already knows or has an estimate of a company's market capitalization. Based on that knowledge or estimate, one can determine which decile the company falls into and then select the corresponding premium from the Ibbotson table. But when the very issue in dispute is the value of the company itself and when a discounted cash flow analysis is a proposed means for resolving the dispute, the appropriate risk premium cannot be taken as exogenous. That is, a discounted cash flow analysis both values the size of a company (and thus points to the appropriate Ibbotson premium to use) and relies on the appropriate Ibbotson premium to determine the value of the company. This process is circular; which should come first, the valuation of the company or the selection of the Ibbotson risk premium?

In re Sunbelt Beverage Corp. S'holder Litig., 2010 WL 26539, at *11 (Del. Ch. Feb. 15, 2010). Although ISN believes the CAPM method is inappropriate to use

in this instance for the reasons stated in Section II.A, Mr. Beaulne's selection of a CAPM size premium demonstrates proper technique. Mr. Beaulne selected a CAPM size premium corresponding to Ibbotson 10y sub-decile for companies with a market capitalization of $96,483,000 to $165,600,000. A644; A791. Use of the 10y decile was proper because (i) Mr. Beaulne's calculated value of recent transactions in ISN's stock (Polaris and Gallagher Industries) supported this range and (ii) because his DCF valuation result fell squarely within that range.

The Trial Court's use of the 8th decile is not supported by either the factual record or the Trial Court's valuation conclusion. That size premium selection was erroneous for two reasons. First, there are no recent transactions that suggest ISN's value falls in the range of $514,459,000 and $818,065,000. Second, the Opinion's $357 million valuation conclusion does not fall within the range of the 8th decile. *See* A791. The Opinion's Ibbotson CAPM size premium (decile 8) runs contrary to valuation principles and Delaware law. The change in decile from 10y to 8 added $138 million or $38,184 per share to the Opinion's DCF valuation conclusion, representing 39% of the Opinion's total $357 million valuation. That choice of CAPM size premium was legally and factually erroneous and must be overturned.

III. THE TRIAL COURT ERRED BY DECLINING TO CONSIDER THE POLARIS TRANSACTION

A. Question Presented

Whether the Trial Court committed legal error by failing to account for the Polaris Transaction as a relevant factor under Section 262(h) in determining the fair value of ISN?

This argument was preserved in the Trial Court at A860-65; A922-28; A939-41; A1051-54; A1096-99.

B. Scope of Review

As set forth above, "the Court of Chancery's construction of Section 262 must be reviewed *de novo* on appeal." *M.G. Bancorporation*, 737 A.2d at 524.

C. Merits Of The Argument

Section 262 required the Trial Court to "take into account all relevant factors" in determining the fair value of ISN. 8 *Del. C.* § 262(h). In interpreting the "all relevant factors" language of Section 262, this Court has held that

> market value, asset value, dividends, earning prospects, the nature of the enterprise and *any other facts which were known or which could be ascertained as of the date of merger* and which throw *any light* on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but *must be considered* by the agency fixing the value.

Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (emphasis added) (quoting *Tri-Continental*, 74 A.2d at 72). In the Opinion, the Trial Court recognized this principle as it observed that it "'must take into consideration all

factors and elements which reasonably might enter into the fixing of value,' and account for 'facts which were known or which could be ascertained as of the date of merger.'" Opinion at 6 (quoting *Weinberger*, 457 A.2d at 713). The Trial Court committed reversible error by failing to follow clear Delaware law.

On October 10, 2012, approximately 90 days before the Merger, Polaris purchased 201 shares, plus a put option, a call option and other inducements, from Ad-Venture for $29,783.30 per share in cash. A488-502. Mr. Beaulne, in his opening report, concluded that this transaction implied a value of ISN of $124 million or $34,345 per share. *See* A656-58; A661. To reach this conclusion, Mr. Beaulne accounted for the value of the cash consideration paid for the ISN shares, valued the put option and the call option, and then applied a 40% premium to adjust for lack of marketability and control. A656-58. This market based observation yields an implied value that is less than one-third of the Opinion's conclusion.

The Opinion rejected reliance on the Polaris Transaction on grounds that are factually incorrect and contrary to Delaware law. The Polaris Transaction's deal characteristics included:

- Both parties were sophisticated investors with no pressure to buy or sell. *See* A490-91; A492-93; A117 at 86:24-87:8; A134 at 153:16-23; A234-35 at 554:23-555:23.

- Both parties had available confidential books and records produced

in response to the Trial Court's order in the Section 220 action. *See* A125-29 at 118:12-133:15.

- ISN was not a party to the Polaris Transaction, and information was transparent and equal to both parties. *See* A488-505; A125-29 at 118:12-133:15.

- Multiple buyers expressed interest in Ad-Venture's shares. *See* A488; A506.

- The size of the transaction was material -- 9.9% of ISN's shares transacted and 12% were offered. *See* A488; A470.

- Both parties made contractual representations that they had adequate information to value ISN's shares.[10] *See* A491; A492-93.

The record demonstrates that the Trial Court could, and should, have fulfilled its statutory mandate by relying on the Polaris Transaction as a relevant factor under Section 262. In most instances where a recent transaction is rejected by the Trial Court, the respondent company is a party in the transaction and unequal information leads to suspicion of unequal dealing. *See, e.g.*, *Taylor v. Am.*

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[10] On December 20, 2012, just days before the Merger, Gallagher Industries purchased another large block (155 shares) of ISN stock and a put option from Ad-Venture for $4.5 million in land and ranch association discounts. Mr. Beaulne, in his opening report, concluded that this transaction implied a value of ISN of $119 million, or $32,855 per share, based on the value of the ranch properties, the value of the association fees, the value of the put option and application of a 40% premium to adjust for lack of marketability and control. *See* A659-61. ISN argued below that the Trial Court should rely on the Gallagher Industries Transaction as a "relevant factor" under Section 262. *See* A860-65; A922-28; A939-41; A1051-54; A1096-99. ISN continues to believe that the Gallagher Industries Transaction should be considered in determining the fair value of ISN. The value implied by the Gallagher Industries Transaction is essentially the same as the value implied by the Polaris Transaction. Therefore, for purposes of simplicity, ISN focuses only on the Polaris Transaction on appeal.

Specialty Retailing Grp., Inc., 2003 WL 21753752, at *10 (Del. Ch. July 25, 2003) (observing that "a special-purpose entity comprised primarily of [the company's] officers bought" stock from a third-party stockholder); *Gonsalves v. Straight Arrow Publishers, Inc.*, 793 A.2d 312, 326 (Del. Ch. 1998) (rejecting past transactions because "in every case, [the company] was the purchaser"), *aff'd in part, rev'd in part*, 725 A.2d 442 (Del. 1999) (TABLE); *Crescent/Mach I P'ship, L.P. v. Turner*, 2007 WL 1342263, at *15 n.101 (Del. Ch. May 2, 2007) (recognizing that the "only potential buyer" was the company). ISN did not participate in the Polaris Transaction.

Moreover, the Trial Court's reasons for declining to assign any weight to the prior transactions are contrary to the factual record. The Trial Court concluded that Ad-Venture "desire[d] liquidity" and that "there [was] no indication that the stock was shopped to multiple buyers, or that the sales prices were determined using complete and accurate information." Opinion at 11-12. Ad-Venture was not a distressed seller, did not need liquidity and was under no pressure to sell. *See* A74 ("Q: Is there any reason that you needed the cash that you ultimately got through your sale of the shares of ISN? A: No.")). More importantly, Ad-Venture did not actually achieve liquidity in the transaction because it was required to escrow virtually all of its after-tax sale proceeds for 12 years. *See* A494-95; A211 at 460:2-8. In addition to Polaris and Gallagher Industries, Ad-Venture shopped its

ISN shares to at least two other potential purchasers. *See* A485-87; A506; A232-33 at 545:15-550:1. Ad-Venture and Polaris also had the benefit of ISN's financial information produced pursuant to a court order. A453-69; A471-84. That is, the Court of Chancery, following a Section 220 trial, determined the specific books and records that ISN had to produce in order to facilitate a sale of ISN shares from Ad-Venture to Polaris. A453-69; A471-84.

The Opinion erred by not considering "all relevant factors" under Section 262, including the implied valuation of the Polaris Transaction. The Polaris Transaction indicated a valuation of $124 million. A661. This clear indication of fair value is not anywhere near the Trial Court's $357 million valuation.

The Polaris Transaction was an arm's-length transaction between two sophisticated parties consummated after both parties received the information that the Court of Chancery required ISN to produce for the very purpose of facilitating the transaction. Taking into account the fact that it was a sale of a minority interest, Mr. Beaulne concluded that the sale implied a valuation which was approximately one-third of the Trial Court's valuation conclusion. The Trial Court's decision not to consider the Polaris Transaction -- at least as a cross-check on the Trial Court's fair value conclusion -- constitutes reversible error.

IV. THE TRIAL COURT'S AWARD OF INTEREST RUNNING FROM THE DATE OF AD-VENTURE'S APPRAISAL DEMAND ERRONEOUSLY MISAPPLIED SECTION 262

A. Question Presented

Whether the Trial Court misapplied Section 262 in awarding Ad-Venture interest at the statutory rate from the date of its appraisal demand?

This argument was preserved in the Trial Court at A866-67; A945; A1099-1102.

B. Scope Of Review

Because this argument challenges the Trial Court's application of Section 262, it must be reviewed *de novo* on appeal. *See M.G. Bancorporation*, 737 A.2d at 524; *see also Cede*, 884 A.2d at 42 ("[W]hen the Court of Chancery's interest award involves questions of law, that award will be subject to a *de novo* standard of review.").

C. Merits Of The Argument

Before the Trial Court, ISN argued that Ad-Venture should be denied statutory interest because Ad-Venture's stock in the Merger was not involuntarily converted into a right to receive cash. A866-67; A945; A1099-1102. Rather, in this case, Ad-Venture was allowed to remain a stockholder of ISN until it voluntarily decided to exercise its right to seek appraisal.

Rejecting ISN's argument, the Trial Court held that:

> Unless the Court in its discretion determines otherwise "for good cause shown," a petitioner is entitled to statutory interest from the effective date of the merger through the date of payment of the judgment. Statutory interest accrues at 5% over the Federal Reserve discount rate, compounded quarterly. ISN alleges that good cause exists here to deny Ad-Venture interest at the statutory rate. *ISN's argument is based on the unusual nature of the Merger here, in which only Polaris' (and Gallagher Industries') shares were squeezed out*. Here, Polaris was deprived of its stock as of the date of the Merger, January 9, 2013, and statutory interest (as modified by the agreement between Polaris and ISN) runs from that date. Ad-Venture is in a somewhat different position; the Merger, the parties agree, did not take Ad-Venture's stock, but did convey to Ad-Venture a statutory appraisal right to demand fair value for its stock. *Ad-Venture perfected that right with its demand, dated January 31, 2013. I find that to be the appropriate date for statutory interest to begin to run. ISN's obligation to pay fair value accrued as of that date*, *and it has, effectively, had the use of that value since the demand was perfected*. Based on the foregoing, Ad-Venture is entitled to pre- and post-judgment interest as described above.

Opinion at 15-16 (emphasis added) (footnotes omitted).

The critical fact here is that under the terms of the Merger Agreement, ISN did not have an obligation to pay cash fair value to Ad-Venture on the Merger Date. In that respect, this case is atypical and requires a more contextual analysis of when Ad-Venture became entitled to interest.

Ordinarily, interest runs from the merger date because that is when the dissenting stockholder is involuntarily forced to surrender its equity interest in exchange for a debt, *i.e.*, a right to receive in cash the adjudicated fair value of the shares being appraised. The reason is that in an appraisal valuation "[t]he underlying assumption . . . is that the dissenting shareholders would be willing to

maintain their investment position." *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996). "The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him." *Tri-Continental*, 74 A.2d at 72; *see also Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549, 556 (Del. 2000) (same). Here, *nothing was taken* from Ad-Venture because it was permitted to continue its status as a stockholder if it so chose, unaffected by the Merger. Although Ad-Venture chose to give up its stock by demanding appraisal, it did so voluntarily, not because it was forced to do so.

Because of the "unusual" nature of this Merger, the Trial Court's holding that interest should begin to accrue for Ad-Venture on January 31, 2013, rests on its finding that "the Merger . . . did not take Ad-Venture's stock, but did convey to Ad-Venture a statutory appraisal right to demand fair value for its stock" and that therefore, "ISN's obligation to pay [cash] fair value accrued as of that date." *See* Opinion at 16. The Trial Court's analysis misapplied Section 262 in these circumstances. The correct application of Section 262 is that where, as here, a dissenting stockholder is permitted to remain as a stockholder notwithstanding the merger, then its voluntary election to exercise an optional appraisal right does not trigger a right to receive interest unless and until the Court of Chancery makes a cash fair value determination. Because there is no Delaware case law that squarely addresses this precise interpretation, the issue is one of first impression. ISN

submits that the Trial Court's application of Section 262 to the circumstances peculiar to Ad-Venture was legally erroneous.

ISN's position that Ad-Venture did not become entitled to cash on the Merger Date is supported by the plain language of Section 262. To reiterate, the Merger did not cash out Ad-Venture as a stockholder. It did afford Ad-Venture the option to seek appraisal, which Ad-Venture elected to exercise, but that was not obligatory. That is, Ad-Venture had no ability to require ISN to pay it cash on any particular date. Indeed, Ad-Venture could have withdrawn its appraisal demand, in which case, as Section 262(e) provides

> [n]otwithstanding the foregoing, at any time within 60 days after the effective date of the merger or consolidation, any stockholder who has not commenced an appraisal proceeding or joined that proceeding as a named party shall have the right to withdraw such stockholder's demand for appraisal and to accept the terms offered upon the merger or consolidation.

8 *Del. C.* § 262(e).

Under that scenario, the "terms offered upon the merger or consolidation" to Ad-Venture would have been for Ad-Venture to remain a stockholder -- not to receive cash. Stated differently, Ad-Venture would not have received cash had it withdrawn its appraisal demand under Section 262(e). Rather, Ad-Venture would have received its ISN shares. It follows as a consequence that Ad-Venture was not entitled to cash either on January 9, 2013 (the Merger Date), January 31, 2013 (the date of the appraisal demand), or March 7, 2013 (the filing of the verified petition

for appraisal). Rather, Ad-Venture became entitled to cash fair value, on which interest could accrue only on August 11, 2016 (the date of the Opinion), at the earliest or (at the latest) the date that judgment was entered.

Because by demanding appraisal, Ad-Venture did not obtain a right to immediate payment of cash fair value, ISN did not have the "use" of any cash owed to Ad-Venture on that date. Therefore, the rationale for awarding interest in the typical cash out merger scenario is not present here. Ad-Venture's right to receive cash fair value did not accrue until fair value was determined in the Opinion or a final judgment was entered.

Although the Trial Court rejected this position, its Opinion does not supply *any* reasons, let alone persuasive reasons, why ISN's construction of Section 262 is incorrect. In awarding Ad-Venture interest from the date it perfected its appraisal demand, ISN submits that the Trial Court reversibly erred.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment of the Trial Court and remand with the following instructions:

a. calculation of a DCF value starting with Mr. Beaulne's DCF but utilizing:

   i. a working capital requirement of at least 2% to 18% of revenue, which is (1) representative of ISN's operative reality, (2) required by the Trial Court's determination that ISN needed additional working capital, (3) comparable company independent and (4) supported by other industry metrics;

   ii. if CAPM is rejected, a cost of equity of 16.1% or 16.3% derived from the build-up method, or an average of the two, which metrics do not require reliance on comparable companies; and

   iii. if CAPM is not rejected, a CAPM size premium selected consistent with the Trial Court's overall valuation conclusion.

b. consideration of the Polaris Transaction (valuing ISN at $124 million), at the very least, as a cross-check on the Trial Court's valuation.

c. an award of interest to Ad-Venture beginning to accrue no earlier than August 11, 2016, if at all.

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