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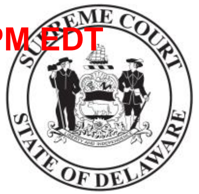

IN THE SUPREME COURT OF THE STATE OF DELAWARE

ISN SOFTWARE CORPORATION, Respondent Below, Appellant / Cross-Appellee, 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 / Cross-Appellants.	)	No. 43, 2017 On Appeal from: The Court of Chancery of the State of Delaware, Consol. C.A. No. 8388-VCG PUBLIC VERSION EFILED ON APRIL 20, 2017

APPELLEE'S / CROSS-APPELLANT'S ANSWERING BRIEF ON APPEAL
AND OPENING BRIEF ON CROSS-APPEAL

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES v

NATURE OF PROCEEDINGS 1

SUMMARY OF ARGUMENT 4

SUMMARY OF ARGUMENT ON CROSS-APPEAL 5

STATEMENT OF FACTS 6

A. Bill Addy Controls ISN Software. 6

B. ISN Dominated Its Market And Experienced Consistent And Remarkable Growth Prior To The Merger. 6

C. The Controlling Stockholder Attempted To Block Ad-Venture From Selling ISN Stock. 11

D. The Merger Triggered Appraisal Rights For All Minority Stockholders. 13

E. The Controlling Stockholder Failed to Preserve Valuation Materials. 16

F. The Trial Court's Valuation. 18

G. Evidence Of The Flaws In The Controlling Stockholder's Valuation. 19

1. ISN's Margin "Fade" Theory Was Not Supported By The Record. 19

2. ISN's Working Capital "Adjustment" Was A Post-Merger Accounting Device Employed To Make ISN's Cash "Disappear." 21

3. ISN's Valuation Is Prima Facie Unreasonable. 23

H. ISN Moved For Reargument on Every Valuation Issue. 24

TABLE OF CONTENTS (Continued)

Page

ARGUMENT 25

I. THE TRIAL COURT PROPERLY ACCOUNTED FOR ISN'S WORKING CAPITAL..25

A. Question Presented..25

B. Standard of Review...25

C. Merits of the Argument..26

1. ISN Never Carried A Positive Working Capital Balance Before The Merger...............................28

2. ISN Created A Litigation-Driven Working Capital Assumption Contrary To Its Operative Reality..30

3. There Is No Record Upon Which To Set Working Capital "In The Range Of 2% to 18% Of Revenue."..32

4. The Trial Court's Valuation Does Not Render ISN Insolvent. 34

II. THE TRIAL COURT PROPERLY CALCULATED ISN'S COST OF CAPITAL..40

A. Question Presented..40

B. Standard of Review...40

C. Merits of the Argument..40

1. The Trial Court Properly Utilized CAPM To Calculate ISN's Cost of Capital. 40

2. The Trial Court Properly Selected A Size Premium...43

TABLE OF CONTENTS (Continued)

Page

III. THE TRIAL COURT PROPERLY CONSIDERED AND REJECTED PRIOR TRANSACTIONS AS UNRELIABLE INDICATORS OF FAIR VALUE............................45

A. Question Presented..45

B. Standard of Review..45

C. Merits of the Argument..46

IV. THE TRIAL COURT CORRECTLY DETERMINED THAT AD-VENTURE IS ENTITLED TO PRE-JUDGMENT INTEREST. 49

A. Question Presented..49

B. Standard of Review..49

C. Merits of the Argument..50

V. THE TRIAL COURT BASED ITS VALUATION ON REVENUE AND EXPENSE PROJECTIONS THAT WERE NOT SUPPORTED BY THE RECORD................................53

A. Question Presented..53

B. Standard of Review..53

C. Merits of the Argument..53

1. ISN's Revenue Projections Were Not Supported By The Evidence..53

2. ISN's Expense Projections Were Not Supported By The Evidence..60

TABLE OF CONTENTS (Continued)

Page

VI. THE TRIAL COURT OVERSTATED THE NUMBER OF SHARES ENTITLED TO APPRAISAL. 64

A. Question Presented. 64

B. Standard of Review. 64

C. Merits of the Argument. 64

CONCLUSION 67

TABLE OF AUTHORITIES

Page

Cases

Ala. By-Products Corp. v. Neal,
588 A.2d 255 (Del. 1991) 26

Bd. of Adjustment of Sussex County v. Verleysen,
36 A.3d 326 (Del. 2012) 51

Cede & Co. v. Technicolor, Inc.,
758 A.2d 485 (Del. 2000) 51

Cede & Co. v. Technicolor, Inc.,
2003 WL 23700218 (Del. Ch. Dec. 31, 2003),
rev'd in part on other grounds 884 A.2d 26 (Del. 2005) 37

Cede & Co. v. Technicolor, Inc.,
884 A.2d 26 (Del. 2005) 25, 40, 49

Gerreald v. Just Care, Inc.,
2012 WL 1569818 (Del. Ch. Apr. 30, 2012) 43

Gesoff v. IIC Indus., Inc.,
902 A.2d 1130 (Del. Ch. 2006) 43, 47

Gholl v. eMachines, Inc.,
2004 WL 2847865 (Del. Ch. Nov. 24, 2004),
aff'd 875 A.2d 632 (Del. 2005) 52

Gilbert v. M.P.M. Enters., Inc.,
709 A.2d 663 (Del. Ch. 1997),
aff'd, 731 A.2d 790 (Del. 1999) 41

Golden Telecom, Inc. v. Global GT LP,
11 A.3d 214 (Del. 2010) 25, 49, 53, 64

Huatuco v. Satellite Healthcare,
93 A.3d 654 (Del. 2014) 51

In re Appraisal of Ancestry.com, Inc.,
2015 WL 399726 (Del. Ch. Jan. 30, 2015) 37

Page(s)

In re Appraisal of DFC Global,
2016 WL 3753123 (Del. Ch. July 8, 2016) 43

In re Appraisal of Ford Hldgs, Inc. Pref'd Stock,
698 A.2d 973 (Del. Ch. 1997) 65, 66

In re Appraisal of Metromedia Int'l Grp.,
971 A.2d 893 (Del. Ch. 2009) 50

In re Orchard Enters., Inc.,
2012 WL 2923305 (Del. Ch. July 18, 2012),
aff'd, 2013 WL 1282001 (Del. Mar. 28, 2013) 41, 42

In re Sunbelt Beverage Co. S'holders Litig.,
2010 WL 26539 (Del. Ch. Feb. 15, 2010) 43, 48

Kahn v. Household Acq. Corp.,
591 A.2d 166 (Del. 1991) 26

Leatherbury v. Greenspun,
939 A.2d 1284 (Del. 2007) 51

M.G. Bancorp., Inc. v. Le Beau,
737 A.2d 513 (Del. 1999) 25, 46

M.P.M. Enters., Inc. v. Gilbert,
731 A.2d 790 (Del. 1999) 40

Merion Capital L.P. v. 3M Cogent, Inc.,
2013 WL 3793896 (Del. Ch. July 8, 2013) 28

Montgomery Cellular Hldg Co. v. Dobler,
880 A.2d 206 (Del. 2005) 49

Motorola Inc. v. Amkor Tech., Inc.,
958 A.2d 852 (Del. 2009) 41

Owen v. Cannon,
2015 WL 3819204 (Del. Ch. June 17, 2015) 66

Page(s)

Rapid Am. Corp. v. Harris,
603 A.2d 796 (Del. 1992) 26

Schenley Indus., Inc. v. Curtis,
152 A.2d 300 (Del. 1959) 52

Seagraves v. Urstadt Prop. Co.,
1996 WL 159626 (Del. Ch. Apr. 1, 1996) 47

Taylor v. Am. Specialty Retailing Grp., Inc.,
2003 WL 21753752 (Del. Ch. July 25, 2003) 43, 46

Zhurbin v. State,
104 A.3d 108 (Del. 2014) 51

Other Authorities

JOHN D. STOWE, ET AL., EQUITY ASSET VALUATION (2007) 38

TIM KOLLER, ET AL., VALUATION (5th ed. 2010) 28

Rules and Statutes

8 Del. C. § 262 ....*passim*

Supr. Ct. R. 8....................51

Supr. Ct. R. 14....................31, 46

NATURE OF PROCEEDINGS

This is an appeal from the Court of Chancery's determination of the fair value of ISN Software Corporation ("ISN" or the "Company") in an appraisal action. In the merger giving rise to appraisal rights, ISN's controlling stockholder (William "Bill" Addy) valued the Company at $138.5 million to set the merger consideration without engaging a financial advisor or obtaining a fairness opinion. Instead, he simply made his own *ad hoc* adjustments to a two-year-old valuation that failed to include any data from the two most recent and profitable years in the Company's history, during which ISN had experienced rapid growth in cash collections and steadily increasing profit margins, and had accumulated substantial excess cash balances.

Minority stockholders Ad-Venture Capital Partners, L.P. ("Ad-Venture"), Polaris Venture Partners Founders' Fund VI, L.P. and Polaris Venture Partners VI, L.P. ("Polaris") demanded appraisal. Less than a month later, Bill Addy announced that he was abandoning ISN's long-standing cash-basis accounting method in favor of GAAP, which he claimed—contrary to valuation principles—would:

- "***[R]educe the DCF value of ISN***;" and
- ***"[Create a] Deferred Revenue Liability [that would] eliminate any excess cash added back to the value of a share…."***

Of course, ISN had never had a deferred revenue liability before the merger, and had never set aside any excess cash to cover any such liability.

Shortly thereafter, Bill Addy attempted to further dampen the determination of ISN's fair value by generating projections that artificially depressed the growth in the number of new contractors (the key driver in ISN's subscription business year-over-year), and by arbitrarily "fading" ISN's consistently growing profit margins.

Remarkably, ISN's valuation expert adopted each of Bill Addy's theories, and artificially depressed his DCF valuation conclusion to the point of arguing that, on the date of the merger, ISN was worth only $100 million—$38.5 million ***less*** than Bill Addy's contrived valuation as of the date of the merger, and even less than the value that Bill Addy had assigned to the Company in 2011.

During discovery, the financial advisor (Peter Phalon) that Bill Addy had engaged in 2008 and 2011 while considering buying out Ad-Venture claimed that his firm could not produce all of the supporting materials underlying its financial analysis because its servers had "crashed" around the time Ad-Venture had subpoenaed their documents. To make matters worse, after multiple motions to compel, Bill Addy admitted that ISN had not preserved all of its valuation materials. ISN's conduct created delay and ultimately led to a finding of spoliation and an award of sanctions against ISN.

Following a week-long trial, the trial court determined that the fair value of ISN was $357 million. ISN sought reargument on virtually every valuation issue,

making several arguments that undermined its own expert's valuation, including the reliability of his revenue forecast. The Court denied that motion.

On January 24, 2017, ISN filed its appeal. Ad-Venture and Polaris (collectively, "Petitioners") each filed cross-appeals.

SUMMARY OF ARGUMENT

1. Denied. The trial court properly removed ISN's annual "*cash flow adjustment for incremental working capital*" from its fair value calculation. ISN's argument that the court's valuation would render ISN insolvent is a myth based solely upon ISN's insistence that its post-merger accounting change would introduce a massive working capital requirement that would consume all of the excess cash stockpiled for years on its balance sheet to offset a newly-created deferred revenue liability. The controlling stockholder made the change to GAAP accounting under the bogus claim that it would "*reduce the DCF value of ISN….*"

2. Denied. The trial court applied the capital asset pricing model ("CAPM") to calculate ISN's cost of equity using the beta calculated by ISN's expert, just as ISN's expert had done. In applying CAPM, the trial court did not abuse its discretion in selecting a size premium that reflected ISN's risk profile, which was well-supported by the trial record.

3. Denied. The trial court construed Section 262 precisely as this Court has instructed: it considered prior transactions in ISN stock and determined, based on the record, that those sales were not reliable indicators of the fair value of ISN.

4. Denied. The trial court did not misconstrue Section 262(h), which reflects the legislature's decision to award pre-judgment interest to all appraisal petitioners.

SUMMARY OF ARGUMENT ON CROSS-APPEAL

5. The trial court abused its discretion by adopting the revenue and expense projections proffered by ISN's valuation expert because those projections were not supported by the record. Specifically, ISN's DCF model flattened the Company's projected revenue growth based solely on self-serving speculation regarding increased competition that was contrary to the evidence. Further, ISN's expert admitted that he did not analyze ISN's actual expenses: instead, he "backed into" his expense projections based on hypothetical margins from public companies. He then arbitrarily reversed the growth trend of ISN's profit margins based on the controlling stockholder's theory that ISN's margins would fade over the course of the projection period, without ever identifying any actual expense that was expected to grow faster than the Company's historic trends. Neither of those theories to depress ISN's DCF value was supported by evidence in the trial record.

6. The trial court erred as a matter of law in determining the number of outstanding shares eligible for appraisal by adding employee and former employee stock options to ISN's fully-diluted share count, despite the fact that those shares did not have voting rights and were contractually restricted from dissenting from the merger and seeking appraisal.

STATEMENT OF FACTS

A. Bill Addy Controls ISN Software.

ISN is a privately-held Delaware corporation that provides software subscription services to contractors and the companies that hire them to facilitate record-keeping and compliance requirements. Bill Addy, who owned approximately two-thirds of ISN's stock before the merger, has controlled ISN throughout its history.[1] Ad-Venture, a limited partnership run by Brian Addy, provided the early-stage capital for ISN and, in exchange, received a minority stake in the Company and a board seat. Brian Addy served on ISN's board until 2007, when Bill Addy removed him and stopped paying dividends, instead increasing his own compensation and providing lavish perquisites to himself and ISN's President (and only other board member), Joseph Eastin.[2]

B. ISN Dominated Its Market And Experienced Consistent And Remarkable Growth Prior To The Merger.

There is no debate that ISN experienced dramatic and sustained growth in the years leading up to the merger. As Bill Addy testified, "*there's only one company in the Russell 3000 that outperformed us over that time period [from 2000 to 2011] …*,"[3] ISN continued to grow rapidly in 2012, at a 45% growth rate,

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[1] Op. *1, *2.

[2] Op. *2.

[3] A284; B1548 ("15,000% increase overall" in share value).

and 2012 was ISN's "*best margin year ever*."[4] ISN's consistent growth earned it a place on the Inc. 5000 list of America's fastest growing companies every year since 2006.[5]

ISN's remarkable and continuing growth was evidenced by every measure.

First, ISN consistently generated substantial new business every year. Contractor subscriptions grew from 1,000 subscribers in 2003 to nearly 45,000 subscribers by the time of the merger (at an escalating average price per contractor of $1,862 at the time of the merger).[6] The majority of that growth occurred in the three years before the merger, during which ISN added an average of 7,300 net new contractors per year.[7] ISN's 2013 budget reflected management's expectation that the Company's subscriber base would continue to grow by 6,300 to 7,700 net new contractors in 2013.[8] That growth was driven by continued expansion in the oil and gas industries (where ISN had a "*truly dominant*" position[9]), as well as continued expansion into new markets.

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4 A277, A289-90; B1612-14.

5 B3012; A288-89.

6 B1654-55; B2284, B22992.

7 B1921.

8 B1666-67.

9 A287.

Second, ISN's annual cash collections increased from $9 million in 2006 to $92 million in 2012. For 2013, the Company estimated cash collections to increase to between $105 million and $110 million.[10]

Third, the cost of fulfilling subscriptions was far below the non-refundable price customers paid and was covered by current subscriptions. The principal cost of servicing ISN's customers was "people" costs, which were accounted for as payroll expenses.[11]

Fourth, ISN's employee headcount grew from 20 employees in 2005 to more than 250 employees by 2012.[12] ISN grew from one office in Dallas in 2005 to six offices worldwide by 2013, while also growing its office space in Dallas three-fold between mid-2012 and mid-2013.[13]

Fifth, ISN maintained remarkably high 90% customer renewal rates, despite substantial price increases every three years.[14] Indeed, ISN developed a captive customer base. ISN's hiring clients required their contractors to subscribe to ISN's

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[10] B1666-67; B1918, 1923-24.

[11] B3125-26 ("*We've had a framework since ... 2002, ... we take a dollar that we collect and 50 cents goes to what we call people costs.... And so at the end of 2012 ... we lived within our 50 cent people cost....*"); B3015 (ISN Ratio Analysis showing annual payroll expenses consistently near 50%).

[12] B1633; A331-32.

[13] B1778; B2460; B1577; A352.

[14] A283; A290-91; A323. ISN increased its subscription prices by 50% in 2006, 32% in 2009, and 20% in 2012. B1666.

network to continue doing business with them, leaving contractors with no choice but to subscribe and annually renew their subscriptions. In addition, ISN's scalable software product was easily adaptable to new customers at minimal cost, and was easily replicated to work in new industries and geographies.[15] That inelastic demand and scalable product led ISN's President to characterize its cash flows as an "*annuity*."[16]

Sixth, ISN's profits grew rapidly. Between 2009 and 2012, its EBITDA grew at a compound annual growth rate of 142%.[17] In 2009, ISN had an EBITDA margin of 3.9%; by 2012, that margin had expanded to 20.1%. ISN's management expected continued margin growth to 24.3% in 2013.[18]

Seventh, ISN's cash position nearly quadrupled from 2009 to 2012. At the end of 2012, ISN had $47.4 million in cash and marketable securities on its

[15] A250; A331-32; B3133, B3138.

[16] B1567.

[17] B1918; B2178.

[18] A784; B1918 (calculating 2013 budgeted EBITDA margin). ISN's EBITDA margins based on its "restated" (and unaudited) post-merger GAAP financial statements understate ISN's actual profitability. Given ISN's rapid growth, switching to deferred revenue accounting pushed recognition of a substantial portion of its cash collections into each following year, and thus, implied EBITDA margins below the Company's actual cash operating margin. Before the merger, Bill Addy had always targeted a cash margin of 25% and the Company had "*delivered that 25 [percent] every year up through 2013*," B3152, averaging a cash basis operating margin of 29% in the three-year period from 2010 to 2012. B2066, 2074-75.

balance sheet.[19] ISN also expected to receive a $16.5 million tax refund, which would further strengthen its cash position.[20]

Finally, as Bill Addy testified, ISN had significant excess cash[21] that was not required for operations.[22] Rather than distributing ISN's excess cash as dividends, Bill Addy funded a buyout and litigation reserve,[23] invested the Company's money in unrelated business ventures, purchased shares in private jets for his personal use,[24] and moved cash off the balance sheet to charitable funds to be used at his and Eastin's personal discretion.[25] As Bill Addy detailed in the minutes of the meeting approving the merger: "*the Company had accumulated sufficient cash on its balance sheet to move forward with some form of the Restructuring Proposal while retaining sufficient cash reserves to finance the*

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[19] B1635.

[20] B1642; A241; B2032; A632.

[21] A302 ("*[F]or valuation purposes, you want to add back what they call excess cash …. And what we had in the bank on the merger date was 33.9 [million].*").

[22] A337; A339; A387.

[23] A286; A302; A337.

[24] ISN's policy allowed Bill Addy and Eastin to allocate up to 45% of the Company's private jet hours for their personal use. A286. ISN's tax returns revealed the actual allocation for personal use was between 50% and 90%. B2594, B2651, B2865.

[25] The funds were controlled by Bill Addy and his wife, and ISN's contributions were misleadingly booked as "payroll" or "marketing" expenses, causing a direct hit to ISN's profit margin. A340; B1615-24; B1628-29.

Company's day-to-day business operations" and "*the Company potentially had sufficient cash reserves*" to cash out ***all*** minority holders, including Ad-Venture.[26]

Based on this and the other evidence presented at trial, the trial court found that ISN "experienced substantial growth in the years leading up to the Merger."[27]

C. The Controlling Stockholder Attempted To Block Ad-Venture From Selling ISN Stock.

In addition to the unequivocal evidence of ISN's rapid growth, the trial record also showed that, since 2008, Bill Addy sought to take out Ad-Venture's interest at an unfairly low price by withholding financial information or providing misleading valuations.[28] In 2010, Polaris and Bill Addy discussed a "solution" in which Polaris would finance the purchase of Ad-Venture's entire minority position in ISN based on a $100 million valuation provided by Bill Addy.[29] Later that year, Polaris separately met with Brian Addy to discuss purchasing a portion of Ad-Venture's ISN shares. Those discussions led to a term sheet between Polaris and Ad-Venture in December 2010 (the "2010 Term Sheet"),[30] whereby Ad-Venture agreed to sell 8% of ISN's common stock to Polaris for $7.75 million.

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[26] A541-42; A298; *see also* A297.

[27] Op. *3.

[28] A236; A286.

[29] Op. *11 & n.41; A100-104.

[30] B1462-66; A103. As the parties lacked complete information, they assumed that there were "no more than 3,700 shares of … stock ... outstanding." B1463.

When Polaris and Ad-Venture informed Bill Addy that they had signed a term sheet, Polaris requested confirmatory due diligence from ISN.[31] Bill Addy made every effort to stymie the review and frustrate the deal, insisting that Polaris provide no more than its "*absolute minimum* [due diligence] *requirements list,*"[32] and demanding that Polaris sign a non-disclosure agreement containing a $5 million liquidated damages provision.[33] As Polaris noted, *"[i]t is quite obvious that [Bill Addy] is making up ridiculous excuses to prevent you from completing this transaction.... In my nearly 14 years in the private equity business, I have never seen anyone act like Bill has.*"[34]

Ultimately, Ad-Venture was forced to litigate a books and records demand against ISN in order to get financial information for Polaris.[35] During the trial in that action, Bill Addy admitted that: (1) he had not given Ad-Venture financial information from ISN since 2008; and (2) Ad-Venture did not have the information necessary to value its ISN stock.[36] Following that trial, even though the court ordered ISN to produce documents necessary for a fair valuation, ISN withheld

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[31] B1467.

[32] B1475.

[33] B1482, B1485.

[34] B1490. Bill Addy also stonewalled other potential buyers, including Gallagher.

[35] A221; A453-69.

[36] B1561-62.

from its production both valuations that ISN had commissioned from Peter Phalon (effective May 2008 and February 2011 (the "2011 Phalon Valuation")),[37] the off-balance sheet charitable funds, an office space forecast that contained revenue projections,[38] and other projections that Bill Addy had prepared on his "*own little spreadsheet*."[39]

The trial court found that the principal terms of the Polaris transaction that closed in 2012 were materially the same as the 2010 Term Sheet, and that the price agreed to by Polaris and Ad-Venture "w[as] largely based on an unsubstantiated value provided by Bill Addy."[40]

D. The Merger Triggered Appraisal Rights For All Minority Stockholders.

On January 9, 2013, Bill Addy and Joe Eastin (ISN's only two directors) approved a merger pursuant to 8 *Del. C.* § 251, which provided appraisal rights to all of ISN's minority stockholders. ISN did not retain a financial advisor or obtain a fairness opinion in connection with the merger.[41] Instead, to set the merger consideration, Bill Addy "*just eyeballed the up and down arrows*" on a "*little*

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[37] B1493-1547.

[38] B2317-18.

[39] A316 (referring to B1716-17; B3042).

[40] Op. *11 & n.41; B3047; *see* B1589-1611; B1462-66; *see also* A100-103, A113-16; A219-21.

[41] Op. *2; A280.

yellow scratch paper" to "adjust" the 2011 Phalon Valuation and set the merger price based on an enterprise value of $138.5 million.[42] *See* Exhibit A.

Bill Addy structured the deal to cash out minority stockholders Polaris and Gallagher Industries, LLC and to freeze Ad-Venture into its minority position.[43] A week after approving the merger, ISN informed the minority holders, providing "Supplemental Documentation" that included its cash-basis financial statements, budget for new contractors and cash collections for 2013, and other materials previously produced in the books and records action.[44] Inexplicably, however, the documentation did not include the information Bill Addy had used to set the merger price, such as the 2011 Phalon Valuation, the single sheet of paper on which he applied the "arrow method" to "adjust" that valuation, or the minutes of the board meeting where Bill Addy and Joe Eastin approved the merger.

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[42] A280, A299-300; A301 (citing B1648-49; B1493-1547); *accord* Op. *4-5.

[43] A543; A279-80, A318; A337-38.

[44] B2942-44 (consolidated cash-basis financial statements), B2951 (budget).

The documents included Bill Addy's false and misleading "Halloween Letter" to Ad-Venture (dated October 31, 2011) stating that ISN had undergone a "*significant change in strategy*" and would now "*pursue two new and complimentary strategic thrusts*": acquisitions of businesses and acquisitions of real estate to be used for "*employee personal use*." B2700. None of those statements were true when made or when provided to the minority stockholders in 2013.

Ad-Venture and Polaris demanded appraisal on January 31, 2013.[45] Two weeks later, Bill Addy offered Ad-Venture the opportunity to sell its stock back to ISN at the merger price, but offered no additional information concerning the value of the Company.[46] Instead, on February 21, 2013, Bill Addy informed Petitioners that he had converted the Company's accounting from its long-standing practice of cash accounting to GAAP accounting.[47] *See* Exhibit B. In that letter, Bill Addy stated that the merger price was likely ***too high*** because his decision to change the post-merger accounting would result in "*lower Pretax Operating Income* [*that*] ***will reduce the DCF value of ISN*** *and the Deferred Revenue Liability* ***will eliminate any excess cash*** *added back to the value of a share*."[48]

Nearly three years after the appraisal petitions were filed, ISN produced "restated" (and unaudited) consolidated GAAP financial statements for 2011 through 2014.[49] Those financial statements were prepared by ISN's (now former) CFO, who admitted that they were prepared with the input of ISN's litigation team,

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[45] B1709-10; B1711-14. Bill Addy was surprised that the merger gave Ad-Venture appraisal rights. A319.

[46] B1718.

[47] B1721. While trying to stymie the transaction between Ad-Venture and Polaris, Bill Addy had informed Petitioners that ***"[w]e do not do GAAP accounting and have no plans to adopt it.*** " B1479.

[48] B1721 (emphasis added).

[49] B1634-46; B1773-86; B1787-1800; A783-84.

and each document was dated "August 14, 2015"—less than six months before trial and mere days before depositions were set to commence.[50]

E. The Controlling Stockholder Failed to Preserve Valuation Materials.

In a continuing attempt to create artificially-low valuations to take out the minority at the lowest possible price, ISN, led by Bill Addy,[51] engaged in a systematic course of misconduct that frustrated Petitioners' ability to conduct open and fair discovery of evidence of the Company's true value. Bill Addy admitted that ISN had failed to put a written litigation hold in place following the demands for appraisal and that ISN had not suspended its document destruction policy.[52] Worse yet, ISN's Texas counsel sent an email message to ***thank*** Eastin ***for instructing others to delete emails*** related to expressions of interest in ISN by third parties (at much higher valuations than the controlling stockholder was willing to offer) in the run-up to the merger.[53] In addition, laptops and desktop computers were not timely searched, and many were destroyed.[54] And contrary to ISN's

[50] A385. Richard FitzPatrick, a personal friend of Bill Addy, was hired shortly after the merger and disappeared from ISN shortly after trial. A384-86. Prior to FitzPatrick's hiring, ISN did not have a CFO.

[51] A317 (testifying he managed the document collection process).

[52] A317.

[53] B2452.

[54] B1322-29, B1332-34.

claim that it transferred all of the data from its custodians' old computers to their new computers when it decided to exchange their computers shortly after this litigation was filed, the transfer included only "*certain files*" that were hand selected by the custodians.[55]

At trial, Bill Addy tried to rehabilitate those failures by claiming that, in late 2014—after nearly two years of litigation and Petitioners' fourth motion to compel—he finally directed ISN to have "*every single computer ... and all of our cell phones ... forensically examined....*"[56] But just moments later, he was forced to "*clarify*" that statement, conceding that "*a number of computers ... had been destroyed or replaced...*," and that "*[t]here's many, many computers in the company that we didn't forensically examine*" *or even look at*.[57] Moreover, no amount of forensic examination could recover the documents that had been lost when Bill Addy occasionally cleaned out of ISN's shared drive "*like a dirty fridge*"—a process he did not suspend during the pendency of this litigation.[58]

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[55] A378-79; B3092.

[56] A321.

[57] A322-23. ISN confirmed that "*various ISN storage areas ... contained 153 additional laptop computers and 5 desktop computers*" that were never searched. B1358-60.

[58] A317.

The trial record also showed that ISN concealed or destroyed evidence of Bill Addy's contemporaneous views of ISN's value. Despite testifying for years that "*ISN doesn't prepare long-term projections*,"[59] when confronted at trial with evidence that he had, in fact, done so, Bill Addy finally admitted that he had run "*personal little valuation scenarios*" on his "*own little spreadsheet*"—a practice he engaged in "*occasionally*" before this litigation was commenced, and "*pretty regularly*" thereafter.[60] Those were never produced.

F. <u>The Trial Court's Valuation.</u>

In rendering its opinion on fair value, the trial court detailed multiple reasons for finding that the guideline public company ("GPC") and past transaction valuation methods were not reliable indicators of fair value.[61] Addressing ISN's "past transactions" analysis, the Court found that "the characteristics of the Company and its stock, along with the nature of the prior transactions, are fatal to the reliability of the resulting sales price."[62] Among other reasons, the Court noted that ISN was a controlled company with illiquid stock, and that the transactions were not priced using complete and accurate information.[63]

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[59] *E.g.*, A278, A314-15.

[60] A316 (citing B1716-17; B3042). *See generally* A315-17.

[61] Op. *9-10.

[62] Op. *10.

[63] Op. *11 (citing A100).

After analyzing the alternative valuation methods presented by the experts, the trial court decided to rely exclusively on the DCF method to determine the fair value of ISN. The trial court started with ISN's expert's five-year projection, even though all of the valuation experts agreed that there would be a price increase in the sixth year of the projection period, and the evidence did not support ISN's revenue or expense forecasts. The trial court then adjusted that model to reflect the court's resolution of the disputes among the valuation experts, and concluded that the fair value of ISN as of the merger date was $357 million.[64]

G. Evidence Of The Flaws In The Controlling Stockholder's Valuation.

1. ISN's Margin "Fade" Theory Was Not Supported By The Record.

One of the largest drivers of ISN's expert's artificially low value is his mistaken assumption that ISN's profit margin would "fade." Contrary to ISN's historical experience of expanding margins due to economies of scale, he simply assumed that ISN's expenses would suddenly begin to grow substantially more quickly than they ever had—so quickly that, under ISN's expert's model, ISN's incremental operating expenses would eclipse its incremental collections by 2016—just three years after the Valuation Date.[65]

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[64] Op. *11-15.

[65] A423.

But the record showed that ISN's expert had admitted that he performed no analysis of ISN's historical or anticipated expenses, nor any analysis to determine whether ISN's historical trend of increasing profitability would continue. Instead, he merely "backed into the expenses" after selecting his "fading" EBITDA margin.[66] And, even though Bill Addy had been peddling the margin fade theory to drive down valuations of ISN since 2008,[67] and identified the "fade" as part of his litigation strategy in any appraisal case,[68] *see* Exhibit C, the "fade" never occurred—a fact that Bill Addy conceded at trial.[69]

Moreover, there was no support in the record to indicate either that ISN's margins would fade or, if they did, that 15% was an appropriate endpoint just six years after the merger. Instead, the evidence showed that ISN's margins had been steadily increasing (despite the fact that Addy and Eastin were siphoning off millions from cash flow for their personal use of corporate jets, personal charitable slush funds, and ever-increasing compensation, including retroactive bonuses).[70]

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[66] A422-23; A425-25; A620 n.165.

[67] B1459 (2008 memo from W.Addy to Phalon predicting "*margins will suffer*"); B1487 (2011 email from W.Addy to Phalon colleague predicting "*historical margins will [not] hold up….*").

[68] B1772 (2013 email from W.Addy to Eastin describing "*The Fade*" as part of litigation strategy).

[69] A296; A304-06.

[70] A305; A312-14. *See generally* B0047-50; B0214-18.

Consistent with that evidence, the "fade" was not reflected in ISN's budget at the time of the merger.[71]

2. ISN's Working Capital "Adjustment" Was A Post-Merger Accounting Device Employed To Make ISN's Cash "Disappear."

The trial court rejected ISN's attempt to "adjust" (*i.e.,* arbitrarily increase) ISN's post-merger working capital requirements because ISN had no need for working capital before the merger.[72] Historically, the Company's annual cash collections had always been more than sufficient to cover operating expenses, turn a profit, and generate substantial excess cash. The cash on ISN's balance sheet was excess, and thus, was never needed to fund its operations or growth. That excess cash was evidenced by the fact that, instead of distributing excess cash as dividends, Bill Addy created a substantial cash "*Buyout and Litigation Reserve*" that was never used to fund operations, but rather was reserved to be used to someday purchase Ad-Venture's shares.[73] ISN's stable business model (pre-paid, non-refundable software subscriptions) did not indicate that ISN would suddenly develop needs for additional working capital.[74]

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[71] EBITDA margin increased from 20.1% in 2012 to 24.3% in 2013 based on the 2013 budget. A784; B1918.

[72] Op. *14 & n.47, A310.

[73] A337; A387; *accord* A182.

[74] Op. *14 & n.47, A310.

At trial, ISN presented a phantom working capital requirement premised on the false presumption that ISN had a large and growing deferred revenue liability against which it needed to reserve cash. That liability, however, ***never existed*** and was not a part of ISN's operative reality at the time of the merger—a fact plainly illustrated by the absence of such a liability on the cash-basis financial statements contained in the "Supplemental Documentation" provided to the minority stockholders when ISN informed them of the merger and their appraisal rights.[75]

To the contrary, the evidence showed that ISN's deferred revenue liability was merely an accounting construct introduced when ISN converted to GAAP after the merger and Bill Addy attempted to mislead the minority by claiming that such conversion would "***reduce the DCF value of ISN*** *and the Deferred Revenue Liability* ***will eliminate any excess cash*** *added back to the value of a share*."[76] ISN's expert, who never analyzed ISN's actual working capital needs, simply accepted Bill Addy's direction and created a working capital assumption based on an analysis of five public companies that had nothing to do with ISN but selected specifically because he found that they had large deferred revenue liabilities.[77]

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[75] B2942-44; *accord* A280 ("[*W]e had never put a deferred revenue liability on our balance sheet because we were doing cash financials.*").

[76] B1721 (emphasis added).

[77] A631; A431; A432.

Thus, the evidence contradicted ISN's analysis that the Company would require any additional working capital, much less a working capital account equal to 12% of revenue, as ISN now insists.[78] In sum, as ISN's CFO testified, the Company had "*no significant capital needs to grow*."[79]

3. ISN's Valuation Is *Prima Facie* Unreasonable.

As an indication of just how much value ISN stripped out of its DCF analysis through its working capital "adjustment" and other accounting sleight-of-hand, *ISN's expert projected that the Company's cash flow would drop* from $17.9 million in 2012 to just $11.3 million in 2013—*even though he was simultaneously projecting an increase in revenue* of nearly $12 million and no material increase in expenses.[80] Even ISN's CFO testified that it would be "***crazy to see***" any kind of decrease in cash flow in 2013—let alone one of the magnitude that ISN's expert was forecasting.[81] Furthermore, ISN's expert's projected cash flow for the remainder of the projected period never returns to anywhere near pre-merger levels.

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[78] *See, e.g.*, A183.

[79] A382, A387; A391.

[80] *Compare* A663 (2013 net cash flow of $11.3M), *with* B1638 (2012 net cash flow of $17.9M).

[81] A391.

The cumulative effective of ISN's adjustments was a DCF analysis that yielded a fair value of only $100 million—well below the back-of-the-envelope valuation that Bill Addy used to set the merger price ($138.5 million)—using a process that the trial court described as "clearly improper" and one that "cannot satisfy a duty of care for a fiduciary"[82]—and well below the stale 2011 Phalon Valuation ($127 million) that the controlling stockholder used as his baseline for setting the merger price. ISN's valuation conclusion is patently unreasonable in light of the sustained, significant, and uncontroverted growth ISN experienced in 2011 and 2012, and its contemporaneous projections for 2013.

H. <u>ISN Moved For Reargument on Every Valuation Issue.</u>

ISN moved for reargument on virtually every issue, including the trial court's decision to include ISN's operating cash in the valuation, the calculation of the cost of equity, the accounting for working capital, the alleged failure to consider prior transactions, and the award of interest to Ad-Venture. The trial court rejected each of ISN's arguments.[83]

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[82] Tr. (Rearg. Hr'g) *30.

[83] Tr. (Rearg. Hr'g) *90. Some of ISN's "reargument" theories were never raised at trial; most were simply a "rehashing" of arguments ISN had unsuccessfully presented below, and some even went so far as to undermine ISN's own expert's work.

ARGUMENT

I. THE TRIAL COURT PROPERLY ACCOUNTED FOR ISN'S WORKING CAPITAL.

A. Question Presented.

Whether the trial court properly rejected ISN's attempt to create a working capital requirement that did not exist at the time of the merger to strip all non-operating cash out of its DCF valuation model.

B. Standard of Review.

The trial court's determination of fair value in an appraisal proceeding "is accorded a high level of deference on appeal."[84] This Court reviews appraisal valuations under an "abuse of discretion" standard. The trial court can be found to have abused its discretion "only when either its factual findings do not have record support or its valuation is clearly wrong."[85] This Court will defer to the trial court's factual findings as long as they are supported by the record, "even if this Court might independently reach a different conclusion."[86]

ISN mistakenly argues that the trial court committed legal error subject to *de novo* review because the court, after reviewing all of the evidence, rejected ISN's

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[84] *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 219 (Del. 2010); *accord Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 34-36 (Del. 2005).

[85] *Golden Telecom*, 11 A.3d at 219; *M.G. Bancorp., Inc. v. Le Beau*, 737 A.2d 513, 526 (Del. 1999).

[86] *Golden Telecom*, 11 A.3d at 219; *Cede*, 884 A.2d at 35.

attempt to create a working capital requirement that did not exist prior to the merger. "It does not follow, however, that a trial court commits legal error every time it adopts a view of the evidence contrary to that held by the losing party."[87] As this Court recognizes, the trial court "enjoys the unique opportunity to examine the record and assess the demeanor and credibility of witnesses."[88] Here, the trial court did exactly that, and, after balancing testimony from competing experts regarding ISN's working capital requirements, rejected ISN's attempt to grossly inflate ISN's working capital needs and depress any DCF valuation.

C. Merits of the Argument.

ISN argues that "*the failure to adopt a working capital requirement is **the critical error** in the Opinion*." More specifically, ISN complains that the trial court refused to accept ISN's expert's view that the Company would need to retain enormous amounts of cash to maintain a "working capital" balance equal to 12% of its projected revenue.

The record established at trial, however, exposed the many infirmities in ISN's argument, beginning with the evidence that ISN had never reserved any funds for working capital—let alone cash sufficient to bring its net working capital to 12% of projected revenue.

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[87] *Rapid Am. Corp. v. Harris*, 603 A.2d 796, 802 (Del. 1992).

[88] *Id.* (citing *Kahn v. Household Acq. Corp.*, 591 A.2d 166, 175 (Del. 1991); *Ala. By-Products Corp. v. Neal*, 588 A.2d 255, 258-59 (Del. 1991)).

As a software subscription service, ISN carried no inventory and, because ISN's customer's pre-paid their subscriptions, ISN had no material accounts receivable.

Faced with that operative reality, ISN attempted to use a post-merger accounting change and "restated" (and unaudited) financial statements created nearly three years after the merger to create a working capital requirement that never existed. ISN's controlling stockholder tried to convince ISN's minority stockholders that such a change would eliminate the Company's excess cash from any DCF valuation. But, as the trial record showed, ISN had always been managed on a cash basis,[89] and the post-merger creation of a phantom working capital requirement was just one of the accounting tricks that ISN's controlling stockholder devised in an attempt to hide the enormous amounts of cash generated annually by ISN's business model to attempt to keep it out of any DCF valuation that would be used to value the minority's shares.[90]

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[89] A310-11.

[90] *See* B1721.

1. ISN Never Carried A Positive Working Capital Balance Before The Merger.

As defined by ISN's expert, "*[o]perating working capital equals operating current assets minus operating current liabilities*."[91] At trial, ISN's expert sourced that definition to a McKinsey & Company treatise:

> The components of *operating working capital* are current assets less current liabilities. *And current assets include operating cash, receivables, inventories*, and operating current liabilities include accounts payable, salaries and deferred revenue and other accrued short term liabilities.[92]

All of the experts—including ISN's—agreed that, at the time of the merger, even if ISN had been using deferred revenue accounting, ISN carried virtually no asset balances that would be included in *operating* working capital—because ISN had no inventory, no accounts receivable, and held minimal "*operating*" cash.[93]

ISN's had no material operating current assets because its business model required its customers to pre-pay a set-up fee and a non-refundable annual subscription fee for access to ISN's software,[94] and the cost of fulfilling those

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[91] A402-03, A442.

[92] A403; *accord* TIM KOLLER, ET AL., VALUATION 137-40 (5th ed. 2010); *see also Merion Capital L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896, *13 & n.119 (Del. Ch. July 8, 2013).

[93] A183; A247-48; A433; *accord* A311; B1732 (pre-merger financial statements).

[94] A242, A247; A310; *see also* B1916-18.

subscriptions was far below those cash collections.[95] That generated substantial "excess cash" every year leading up to the merger. Most of that cash was warehoused in a "*Buyout and Litigation Reserve*"[96] that was never needed (or intended) to fulfill subscriptions or to fund growth.[97]

In fact, ISN's working capital needs were so negligible that no one at ISN had ever even found it necessary to calculate or budget for the Company's working capital needs.[98] As ISN's CFO testified, ISN's working capital position as of the merger was "*very comfortable*," because ISN had "*no additional capital needs*," and "*no significant capital needs to grow*."[99]

Consistent with that evidence, Petitioners' experts determined that ISN "had not carried a positive working capital balance" prior to the merger and, in fact, had "persistent negative net working capital."[100] That did not come as a surprise—ISN's pre-paid, nonrefundable software subscription business model supported the conclusion that ISN had "no need to invest in working capital to fund future

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95 A247-48; B1985, B1943, B2027.

96 *See* B1726, B1729, B1732 (showing increasing reserve).

97 ISN's only operating liabilities were the limited portion of its bills, rent, payroll, taxes, and other expenses that temporarily accrued in a "payable" account (*e.g.*, "accounts payable" or "income tax payable"). A381; B2942-44; B3112-14.

98 A387.

99 A381, A387.

100 B2028; B2243.

revenue growth."[101] Thus, there was ample record evidence to support the trial court's decision that working capital should have no material effect on the Company's free cash flow.[102]

2. ISN Created A Litigation-Driven Working Capital Assumption Contrary To Its Operative Reality.

At trial, ISN attempted to rewrite history and presented a completely different picture of its working capital needs. To avoid valuing ISN's excess cash, Bill Addy changed ISN's accounting method from cash to accrual accounting a few weeks ***after*** the demands for appraisal were made. He then told the Petitioners that the impact of the accounting change would "***reduce the DCF value of ISN,*** *and the Deferred Revenue Liability* ***will eliminate any excess cash*** *added back to the value of a share*."[103]

Following that lead, ISN's valuation expert baked a false construct into his DCF model that posited that ISN would need to reserve all of its cash to offset a newly-created "deferred revenue liability"—based solely on the post-merger GAAP accounting scheme that did not exist on ISN's books as of the merger

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[101] B2172; *accord* B2091 ("ISN does not need and does not budget for additional working capital investment for its operations.").

[102] *See* B2090; *see also* B2243; B1943-2028; B2172.

[103] B1721 (emphasis added).

date—and, among other adjustments, reserve additional cash to maintain a working capital balance equal to 12% of annual revenue.[104]

ISN's treatment of working capital was a major focus of the expert reports, briefing, and trial testimony. After balancing that testimony and other evidence, the trial court rejected ISN's construct and did not accept ISN's annual cash flow "adjustment" for incremental additions to working capital that would siphon the excess cash out from the DCF model.[105] In doing so, the trial court considered and rejected each of ISN's result-oriented attempts to reserve non-operating cash, including finding that ISN's proposed annual cash flow adjustment for incremental working capital must be "remove[d]" because it was based on the working capital

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[104] In order to achieve Bill Addy's goal to "*reduce the DCF value of ISN*" and "*eliminate any excess cash added back to the value of a share*," ISN's expert claimed that it was necessary to reserve—(1) all of the non-operating cash on ISN's balance sheet, including the litigation reserve and the tax refund; plus (2) all of the cash booked to deferred revenue on ISN's post-merger GAAP financial statements; plus (3) additional cash equal to 12% of incremental annual revenue—all under the rubric of a "*working capital adjustment*." In other words, ISN's view of working capital was built on its own post-merger reconstruction of its financial statements in which it attempted to convince the minority stockholders (and later, the trial court) that ISN needed to reserve more than $75 million in cash in 2013, increasing to more than $120 million in the residual period, all to satisfy a working capital requirement that did not exist on the merger date. ISN has not addressed the trial court's rejection of its treatment of non-operating cash, the tax refund, or deferred revenue, and has therefore waived any claims of error on appeal. Supr. Ct. R. 14(b)(vi)A.(3).

[105] Op. *14-15 & nn.47-50.

needs of non-comparable companies, rather than any evidence of ISN's actual needs.[106]

The trial court's decision not to accept ISN's additional annual "adjustment" for incremental working capital was well-supported by the record; the evidence showed that no such adjustment was necessary in light of ISN's historical working capital requirements and operative reality on the merger date. ISN's claim that the trial court made a "*critical error*" in rejecting ISN's "*working capital adjustment*" is based on no error at all. After considering the record and determining that ISN's expert's adjustment was not supported by any evidence, the court properly refused to adjust ISN's actual working capital needs.

3. There Is No Record Upon Which To Set Working Capital "*In The Range Of 2% to 18% Of Revenue*."

ISN argued below that the trial court should set a working capital requirement of 12% of revenue.[107] Period. It never argued that a different requirement "*in the range of 2% to 18%*" was appropriate.

ISN's new claim on appeal that the trial court should have set a working capital requirement "*in the range of 2% to 18% of revenue*"—a spread of more than $15 million in 2013—merely illustrates the absence of any evidence in the trial record that would support creating a post-merger need for working capital that

[106] Op. *14 & n.47.

[107] A831-38; A894-905.

never existed pre-merger.[108] ISN's witnesses, including its expert, testified that they did not examine what ISN's ***actual*** working capital requirements were prior to the merger. In fact, ISN's CFO admitted that, at the time of the merger, no one at ISN had ***ever*** analyzed the Company's working capital requirements.[109]

ISN's expert ignored ISN's ***actual*** needs, and testified that he determined ISN's working capital requirements at the time of the merger by selecting a set of public companies (different from the companies he selected for his GPC analysis) based on their substantial deferred revenue liabilities and, at least initially, from a study from PricewaterhouseCoopers LLP, to create an ***estimate*** of ISN's working capital needs.[110] Neither ISN nor its expert ever provided the trial court with a basis to determine ISN's ***actual*** working capital needs (if any) at the time of the merger, when the Company was managed on a cash basis and admitted that it made no provision for working capital.[111]

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[108] With projected revenue of $97.6 million in 2013 building to $164.4 million in the terminal year, *see* AOB Ex. 5, line A, a "*range of 2% to 18% of revenue*" is a significant disparity: between $2.0 million and $17.6 million in 2013 increasing to between $3.3 million to $29.6 million in the terminal year.

[109] A387.

[110] A431, A433-34.

[111] As of the merger, ISN carried, at most, $2.5 million in cash for operations. B1732; A302. Most of the substantial cash ($47 million) ISN had accumulated over the years was in the reserve that Bill Addy testified he intended to use for

(Continued . . .)

For those reasons alone, the trial court was justified in rejecting as baseless ISN's litigation-driven working capital "adjustment" to swallow cash amounting to both the change in the Company's deferred revenue account ***and*** an additional 12% of the growth in revenue in each period.

4. The Trial Court's Valuation Does Not Render ISN Insolvent.

ISN's argument that the trial court's decision to refuse to accept its working capital adjustment would result in a large negative working capital balance that would render the company insolvent is both hyperbolic and incorrect. First, contrary to the statements in ISN's brief, the trial court did not "*subtract large amounts of working capital*" from the DCF.[112] Instead, after reserving $13.4 million in cash as operating cash,[113] the trial court removed ISN's annual cash flow "adjustment" for working capital from its DCF model because it did not accept

(. . . continued)
cashing out the minority stockholders. A286, A302; *see also* B1726, B1729, B1732 (showing "Buyout and Litigation Reserve" building to $34 million).

[112] It is unclear why ISN bases its argument on the false notion that the trial court made an adjustment that the court expressly stated it did not accept. Op. *14 n.47. Nevertheless, ISN's brief and newly-minted exhibits incorrectly label the annual cash flow adjustment necessary to account for the change in deferred revenue as an adjustment for "Incremental Working Capital." AOB at 16-17 & Ex 1, line M; *see also* AOB Ex. 2, line C; Ex. 4, line M; Ex. 5, line C.

[113] ISN had $47.4 million in cash and marketable securities on hand at the time of the merger. B1635. The trial court determined that $34 million of that cash was a distributable, non-operating asset. Op. *14-15 & n.50.

ISN's decision to create a new working capital requirement equal to 12% of projected revenue.[114] The trial court properly retained the adjustment for the change in the Company's deferred revenue account in each period because that basic adjustment is necessary to ensure that the DCF values ***all*** of the cash collected by the Company, regardless of when the revenue is recognized for accounting purposes.

ISN's exaggerated conclusion is only possible if the trial court had accepted the false assumptions and bag of accounting tricks that ISN relied upon during trial. The trial court properly rejected those assumptions and accounting machinations, and held that the cash ISN's expert had stripped out of his DCF model had to be valued.[115] After removing the post-merger accounting devices that ISN proffered to the trial court as a way to drain excess cash and "*reduce the DCF value of ISN*," ISN is left with the same working capital that it had as of the time of the merger.

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[114] Op. *14 & n.47.

[115] Op. *14-15 & nn.47-50. Specifically, the trial court rejected ISN's claim that the change to GAAP accounting required ISN to reserve all of its non-operating cash, all the cash booked as deferred revenue each year, and additional cash equal to 12% (2% on appeal) of ISN's annual revenue—all to satisfy a newly-created post-merger working capital need. The trial court thus recognized that a DCF must include a proper reconciliation to free cash flow by adding back the change in the deferred revenue account, *i.e.*, the amount by which the Company collected cash in excess of its revenue under GAAP-based accounting. ISN does not address that decision in its appellate brief and has waived any claim of error on that issue. *See supra* note 104.

ISN's claim that "*negative working capital*" is a calamity is belied by basic corporate finance and its own reality. Despite years of significant negative working capital balances, ISN never had to take on debt for any reason, let alone to help cover operational expenses. The Company experienced rapid growth and increased profitability every year, and was always awash in excess cash generated by its pre-paid, high-margin, non-refundable subscription business. Indeed, the trial record showed that cash collections each quarter from 2009 through the merger date were always more than sufficient to cover the Company's operational expenses, support continued growth, and build excess cash.[116] ISN never in its history "*had to draw down on th[e] litigation and buyout reserve to fund operations*,"[117] and the Company's excess cash balance increased by millions of dollars each year.

ISN's argument that "*[t]he 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*" suffers from the same fundamental misconception that leads its other arguments to failure. Although it is true that the trial court's forecast shows that ISN had more ***distributable*** cash than it was projected to earn, that fact is irrelevant to a DCF valuation.

[116] B3015-40 (ISN Ratio Analysis showing allocation of cash to expense and the remaining percentage classified as "Net Income").

[117] A337.

The DCF method values a company on its **cash flows**, not its GAAP net income.[118] For a company like ISN, which always collected millions of dollars more in cash than it "earned" under GAAP accounting, reconciling the Company's GAAP income to its free cash flows is a critical step in any DCF valuation.[119] At trial, both Petitioners' experts and ISN's CFO testified that it was necessary to make such an adjustment to ISN's GAAP income to reconcile it to the Company's actual cash flow (*i.e.*, to add back the increase in deferred revenue that ISN inexplicably converted into a working capital adjustment following the merger).[120]

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[118] *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, *18 (Del. Ch. Dec. 31, 2003) (DCF is "based on free cash flow, not income, as measured by [GAAP] or the [IRS]"), *rev'd in part on other grounds* 884 A.2d 26 (Del. 2005).

[119] *See*, *e.g.*, *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726, *22 (Del. Ch. Jan. 30, 2015) (appropriate to add deferred revenue back "to adjust accounting data to cash flow data").

[120] A390-91; A178; A266-67.

Although free cash flow in excess of NOPAT is not problematic, ISN mischaracterizes the 2013 free cash flow implied by the Opinion, presumably for hyperbolic effect. ISN's inflated number of $54,489,062 can only be attained by adding all of the non-operating assets that existed on ISN's books at the time of the merger. *See* AOB at 14, 17 & Ex. 2, line I. However, neither the trial court nor any of the three financial experts who testified at trial—including ISN's—treated those assets as cash flow adjustments to ISN's free cash flow. *E.g.* A619 & A663 (adding undiscounted "Non-Operating Assets" to "Sum of Present Value"). Instead, each of Petitioners' experts and the trial court properly accounted for that cash by treating it in the exact same manner as ISN's Board had at the time of the merger: as non-operating excess cash that should be added to the DCF value. *See* B1791; B2132.

Indeed, prior to 2008, ISN's excess cash was routinely distributed to its stockholders in the form of dividends; in the ensuing years, the excess cash ramped up the Buyout and Litigation Reserve.[121] The Company's excess (distributable) cash is also evidenced by the fact that, following the appraisal demands, the controlling stockholder resumed paying substantial dividends—paying more than $20 million to himself and his fellow insiders in 2015 alone—without regard for any phantom working capital requirement.[122]

For similar reasons, ISN's argument that the distribution of free cash flow results in "*significantly negative shareholders' equity*" is a red herring. The accounting concept of retained earnings has nothing to do with the cash flows valued in a DCF valuation.[123] There is no law or valuation rule stating that an asset must be wholly disregarded for the purposes of a DCF analysis because its hypothetical distribution might leave a company with negative retained earnings, and ISN cites none.

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[121] A286; A218.

[122] A387; A286-87, A312. Bill Addy received $16 million of the $20 million distributed and also received a $10 million loan from the Company. A312.

[123] A178; *see also* JOHN D. STOWE, ET AL., EQUITY ASSET VALUATION 113-16 (2007) ("recognizing a distinction between "free cash flow and accounting measures of income" for DCF valuation purposes, including that noncash charges must be added back to arrive at free cash flow).

In sum, there is no credible basis for ISN's argument that "*the Trial Court's valuation methodology contemplated that ISN will run itself out of business within ten years*" because there is no need to reduce ISN's cash flows to account for Bill Addy's phantom post-merger working capital need.

II. THE TRIAL COURT PROPERLY CALCULATED ISN'S COST OF CAPITAL.

A. Question Presented.

Whether the trial court properly determined ISN's cost of capital using the CAPM methodology to calculate ISN's cost of equity, where the record demonstrated that: (a) ISN's expert (and both other experts) utilized CAPM to calculate ISN's cost of equity; (b) ISN conceded that there was no dispute as to the beta used in that calculation; and (c) ISN's build-up method analysis was flawed.

B. Standard of Review.

This Court reviews the trial court's selection of the inputs to be used in a discounted cash flow analysis for abuse of discretion.[124] In an appraisal proceeding, the trial court abuses its discretion "only when either its factual findings do not have record support or its valuation is clearly wrong."[125]

C. Merits of the Argument.

1. The Trial Court Properly Utilized CAPM To Calculate ISN's Cost of Capital.

ISN's claim of error is built on the extraordinary claim that the trial court abused its discretion by using an uncontested beta determined by ISN's own expert to calculate ISN's cost of equity and that, even though all three valuation experts

[124] *Cede*, 884 A.2d at 34-36; *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 795 (Del. 1999).

[125] *See supra* Section I.B.

used the capital asset pricing model ("CAPM"), the trial court committed reversible error by performing the same analysis.[126] The evidence shows that the Court below did not err in its application of CAPM.

First, ISN is judicially estopped from contesting the appropriateness of its own expert's determination of beta and use of CAPM.[127] Here, not only did ISN urge the court to adopt the beta and CAPM calculations performed by its expert, it repeatedly conceded that there was "no significant debate as to beta" and that "the only real difference in the CAPM between experts is the size premium."[128]

Second, the trial court did not abuse its discretion by using CAPM to determine ISN's cost of equity while also finding "the GPC method less reliable than a DCF to determine ISN's fair value." The trial court's conclusion that it could use CAPM even though the GPC valuation method was not sufficiently reliable to set ISN's fair value is well-supported by Delaware law.[129]

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[126] The trial court determined that ISN's weighted average cost of capital was 10.46% based on its calculation of ISN's cost of equity. Op. *15. Calculating ISN's cost of debt was unnecessary because ISN had no debt. Op. *15 n.52.

[127] *See Motorola Inc. v. Amkor Tech., Inc.*, 958 A.2d 852, 859-60 (Del. 2009) (Judicial estoppel "prevents a litigant from advancing an argument that contradicts a position previously taken that the court was persuaded to accept as the basis for its ruling.").

[128] A839; A1024.

[129] *See*, *e.g.*, *Gilbert v. M.P.M. Enters., Inc.*, 709 A.2d 663, 668, 673 (Del. Ch. 1997), *aff'd*, 731 A.2d 790 (Del. 1999); *see also In re Orchard Enters., Inc.*,

(Continued . . .)

Third, ISN's insistence that the build-up method is a viable alternative for calculating the cost of equity simply ignores the sound reasons that the Court of Chancery previously has rejected the build-up method.[130] As the court has explained, "[t]he build-up method is a method larded with subjectivity, and it incorporates elements that are not accepted by the mainstream of corporate finance scholars."[131]

Fourth, ISN's expert's application of the build-up method is inconsistent with the trial court's findings and is riddled with errors. For example, ISN never acknowledges that its calculations using the build-up method are inflated by its expert's inclusion of an unjustified company-specific risk premium and an inflated industry risk premium—exactly the type of subjective adjustments that the court has cautioned against.

For all of those reasons, the trial court was well within its discretion to utilize the CAPM method and an uncontested beta to calculate ISN's cost of equity, and to reject ISN's calculation based on the build-up method.

(. . . continued)
2012 WL 2923305, *10, 16-18 & n.116 (Del. Ch. July 18, 2012), *aff'd*, 2013 WL 1282001 (Del. Mar. 28, 2013).

[130] *E.g.*, *Orchard*, 2012 WL 2923305, *2-3, 17.

[131] *Id.* *2.

2. The Trial Court Properly Selected A Size Premium.

ISN argues that the trial court's selection of a size premium of 2.46% was erroneous because the trial court did not blindly follow the Ibbotson decile table. But not even the cases ISN cites support such a stilted interpretation of the law. To the contrary, in those cases, the court recognized the "circularity problem inherent in valuing companies with unknown market capitalizations" that requires the court to exercise its discretion when selecting an appropriate size premium.[132] The court may properly exercise its discretion to "adjust a company's size premium where sufficient evidence is presented to show that the company's individual characteristics make it less risky than would otherwise be implied under its corresponding Ibbotson decile based on size alone."[133]

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[132] *In re Appraisal of DFC Global*, 2016 WL 3753123, *13 (Del. Ch. July 8, 2016); *In re Sunbelt Beverage Co. S'holders Litig.*, 2010 WL 26539, *11 (Del. Ch. Feb. 15, 2010).

[133] *Gerreald v. Just Care, Inc.*, 2012 WL 1569818, *12 (Del. Ch. Apr. 30, 2012); *see, e.g.*, *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1161 (Del. Ch. 2006) (applying size premium from decile 9, even though its fair value fell under decile 10, after finding that the company was less risky than other companies of its size); *Taylor v. Am. Specialty Retailing Grp., Inc.*, 2003 WL 21753752, *5, *6 & n.18 (Del. Ch. July 25, 2003) (applying size premium closer to decile 10a, even though its fair value fell under decile 10b, after finding that the company "share[d] more risk characteristics with companies in decile 10a than it [did] with companies in decile 10b ...").

The evidence presented at trial showed that ISN's cash flows faced considerably less risk than might otherwise be suggested by its size. ISN's business model, built upon pre-paid, non-refundable subscriptions, coupled with a consistent 90% customer renewal rate (even in the face of significant triennial price increases), demonstrated the inelasticity of the demand for ISN's product and the stability of its future cash flows, which ISN's President characterized as an "*annuity*."[134] The trial court recognized that stability, and properly adjusted ISN's size premium to account for ISN's lower risk profile.[135]

[134] B1567.

[135] *See* Op. *15 & n.51; Tr. (Rearg. Hr'g) at 79.

III. THE TRIAL COURT PROPERLY CONSIDERED AND REJECTED PRIOR TRANSACTIONS AS UNRELIABLE INDICATORS OF FAIR VALUE.

A. Question Presented.

Whether the trial court properly determined that prior transactions were unreliable indicators of the fair value of ISN, after reviewing the evidence and finding, *inter alia*, that: (i) ISN is a privately-held, controlled company with illiquid stock; (ii) the sales prices were not determined using complete and accurate information; (iii) the transactions involved complex and incompatible forms of consideration that were difficult to value; and (iv) the nature of the transactions made it unlikely that they reflected fair value.

B. Standard of Review.

The standard of review of the trial court's determination as to which valuation method to use in determining fair value is "abuse of discretion." ISN's claim of legal error supporting *de novo* review improperly conflates the requirement to ***consider*** prior transactions as one of the "factors and elements which reasonably might enter into the fixing of value"—which the trial court did—with an obligation to give prior transactions ***weight*** in its analysis—which it appropriately did not.

It is well-settled that the weight that the trial court affords to any particular factor is a matter firmly within the trial court's discretion.[136] The trial court abuses its discretion "only if its factual findings do not have support in the record or its valuation is clearly wrong."[137]

C. Merits of the Argument.

The trial court considered the Polaris and Gallagher transactions and found "that the characteristics of [ISN] and its stock, along with the nature of the prior transactions, are fatal to the reliability of the resulting sales price," and thus, determined that such transactions were entitled to no weight in a fair value determination.[138] The court specifically found that the record showed that ISN was "a privately-held company, controlled by Bill Addy, with stock that does not regularly trade; in other words, the Company's stock is illiquid." Those

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[136] *Le Beau*, 737 A.2d at 524 (applying abuse of discretion standard in affirming reliance on single methodology to exclusion of all others).

[137] *See supra* Section I.B.

[138] Op. *10. In a footnote, ISN claims that it "continues to believe that the Gallagher Industries Transaction should be considered in determining the fair value of ISN …," but fails to include any argument that the trial court abused its discretion in rejecting that transaction as a reliable indicator of fair value. Op. *9-11. Accordingly, any such argument is waived. Supr. Ct. R. 14(b)(vi)A.(3).

characteristics alone are a sufficient basis for the trial court to have rejected the prior transactions as indicators of fair value.[139]

In addition, the trial court found, based on ample record support, that the essential terms of the transaction were determined two years prior to the merger without complete and accurate information,[140] that the stock was not shopped to multiple buyers, and that, in selling a portion of its minority position to Polaris, Ad-Venture was not focused on maximizing the sales price.[141] Although ISN argues that the stock was shopped and that Ad-Venture did not obtain liquidity in those sales, the trial court's findings were well-supported by evidence in the record, and the incontrovertible factors (including the information disparity)

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[139] *E.g. Gesoff*, 902 A.2d at 1154 ("[R]eliance on a price determined in a thinly traded, illiquid, market is evidence of a price's unfairness."); *Seagraves v. Urstadt Prop. Co.*, 1996 WL 159626, *7 (Del. Ch. Apr. 1, 1996) ("To be reliable, market price must be established in an active market.").

[140] Op. *11 & n.41. For example, in November 2011, Bill Addy testified that Ad-Venture had not received financial information for ISN since 2008 and *did not have the information necessary to accurately value its ISN stock*. B1561. Even after ISN ultimately provided Polaris with financial information (pursuant to a court order following the books and records action), that information did not include the 2011 Phalon Valuations (or a previous Phalon valuation from 2008), or other key valuation materials.

[141] Op. *10-11. *See* A219-20; B3052, B3057 (testifying that, after years of tension, Brian Addy was eager to have an "adult in the room"—*i.e.*, an institutional investor that could act as a buffer—whose only interest would be to facilitate growth to increase the value of ISN's stock).

provide more than ample reason to reject the prior transactions because they are not indicative of fair value.[142]

Finally, the trial court also found that both prior transactions involved complex and incompatible forms of consideration—such as financial options, guarantees and unique and illiquid real estate—that were difficult to value.[143] That reason alone supports a finding that such exchanges were not reliable indications of value.

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[142] *E.g. Sunbelt*, 2010 WL 26539, *6 (finding transaction that closed within weeks leading up to merger was not reliable evidence of fair value because "the terms of the transaction were controlled by an agreement negotiated and signed *three years earlier*").

[143] Op. *11.

IV. THE TRIAL COURT CORRECTLY DETERMINED THAT AD-VENTURE IS ENTITLED TO PRE-JUDGMENT INTEREST.

A. Question Presented.

Whether the trial court properly determined that Ad-Venture is entitled to an award of prejudgment interest pursuant to 8 *Del. C.* § 262(h), which directs the payment of interest to appraisal petitioners from the effective date of the merger through the date of payment of the judgment.

B. Standard of Review.

This Court applies *de novo* review in an appraisal proceeding only "to the extent that the trial court's decision implicates the statutory construction of [Section 262]."[144] Here, although ISN frames its argument that Ad-Venture is not entitled to pre-judgment interest as a policy question of first impression, ISN ignores the fact that, in the court below, it conceded that the award of interest is at the discretion of the trial court—it did not argue that interest should be prohibited by the statute.[145] Thus, this Court should review the award of interest under the "abuse of discretion" standard.[146]

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[144] *Golden Telecom*, 11 A.3d at 216-17.

[145] A1102; A867; *accord* A945.

[146] *Cede*, 884 A.2d at 41-42; *Montgomery Cellular Hldg Co. v. Dobler*, 880 A.2d 206, 226 (Del. 2005).

C. Merits of the Argument.

The trial court did not err in awarding pre-judgment interest to Ad-Venture. Section 262(h) provides:

> ***Unless the Court in its discretion determines otherwise*** for good cause shown, and except as provided in this subsection, ***interest from the effective date of the merger through the date of payment of the judgment*** shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during the period between the effective date of the merger and the date of payment of the judgment.[147]

Section 262(h) provides a "simple default rule"— an appraisal petitioner "shall be awarded interest from the date of the merger through the date of payment of the judgment."[148] There is no exception for stockholders who were not forcibly cashed-out, but were nonetheless entitled to seek appraisal pursuant to Section 262.

Thus, the trial court did exactly what Section 262(h) required, and what ISN argued below: it determined whether good cause existed to exercise its discretion to deny Ad-Venture the interest prescribed by the appraisal statute.[149] Finding no such cause, there is no legal error in the trial court's award of interest; the plain language of the statute affords no other interpretation.

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[147] 8 *Del. C.* § 262(h) (emphasis added).

[148] *In re Appraisal of Metromedia Int'l Grp.*, 971 A.2d 893, 907 (Del. Ch. 2009).

[149] Op. *15-16.

To the extent that ISN now believes that such a construction of Section 262(h) is incorrect as a matter of law, it failed to raise that issue below. ISN argued that Ad-Venture's right to interest under the statute was a matter committed to the trial court's discretion.[150] Accordingly, ISN has waived any argument that a different construction of Section 262(h) should apply.[151]

Even if ISN had properly preserved a claim of legal error, the distinction for which it advocates is not supported by the plain language of Section 262(h). Time and again, this Court has rejected invitations to alter the plain language of a statute.[152] "[W]here the intent of the legislature is clearly reflected by unambiguous language in the statute, the language itself controls."[153]

Moreover, the case law cited by ISN cannot mean that the court below should have applied a different rule in this circumstance. The appraisal statute does not—now or ever—condition payment of prejudgment interest on anything

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[150] ISN argued in briefing and on reargument that the trial court should "***exercise its discretion*** in favor of denying Ad-Venture statutory interest" due to "Ad-Venture's choice not to maintain its investment position in ISN." A1102; A867; *accord* A945.

[151] *Huatuco v. Satellite Healthcare*, 93 A.3d 654 (Del. 2014) (TABLE); Supr. Ct. R. 8 ("Only questions fairly presented to the trial court may be presented for review….").

[152] *See*, *e.g.*, *Bd. of Adjustment of Sussex County v. Verleysen*, 36 A.3d 326, 332 (Del. 2012); *Leatherbury v. Greenspun*, 939 A.2d 1284, 1291 (Del. 2007).

[153] *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485, 494 (Del. 2000) (internal quotation omitted); *accord Zhurbin v. State*, 104 A.3d 108 (Del. 2014).

but the proper perfection of an appraisal demand[154]—which is not disputed here. The statute provides interest to compensate the stockholder for the use of its capital during the appraisal process, when the stockholder's claim becomes debt, not equity, and the company has the use of the money that will later be paid following the determination of fair value.[155]

That principle is illustrated here. Following its demand for appraisal, Ad-Venture was not treated as an equity holder, and did not participate in the substantial dividends Bill Addy made to insiders after the minority submitted their shares for appraisal.[156] None of those dividends were paid to—or even offered to—Ad-Venture. In addition, the extended period for the resolution of the Petitioners' demands for appraisal is attributable primarily to ISN's sanctionable discovery tactics. ISN should not be rewarded for such behavior with a waiver of the interest provision of the appraisal statute.

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[154] *See* 8 Del. C. § 262. The appraisal statute was enacted to provide a remedy for stockholders who, through statutory changes, lost the common law right to prevent a merger. *Schenley Indus., Inc. v. Curtis*, 152 A.2d 300, 372-73 (Del. 1959).

[155] *Gholl v. eMachines, Inc.*, 2004 WL 2847865, at *18 (Del. Ch. Nov. 24, 2004) ("An award of interest serves two purposes. It compensates the petitioner for the loss of use of its capital during the pendency of the appraisal process and causes the disgorgement of the benefit respondent has enjoyed during the same period."), *aff'd* 875 A.2d 632 (Del. 2005).

[156] A387; A286-87, A312. ISN paid out more than $20 million in cash distributions to its stockholders—including $16 million to Bill Addy—in 2015 alone.

V. THE TRIAL COURT BASED ITS VALUATION ON REVENUE AND EXPENSE PROJECTIONS THAT WERE NOT SUPPORTED BY THE RECORD.

A. Question Presented.

Whether the trial court erred by adopting revenue and expense projections that arbitrarily reversed ISN's historical performance based on its controlling stockholder's unsubstantiated valuation theories.[157]

B. Standard of Review.

This Court reviews the trial court's factual findings for abuse of discretion. The trial court abuses its discretion when its factual findings are not supported by the evidence.[158]

C. Merits of the Argument.

1. ISN's Revenue Projections Were Not Supported By The Evidence.

The trial court abused its discretion by accepting ISN's expert's "assumptions regarding ISN's future cash collections."[159] Those assumptions, which reversed ISN's consistent growth in new contractor subscriptions (the primary driver of ISN's revenue) resulted in artificially depressed cash collections and revenue projections that lowered the court's fair value conclusion.

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[157] This issue was preserved at B40-52; B199-210.

[158] *Golden Telecom*, 11 A.3d at 217.

[159] Op. *14 n.46.

As the trial court acknowledged, ISN "had generally experienced substantial growth in the years leading up to the Merger."[160] Indeed, the trial record was uncontroverted that, since ISN's formation through the merger date, its growth trajectory was both dramatic and sustained. ISN had consistently added increasing numbers of net new contractors since 2003, and was budgeting for contractor growth to continue in 2013, even after a 20% price increase in 2012.[161] ISN's cash collections, generated from pre-paid, non-refundable subscriptions, had increased more than ten-fold during the years preceding the merger. At trial, Bill Addy concisely summarized that extraordinary growth: "*there's only one company in the Russell 3000 that outperformed us over that time period.*"[162]

ISN's growth did not slow leading up to the merger. In the three preceding years, ISN's cash collections grew at a compound annual growth rate of approximately 34%, with collections continuing to grow "rapidly" in 2012 at a 45% growth rate.[163] ISN expected that growth to continue in 2013, budgeting that its subscriber base would continue to grow by 6,300 to 7,700 net new contractors

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[160] Op. *3 (citing A277; B1921-23).

[161] B1921-22; A290.

[162] A284; B1548-50.

[163] A289-90; B2066.

consistent with its trend, with cash collections of between $105 million to $110 million.[164]

The Petitioners' experts projected ISN's future collections based on the established trend of an increasing number of "net new" contractors each year.[165] ISN's expert, however, assumed an abrupt reversal of that trend.[166] In the three years prior to the merger, ISN had added an average of 7,300 net new contractors, yet ISN's expert projected that ISN would add only 6,400 net new contractors in 2013, and then inexplicably would slow to just 5,300 net new contractors in 2014 and decrease each year thereafter.[167] ISN also projected that its net new contractor growth would flatten out to pre-2008 levels—*i.e.*, less than 5,000 contractors a year—resulting in projected collections and revenue that were far below ISN's operative reality.[168]

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[164] B1666.

[165] A176, A212; B2081-82. Polaris's expert used a regression analysis to observe the net new contractor growth trend over five years prior, smoothing out the trend and then carrying it forward through his projection period. A212; B2081-82. Similarly, Ad-Venture's expert based his projections on ISN's net new contractor growth over seven years prior, the 2013 budget, and the 2013 business development goals. B2006-07, B1974.

[166] A714; A620-25; A710.

[167] A620-25; A710.

[168] A620-25; A710.

There is no support in the record for reversing ISN's growth trend at the rate implicitly adopted by the trial court. At trial, ISN tirelessly argued that its pessimistic projections were defensible because the percentage growth ***rate*** of net new contractors was decreasing, but that was a red herring. Although any growth rate would inevitably decrease as the total number of contractors increased, that does not imply that the business would be adding fewer customers per year or slow its real growth. ISN could not deny that the actual number of new contractors had steadily increased since 2003 and were budgeted to continue to increase in 2013.[169] The court properly did not accept ISN's argument on that point, but allowed that false assumption to taint its DCF by implicitly incorporating ISN's expert's revenue projections when it used that model as the starting point for its DCF analysis. That was contrary to the record evidence, as even ISN's expert admitted Ad-Venture's revenue projections (not his) exactly tracked ISN's pre-merger data.[170]

The only evidence that either ISN or its expert offered in support of their artificially depressed revenue projections was ISN's internal prognostication that it believed that it was faced with increasing competitive pressure, and that ISN had

[169] A283; B1664-69.

[170] A422; A710.

reached a point of market "saturation."[171] But the trial record demonstrated that ISN's self-serving pessimistic forecasts[172] were only speculative theories that were not supported by any evidence.

The evidence showed that ISN had never tracked or analyzed its competition.[173] ISN's expert admitted that he did no competitive analysis.[174] The only evidence presented at trial was from the personal, litigation-driven views of ISN's Executive Vice President (and post-merger stockholder), Brian Callahan, on a handful of ISN's purported competitors, which he admitted was based on research conducted during the month before the trial.[175] ISN's expert could not have relied on Callahan's testimony in formulating his revenue projections because he never spoke to Callahan.[176] Moreover, Callahan had not done his research prior to the submission of the expert reports, and recalled nothing about competitive

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[171] A598, A424.

[172] It should come as no surprise that ISN's expert report tracked exactly to ISN's controlling stockholder's strategy to project "*5,000 net new contractors each year*" so that ISN's long term growth would be "*capped*" at a wholly unsupported industry growth rate of 5%. B1772.

[173] A357; B3097.

[174] A424. A441.

[175] A351-52. A355.

[176] A431.

pressures when he was deposed nearly three years after the merger.[177] Nor was there anything in Callahan's testimony or any other evidence suggesting that ISN's competitive position had changed in any material way or was otherwise expected to increase above the levels that ISN had experienced prior to the merger—and thus no basis for ISN to project that its historic growth rates would plummet following the merger.

ISN's expert's assumption of market saturation is equally baseless. He admitted that he performed no saturation analysis. The only evidence he cited in support of his theory were a handful of stale "overlap analyses" from 2008 as to only two of ISN's clients—showing the percentage of those clients' contractors that were already in ISN's network—that did not establish saturation and preceded by five years ISN's record-breaking collections growth.[178]

In contrast, David Tamm, an expert with over 40 years of experience across almost every segment of the oil and gas industry, tested ISN's market saturation theory by conducting a total available market analysis for ISN.[179] Tamm presented ***unrebutted*** evidence of the universe of potential ISN clients and compared that to

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[177] A363-65; B3075, B3080.

[178] *See, e.g.*, A440.

[179] A142-43.

ISN's client base as of the merger.[180] His conclusion: there was no evidence of market saturation, as ISN had enormous opportunities for continued growth in its core oil and gas markets and other related industries.[181] Tamm was the **only** witness who performed this type of analysis for ISN.[182]

ISN's assumptions regarding its future cash collections were flawed in a further respect: its expert report grossly underestimated the effect of future price increases. ISN raised its prices by 50% in 2006, 32% in 2009, and 20% in 2012, yet still increased its contractor count (and corresponding cash collections) in each year following the price increases.[183] ISN's contractors had no choice but to renew their subscriptions in the face of these price increases. ISN's hiring clients required their contractors to be on ISN's network, so the contractors had to renew if they wanted to continue doing business with those hiring clients.[184]

Each of the three experts agreed that ISN would continue to raise prices on a three-year cycle, but ISN's expert assumed—without evidence—that ISN would implement lower price increases of just 9.9% (or 3.3% on an annual basis) in 2015

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[180] B1829; A149.

[181] B1805; A158.

[182] A424; A329; A362.

[183] B1654; B1922.

[184] A148, A176; Op. *13 (noting "ISN's subscription-based business model, its ability to retain customers, and the inelastic demand for its product").

and 2018.[185] That was not supported by the evidence. ISN's CEO Eastin testified that "*future price increases would be in line with past price increases*," and would be based on "*what the market will bear*."[186] The uncontroverted evidence was that the market would bear another 20% price increase in 2015 and 2018, just as it had supported a 20% price increase in 2012 without a meaningful uptick in customer attrition—indeed, Eastin admitted that ISN did not even bother to track customer churn in response to price increases.[187] Given ISN's established pricing power and dominant competitive position, ISN's assumption that it would limit its price increases to 9.9% every three years (little more than the rate of inflation) is not supported by the record.

2. ISN's Expense Projections Were Not Supported By The Evidence.

The trial court similarly abused its discretion by adopting ISN's expert's expense projections, which ISN's expert candidly admitted he simply "*backed into*" after selecting an EBITDA margin from "*comparable companies*."[188] Critically, despite ISN's conceded growth in the years leading up to the merger, which saw ISN's EBITDA margin increase *every year* since 2008, ISN's expert

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[185] A625.

[186] A323, A329.

[187] A329-33; B2256.

[188] A422-23, A424-25; A432-35.

projected ISN's margins would "fade" from 20.1% in 2012 to 15.0% in his terminal year.[189] Such a finding was unsupported by the trial record and constitutes an abuse of discretion.

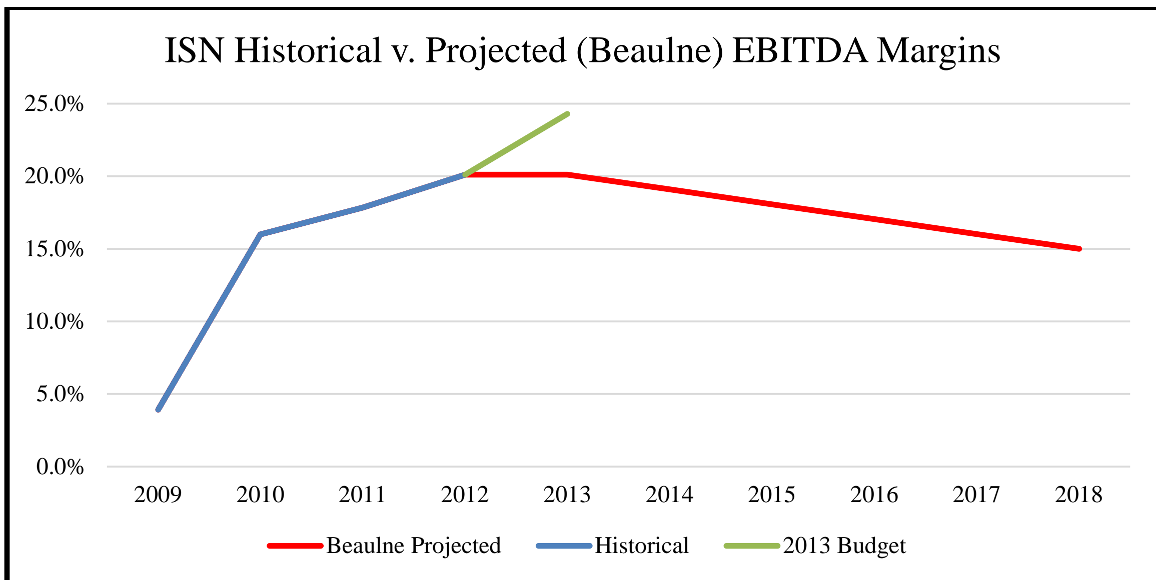
The evidence at trial showed that, at the time of the merger, ISN's EBITDA was growing at a compound annual growth rate of 142%, and its margins had expanded every year since 2008. In the four years leading up to the merger, ISN's EBITDA margin had steadily increased—from 3.9% in 2009 to 20.1% in 2012—and was budgeted to increase to 24.3% in 2013.[190] That margin growth was undisputed. The only drag on EBITDA at the time of the merger was the insiders' ever-increasing pay packages, unnecessary perquisites, and contributions to off-balance sheet charitable funds.

Nevertheless, although the trial court rejected the comparability of ISN's expert's selected companies, the court implicitly (and erroneously) adopted ISN's expert's expense projections by starting with ISN's DCF model. ISN's expert's approach arbitrarily reversed the upward trend in ISN's profitability, "fading"

[189] A400, A423.

[190] B1918 (calculating margin from budget); B2178. ISN's budgeted increase in EBITDA margin is further supported by the fact that only half of the 2012 price increase was recognized in 2012 under GAAP accounting, which defers 50% of ISN's cash collections to the following year. ISN's average cash margin for the period 2010 to 2012 was 29%. B2244-46.

ISN's margin to 15.0% over the course of the projection period.[191] As demonstrated on the chart below, slamming the brakes on ISN's rapid margin growth is inconsistent with ISN's operative reality at the time of the merger. Indeed, ISN's 2013 budget, indicated that ISN expected its EBITDA margin to continue to grow significantly in 2013, not to recede.



There is no support in the record for ISN's decision to reverse the course of history and arbitrarily "fade" ISN's profit margin. Instead, ISN's expert's conceded that he was aware of and ignored the evidence that ISN's historical margins were expanding year-over-year leading up to the merger and that ISN expected that trend to continue in 2013.[192] His explanation for doing so was nothing more than a repackaged theory that ISN's margins would eventually

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[191] A423.

[192] A400.

"*revert[] to the average of the overall industry of comparable companies*"[193]—a theory that ISN's controlling stockholder had been positing to drive down valuations of ISN since 2008, and which had never yet come true.[194] Indeed, like the cap on net new contractors discussed above, "*The Fade*" was nothing more than a strategy ISN's controlling stockholder had developed to artificially depress the DCF used in an appraisal action.[195] In fact, when faced with ISN's consistent growth in its EBITDA margin at trial, the controlling stockholder abandoned his "margin fade" theory.[196] The court should have rejected that assumption as well.

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[193] A400.

[194] A424; *see supra* notes 67-68.

[195] B1772.

[196] A305-06.

VI. THE TRIAL COURT OVERSTATED THE NUMBER OF SHARES ENTITLED TO APPRAISAL.

A. Question Presented.

Whether the trial court erred in setting the number of outstanding shares eligible for appraisal by including shares that did not have voting rights and were contractually restricted from dissenting from the merger and seeking appraisal.[197]

B. Standard of Review.

In a statutory appraisal proceeding, this Court applies *de novo* review "to the extent that the trial court's decision implicates the statutory construction of [Section 262]" or otherwise implicates a question of law.[198] This Court reviews the trial court's factual findings for abuse of discretion.[199]

C. Merits of the Argument.

At the time of the merger, 162 shares of ISN common stock (and options to purchase 552 shares) held by ISN employees and former employees were subject to mandatory, highly-restrictive stockholder agreements (the "Restricted Shares").[200] Among other restrictions, the Restricted Shares did not have independent voting rights (the stockholders' agreements granted an irrevocable

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[197] This argument was preserved at B71-73; B226-28.

[198] *Golden Telecom*, 11 A.3d at 216-17.

[199] *Id.* at 217.

[200] A249; B1964-66; B2201-02; *see*, *e.g.*, B2965-78 (Connelly Agreement); B2996-3011 (Eastin Agreement). *See generally* B1647 (Capitalization Table).

proxy to Bill Addy)[201] and were contractually obligated to accept the "fair market value" determined solely by the ISN board (*i.e.* Bill Addy).[202] In other words, holders of the Restricted Shares could neither dissent from the merger and seek appraisal under Delaware law nor receive the fair value for their shares of the Company as determined by a Court at any time in the future.[203]

At the time of the merger, ISN "*ha[d] established a practice of acquiring vested options from former employees when former employees request to exercise their vested options…*," fixed the redemption value of the Restricted Shares at $23,000, and calculated that, if all outstanding vested options were exercised, the Company would receive $4.4 million in proceeds.[204] This practice is reflected in ISN's "restated" (and unaudited) 2012 GAAP financial statements in which the company booked a liability of $729,666 related to 49.34 vested options held by former employees.[205]

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[201] *E.g.*, B2971; B3005-06.

[202] *E.g.*, B2972; B3001.

[203] *See In re Appraisal of Ford Hldgs, Inc. Pref'd Stock*, 698 A.2d 973, 974 (Del. Ch. 1997).

[204] B1641 ("A *stock option repurchase liability was recognized at the time of the termination of the former employees*."); B1647 (cost to exercise); *accord* A249; A287; A388-89; *see also* B1964-66; B2201-02.

[205] B1641. The 49.34 shares were therefore included both in ISN's fully-diluted share count and as a liability on its balance sheet—*i.e.*, they were improperly double-counted as both a liability and as equity. A389.

It is well-settled that shares subject to such restrictions are not counted in the denominator of the calculation of the per share merger price in an appraisal proceeding.[206] The trial court, however, improperly included those shares in its calculation of the per share price.[207]

The trial court's decision was an error of law. In light of the contractual restrictions on the Restricted Shares and the evidence relating to ISN's valuation of the Restricted Shares and redemption rights, the trial court should have accounted for the net liability related to the exercise and subsequent redemption of the Restricted Shares in its valuation,[208] then **excluded** those 714 shares of stock from the shares eligible for appraisal.[209] Thus, the denominator for determining the fair value per share should have been limited to the remaining 2900 shares of common stock that were eligible for appraisal.

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[206] *Ford*, 698 A.2d 973, 974 (Del. Ch. 1997) (shares subject to restrictions that preclude stockholders from receiving fair value in appraisal are not counted in denominator of appraisal equation); *Owen v. Cannon*, 2015 WL 3819204, *28 (Del. Ch. June 17, 2015) (same).

[207] Op. *15 & n.53.

[208] The maximum net liability related to the exercise and subsequent redemption of the Restricted Shares was $12 million, which amount should be treated as a non-operating liability and deducted from the indicated value of the DCF. B1965-66; *see also* B1970-71 (deduction for liability).

[209] At a minimum, the 49.34 shares actually booked as a liability must be excluded in ISN's fully-diluted share count. A389.

CONCLUSION

For the foregoing reasons, the decision by the trial court should be affirmed with respect to Arguments I through IV and reversed and remanded with respect to Arguments V and VI, with instructions for recalculating the fair value of ISN consistent with the opinion of this Court.

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April 10, 2017

CERTIFICATE OF SERVICE

I hereby certify that on April 20, 2017, the foregoing was caused to be served upon the following counsel of record via File & Serve*Xpress*:

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