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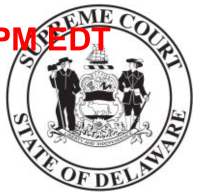

**IN THE SUPREME COURT OF THE STATE OF DELAWARE**

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| ISN SOFTWARE CORPORATION,<br><br>Respondent-Below, Appellant / Cross-Appellee,<br><br>v.<br><br>AD-VENTURE CAPITAL PARTNERS, L.P., POLARIS VENTURE PARTNERS FOUNDERS' FUND VI, L.P. and POLARIS VENTURE PARTNERS VI, L.P.,<br><br>Petitioners-Below, Appellees / Cross Appellants. | ) | No. 43, 2017<br>On Appeal from the Court of Chancery of the State of Delaware, Consolidated C.A. No. 8388-VCG |

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

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## INTRODUCTION

In this appraisal action, three experts proposed ten different methods for valuing ISN.[1] *See* Opinion at 8. These ten methods had widely diverging assumptions embedded within them. The embedded assumptions included, among other things, which companies were comparable, which accounting methods to use, how to calculate working capital, how many years to forecast results, which discount rate method to use, how to calculate the discount rate and which transactions were comparable.

The Trial Court rejected nine of the ten valuation methodologies and selected the DCF methodology proffered by ISN's expert Mr. Beaulne as its *sole* starting point (*see* Opinion at 13) and Mr. Beaulne's model as the *sole* calculation method (*see* Opinion at 18). The Trial Court made only a few (but very impactful) changes to Mr. Beaulne's DCF, in particular, the treatment of working capital and the calculation of the discount rate.[2]

Petitioners devoted much of their Answering Brief to DCF-related issues that were debated at trial, later resolved by the Opinion's selection of Mr. Beaulne's DCF assumptions and calculations and -- most significantly for purposes

[1] Capitalized terms not otherwise defined herein shall have the meaning ascribed to them in Appellant's Opening Brief. *See* Trans. ID 60324136.

[2] The changes to Mr. Beaulne's treatment of working capital and discount rate increased his valuation from $100 million to $357 million.

of this appeal -- were not cross-appealed by Petitioners.[3] ISN will not burden the Court by refuting Petitioners' allegations and arguments that are not pertinent to the issues on appeal.

There are seven issues properly before the Court -- four issues raised by ISN on its direct appeal and three issues raised by Petitioners on cross-appeal. As set forth below, the four issues on appeal should result in a remand to the Trial Court, and Petitioners' three issues on cross-appeal should be rejected.

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[3] Unless otherwise noted, references to "Answering Brief" refer to Appellee's / Cross-Appellant's Answering Brief on Appeal and Opening Brief on Cross-Appeal, as filed by Ad-Venture (*see* Trans. ID 60454124) and incorporated by reference by Polaris in its separate brief. References to "Polaris' Answering Brief" refer only to the Polaris Petitioners' Answering Brief and Opening Brief on Cross-Appeal (Trans. ID 60452142). Citations to "Op. Br. at __" refer to Appellant's Opening Brief. Citations to "Ans. Br. at __" refer to Appellee's / Cross-Appellant's Answering Brief on Appeal and Opening Brief on Cross-Appeal. Citations to "Polaris Ans. Br. at __" refer to Polaris Petitioners' Answering Brief and Opening Brief on Cross-Appeal.

## SUMMARY OF ARGUMENT ON CROSS-APPEAL

1. Denied. The Trial Court properly exercised its discretion in determining the appropriate revenue and expense projections to use in its discounted cash flow analysis by selecting ISN's expert's inputs "as the best indication of ISN's value." *See* Opinion at 13.

2. Denied. The Trial Court properly exercised its discretion in determining the appropriate number of ISN shares to include in its per share calculation. *See* Opinion at 15 n.53.

3. Denied. The Trial Court properly exercised its discretion by denying Polaris' request for additional attorneys' fees and costs. *See* Opinion at 17-18.

# ARGUMENT

## I. THE TRIAL COURT'S FAILURE TO ESTABLISH A WORKING CAPITAL REQUIREMENT WAS LEGAL ERROR

In its Opening Brief, ISN argued that the Trial Court was required as a matter of law to value ISN as a going concern based upon its "operative reality" as of the date of the Merger. *See* Op. Br. at 14 (citing *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 525 (Del. 1999)). ISN's operative reality on the Merger date was that the Company had positive working capital and positive shareholders' equity. *See* A783. The Trial Court specifically recognized ISN's need for additional working capital as it grew during the projection period. *See* Opinion at 14 n.47. The Trial Court's failure to adhere to this determination regarding working capital in calculating its DCF value, however, transformed ISN during the projection period into an insolvent company unable to continue as a going concern into perpetuity with significant negative working capital and negative shareholders' equity. *See* Op. Br. at 7-8, 14-21.

The critical legal error ISN identified in its Opening Brief was the Trial Court's failure to set a working capital requirement and resulting presumed liquidation of ISN, thus erring as a matter of law while also contradicting its own finding that "[t]he nature of ISN's business indicates that its need for additional working capital would be small (although not nonexistent)." Opinion at 14 n.47.

In their Answering Brief, Petitioners responded by advancing inaccurate assertions about ISN's historical working capital balances and arguments regarding how to calculate working capital, in an effort to transform the legal issue before the Court into a factual one. But Petitioners never grapple with the fundamental legal error raised by ISN: *ISN had positive working capital leading up to and on the date of the Merger (A783), the Trial Court concluded that ISN would need additional working capital in the future (Opinion at 14 n.47), yet the Opinion's treatment of working capital inexplicably results in significantly negative working capital throughout the projection period and into perpetuity* (Op. Br. at 14-20 & Op. Br. Ex. 3). That conclusion contravenes ISN's operative reality (a reality the Trial Court apparently intended, but failed, to retain) and, therefore, necessarily constitutes an error of law.[4]

To divert attention from the legal issue presented on this appeal, Petitioners argue factually that ISN never carried a positive working capital balance before the Merger. Ans. Br. at 28. That is incorrect. As shown in ISN's Opening Brief, and not rebutted, ISN had a positive working capital balance (*i.e.*, current assets minus

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[4] For example, the Opinion noted the need to maintain ISN's operative reality when it rejected Petitioners' attempts to add-back certain expense items. In this instance, the Trial Court stated that it did "not make separate adjustments for executive compensation, charitable contributions, or private jet usage[ as] [t]hose expenditures were a part of the Company's operative reality on the date of the Merger, and there is no evidence sufficient, in my opinion, to demonstrate that they represent waste or actionable breaches of fiduciary duty; as such, they would have likely continued in a going-concern ISN." Opinion at 13 n.46.

current liabilities), during the two years immediately preceding the Merger. Moreover, the four-year average prior to the Merger was positive. *See* Op. Br. at 7-8.

Unable to rebut ISN's clear showing of a positive working capital balance, Petitioners next resort to an effort to disavow GAAP. Petitioners argue that "ISN's deferred revenue liability was merely an accounting construct introduced when ISN converted to GAAP." Ans. Br. at 22. That is, Petitioners attempt to redefine working capital using a non-GAAP definition -- a definition the Trial Court properly refused to utilize. The Trial Court's decision to premise its valuation conclusion on Mr. Beaulne's DCF model (*see* Opinion at 13) -- which Petitioners do not challenge on appeal -- shuts the door on Petitioners' redefined GAAP arguments in the Answering Brief. [5] Mr. Beaulne relied on ISN's historic GAAP financials and used GAAP to calculate his DCF projection. The Trial Court adopted Mr. Beaulne's DCF except for its changes to Mr. Beaulne's treatment of working capital and his cost of equity.[6] By adopting Mr. Beaulne's DCF, the

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[5] Petitioners did not appeal this aspect of the Trial Court's decision, and therefore, have waived any challenge to the Trial Court's decision to follow GAAP. *See Roca v. E.I. du Pont de Nemours & Co.*, 842 A.2d 1238, 1242 (Del. 2004) (holding that "failure of a party appellant to present and argue a legal issue in the text of an opening brief constitutes a waiver of that claim on appeal") (citation omitted).

[6] *See* Opinion at 13-14 ("I find it appropriate to start with Beaulne's DCF model as a framework. I have closely examined the disagreements among the experts and have adjusted Beaulne's DCF model to reflect my conclusions

Opinion necessarily adopted ISN's historic GAAP financials and used GAAP to calculate its DCF analysis, and rejected Petitioners' re-definition of working capital inconsistent with GAAP.[7]

Faced with this reality, Petitioners are left to argue that the Trial Court's methodology was improper because ISN utilized non-GAAP accounting before the Merger. *See, e.g.*, Ans. Br. at 30-31. But the accounting methodology used by ISN is irrelevant. The issue is what methodology is appropriate for valuation purposes. All three experts and the Trial Court utilized GAAP in their DCF calculations. *See* A628; B1939; B2129. Importantly, the Trial Court's use of ISN's GAAP financials as a starting point for its valuation conclusion is a factual determination that Petitioners do not challenge on appeal.

Petitioners also argue that "[t]here 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." Ans. Br. at 38. But ISN has never advanced any such

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regarding those items. A list of my adjustments follows. *To the extent an assumption or input is not mentioned below, I have considered the issue, and adopted Beaulne's input as the best indication of ISN's value*, notwithstanding the fact that one of the Petitioners' experts projected a different value.") (emphasis added).

[7] ISN's historic working capital balances and shareholders' equity are displayed in Exhibits 3, 4, 5 and 6 to the Opening Brief; the Opinion's projected working capital balances and shareholders' equity are displayed in Exhibits 2, 3, 4, 5 and 6 to the Opening Brief.

argument. The law -- Section 262 -- requires that ISN be valued as a going concern based on its operative reality on the date of the Merger. Here, the Trial Court's omission of any working capital requirement presumes the eventual distribution of all of ISN's cash and other operating assets, thus depleting its positive working capital balance and creating an insolvent company that cannot operate. ISN's Opening Brief demonstrated that this working capital treatment is an error of law that must be corrected to reach a fair value conclusion. *See* Op. Br. at 14-20.

Finally, Petitioners do not address, let alone rebut, the calculations in ISN's Opening Brief showing that the Opinion's failure to set a working capital requirement projects an ISN that will run out of cash and other operating assets eight years into the projection period. *See* Op. Br. Ex. 4. As argued in the Opening Brief, such a calculation is tantamount to a liquidation valuation, which is not appropriate. *See* Op. Br. at 14-20.

The bottom line is that Delaware law required the Trial Court to set a working capital requirement. *See Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *18 (Del. Ch. July 9, 2004), *aff'd in part, rev'd in part*, 884 A.2d 26 (Del. 2005) (stating that "it is vitally important to account for working capital requirements and fixed capital investment (net of depreciation) in determining the free cash flow that will be discounted back to present value"). Setting a working

capital requirement was also required by the Trial Court's factual findings. *See* Opinion at 14 & n.47 ("The nature of ISN's business indicates that its need for additional working capital would be small (although not nonexistent) and the parties have given me no adequate way to compute that small amount."). Petitioners have failed to rebut this reversible error of law. Accordingly, the matter should be remanded to the Trial Court.

## II. THE TRIAL COURT'S COST OF EQUITY CALCULATION WAS ERRONEOUS

### A. The Trial Court Abused its Discretion by Relying on CAPM

In its Opening Brief, ISN demonstrated that the Trial Court abused its discretion by rejecting any use of comparable companies, yet in the same analysis adopted a valuation metric (CAPM) that is predicated on the existence of comparable companies. *See* Op. Br. at 21-24. The Trial Court's use of CAPM cannot be reconciled with its rejection of comparable companies, creating an internal inconsistency that amounts to an abuse of discretion. The appropriate way to reconcile this inconsistency is to rely on the Build-Up Method utilized by Mr. Beaulne.

In their Answering Brief, Petitioners contend that "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 used the capital asset pricing model ('CAPM'), the trial court committed reversible error by performing the same analysis." Ans. Br. at 40-41. This response misapprehends ISN's argument.

The Trial Court selected Mr. Beaulne's beta of .88, the result of averaging the beta of four companies Mr. Beaulne deemed comparable. *See* A665. The Trial Court determined, however, that there were no companies comparable to ISN. *See*

Opinion at 1 (observing that "no comparable company evaluation exists on which [the Trial Court] may reasonably rely"). Accordingly, it is inappropriate to use a beta based on comparable companies in the calculation of the cost of equity where the Trial Court also concluded that ISN did not have any comparable companies. That is, the Opinion's use of any beta at all cannot be reconciled with the Trial Court's elimination of the comparable companies from which beta was derived.[8]

Petitioners also contend that "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.'" Ans. Br. at 41. The problem with this argument is that the Trial Court did not only reject use of market-based comparable companies as a valuation methodology. *See* Opinion at 9 (rejecting the guideline public companies analysis because "ISN has no public competitors"). To the contrary, the Trial Court also rejected reliance on comparable companies to derive inputs for use in other aspects of Mr. Beaulne's

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[8] ISN is not judicially estopped from raising this issue on appeal. Petitioners could have raised their judicial estoppel argument during reargument proceedings before the Trial Court. Petitioners' failure to raise the issue before the Trial Court prevents them for raising it for the first time on appeal. *See Turnage v. State*, 127 A.3d 396, 2015 WL 6746644, at *2 (Del. Nov. 4, 2015) (TABLE) (holding that the appellant "did not raise her judicial estoppel argument in the [Trial] Court and" as a result this Court "will not consider it for the first time on appeal"). Moreover, at the time ISN's expert presented his analysis, and relied on comparable companies, the Trial Court had not yet ruled that reliance on comparable companies was inappropriate. Therefore, there is nothing improper about ISN asserting arguments on appeal based on the Trial Court's findings in the Opinion.

DCF analysis. *See id.* at 14 n.47 ("I reject Beaulne's approach [for determining a 12% working capital requirement] for the same reasons I previously rejected the GPC valuation method: ISN has no direct public competitors, nor are there many companies that provide similar software applications."). Accordingly, the Trial Court abused its discretion by rejecting use of comparable companies to derive certain inputs into a DCF analysis while at the same time accepting use of comparable companies to derive other inputs into a DCF analysis.

Having rejected the use of comparable companies, the only appropriate alternative would have been the rejection of CAPM and reliance on the Build-Up Method to ensure that the Opinion was internally consistent. As explained in the Opening Brief, the Build-Up Method is frequently used to value companies and has been used by the Trial Court. *See* Op. Br. at 23-24 (citing *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 475 (Del. Ch. 2011)). Mr. Beaulne calculated ISN's cost of equity based on two separate, comparable-company-independent, Build-Up Method cost of equity analyses. *See* A645-47. The Build-Up Method Guideline Portfolio Method calculated ISN's cost of equity as 16.1%. A647. The Build-Up Method Regression Equation Method calculated ISN's cost of equity as 16.3%. *Id.* Either of these or an average of the two would be a proper exercise of discretion, thereby resulting in an internally consistent valuation conclusion.

### B. The Trial Court Abused its Discretion by Selecting an Improper Size Premium

To the extent that continued reliance on CAPM is considered appropriate, the Trial Court reversibly erred by selecting a size premium inconsistent with Delaware law. As shown in the Opening Brief, the Trial Court lowered Mr. Beaulne's size premium from 8.9% (Ibbotson Decile 10y) to 2.46% (Ibbotson Decile 8). *See, e.g.*, Op. Br. at 25-27; Opinion at 15. The 8th decile, however, comprises companies having market capitalizations between $514,459,000 and $818,065,000. *See* A791. The Trial Court's valuation conclusion of $357 million does not fall within that range. Moreover, none of the three experts used the 8th decile. By failing to utilize a size premium that corresponded with its ultimate valuation conclusion, the Trial Court abused its discretion.

In response, Petitioners argue that the Trial Court has the 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." Ans. Br. at 43. There are several problems with this argument.

First, the Opinion never explains why the 8th decile was selected. In fact, the Trial Court could not have relied on expert opinions to reach this conclusion because *none* of the experts utilized the 8th decile.

Second, the Ibbotson deciles are designed to isolate solely market capitalization or "size." *See* Michael W. Barad, *Size Matters: How to Apply Size Premium Metrics When Size-Based Category Breakpoints Overlap*, The Value Examiner (Nov./Dec. 2009) ("The beta-adjusted size premium calculation is our purest methodology for isolating firm return that is solely due to size. In other words, we are measuring the return that is attributable to firm size which cannot be explained by other systematic factors."). Accordingly, Ibbotson does not advocate choosing a size premium outside of the corresponding decile to account for factors other than market capitalization thus making the question of "risk" irrelevant to a determination of the appropriate Ibbotson decile. *See Ibbotson SBBI 2013 Valuation Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation 1926-2012*, at 85-93.

Third, even if risk is considered, the Trial Court's DCF assumptions made ISN's ability to produce the forecasted free cash flows significantly *more* risky: an ISN with negative working capital is more risky than an ISN with positive working capital; an insolvent ISN is more risky than a solvent ISN; and a financial model where ISN runs out of cash is more risky than a financial model that allows ISN to operate as a going concern into perpetuity. Compounding one valuation error -- the liquidation of ISN -- with a separate valuation error -- using a "less risky" size premium than "would otherwise be implied under its corresponding Ibbotson

decile based on size alone" (*see Gearreald v. Just Care, Inc.*, 2012 WL 1569818, at *12 (Del. Ch. Apr. 30, 2012)) -- was an abuse of discretion.

## III. THE POLARIS TRANSACTION IS A RELEVANT FACTOR THE TRIAL COURT SHOULD HAVE WEIGHED IN ITS VALUATION CONCLUSION

In its Opening Brief, ISN argued that the Trial Court erred as a matter of law by disregarding the statutory mandate of Section 262, that the Trial Court "take into account all relevant factors" in determining fair value. *See* Op. Br. at 28 (quoting 8 *Del. C.* § 262(h)). Petitioners respond that the Trial Court complied with Section 262, because the statute requires only that the Trial Court "consider" indicators of value, but does not require that those indicators be assigned any weight in making its fair value conclusion. *See* Ans. Br. at 45-46.

Petitioners' argument overlooks two fundamental errors made by the Trial Court. First, the Polaris Transaction was a transaction between the two Petitioners, involving the same asset, three months before the Valuation Date. This highly relevant transaction was deserving of *some* weight. The Trial Court's treatment of this relevant factor was tantamount to not considering it at all. *See Brinckerhoff v. Enbridge Energy Co.*, 2017 WL 1046224, at *14 (Del. Mar. 28, 2017) (criticizing the failure to consider a prior transaction in the same asset); *Commerce Assocs., LP v. New Castle Cty. Office of Assessment*, 2017 WL 1337318 (Del. Apr. 11, 2017) (reversing the trial court's decision because it failed to "consider all relevant factors" bearing on the asset's value).

Second, the Trial Court's rejection of the Polaris Transaction rests on factual conclusions that are directly contrary to the weight of the evidence presented below. Specifically, the Trial Court found that Ad-Venture "desire[d] liquidity" and that "there [was] no indication that the stock was shopped to multiple buyers, or that the sales prices were determined using complete and accurate information." Opinion at 11-12. But quite to the contrary, the evidence established that Ad-Venture was not a distressed seller, did not need liquidity and was under no pressure to sell. *See* A74 ("Q: Is there any reason that you needed the cash that you ultimately got through your sale of the shares of ISN? A: No.")).

More importantly, Ad-Venture did not actually achieve liquidity in the transaction because it was required to escrow virtually all of its after-tax sale proceeds for 12 years. *See* A494-95; A211 at 460:2-8. In addition to Polaris and Gallagher Industries, Ad-Venture shopped its ISN shares to at least two other potential purchasers. *See* A485-87; A506; A232-33 at 545:15-550:1. Ad-Venture and Polaris also had the benefit of specific ISN financial information produced pursuant to a court order following a Section 220 trial, specifically to facilitate a sale of ISN shares from Ad-Venture to Polaris. A453-69; A471-84.

Petitioners' Answering Brief does not come to grips with this evidence. Specifically, (i) Petitioners transacted between themselves; (ii) Petitioners were armed with information deemed by the Trial Court to be sufficient and appropriate

to value their shares of ISN stock; and (iii) ISN was not a party to the transaction. The transaction indicated a value of approximately one-third of the Trial Court's valuation conclusion. The Trial Court's decision not to assign any weight to the Polaris Transaction -- even at least as a cross-check on the Trial Court's valuation -- is a reversible error of law under the circumstances present here.

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

The Trial Court reversibly erred by awarding Ad-Venture interest from the date it perfected its appraisal demand because the rationale for awarding interest in the typical cash-out merger scenario is not implicated here. Before the Trial Court and in its Opening Brief, ISN argued that Ad-Venture should be denied statutory interest because Ad-Venture's stock in the Merger was not involuntarily converted into a right to receive cash. Op. Br. at 33-37; A866-67; A945; A1099-1102. Rather, Ad-Venture was allowed to remain a stockholder of ISN until it voluntarily decided to exercise its right to seek appraisal.

Ad-Venture argues that 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.'" Ans. Br. at 50. Were that the "rule," then presumably the Trial Court would have awarded Ad-Venture interest from January 9, 2013. It did not. *See* Opinion at 16-17. Instead, the Trial Court ruled that Ad-Venture is entitled to interest from the date of its appraisal demand. *See id.* Accordingly, Ad-Venture's reliance on the "default rule" is misplaced and does not support its position.

As a preliminary matter, ISN argued in the Trial Court that this issue was a matter of discretion. Although the issue presented to the Trial Court was

discretionary, the Trial Court's Opinion misinterprets the statute -- which makes the issue on appeal a matter of law. The statute clearly provides that ISN's obligation to pay fair value accrued on the *Merger date*, here January 9, 2013, and ISN did pay fair value to Ad-Venture on that date -- Ad-Venture retained its stock. But the Opinion holds that ISN's obligation to pay fair value accrued as of January 31, 2013, the date Ad-Venture perfected an appraisal right. *See* Opinion at 16-17. Both cannot be correct. ISN's obligation to pay fair value did not accrue as of January 31, 2013. It accrued on January 9, 2013, and was satisfied with Ad-Venture's continuous ownership of ISN stock. Ad-Venture voluntarily decided to surrender its stock for cash payable after the Trial Court determined fair value. The judgment date, or at the earliest, the Opinion date, was the earliest date upon which interest can accrue.[9]

Ad-Venture also argues that "[f]ollowing 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." Ans. Br. at 52. The statute is clear that if a stockholder

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[9] In addition, Ad-Venture argues that "[t]he 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." Ans. Br. at 52. In this case, the point at which the debt is first established and due is the Opinion date at the earliest. *See* Op. Br. at 37 (arguing that "Ad-Venture's right to receive cash fair value did not accrue until fair value was determined in the Opinion or a final judgment was entered").

seeks appraisal, it is not an equity holder and does not participate in distributions. Therefore, Ad-Venture had no right to distributions. Ad-Venture's reliance on the distributions is, in any event, irrelevant. In 2015, two years *after* the Merger, and only after ISN converted to an S corporation, ISN began issuing quarterly distributions to cover stockholder tax obligations, which obligations Ad-Venture did not have because it instead voluntarily sought appraisal. There were no distributions to ISN stockholders in 2013 or 2014, prior to its subchapter S election. A286-87 at 760:13-761:9.

## V. THE TRIAL COURT PROPERLY EXERCISED ITS DISCRETION BY ADOPTING ISN'S EXPERT'S REVENUE AND EXPENSE PROJECTIONS

### A. Question Presented

Whether the Trial Court properly exercised its discretion in selecting ISN's expert's revenue and expense projections as the best indication of ISN's value?

### B. Scope of Review

This Court reviews non-legal issues challenged in appraisal valuations under an "abuse of discretion" standard. *Golden Telecom, Inc. v. Glob. GT LP*, 11 A.3d 214, 217 (Del. 2010). A 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." *Id.* at 219. This Court will defer to the Trial Court's factual findings as long as they are supported by the record, "even if [the Court] might independently reach a different conclusion." *Id.*

### C. Merits Of The Argument

Petitioners claim that the Trial Court "abused its discretion by accepting ISN's expert's 'assumptions regarding ISN's future cash collections.'" Ans. Br. at 53. Specifically, in the Answering Brief, Petitioners assert that the Trial Court abused its discretion by relying on projections that "reversed ISN's consistent growth in new contractor subscriptions (the primary driver of ISN's revenue) [and] resulted in artificially depressed cash collections and revenue projections that lowered the court's fair value conclusion." *Id.* The Trial Court properly exercised

its discretion in selecting ISN's expert's forecasts. In the Opinion, the Trial Court held that:

> each of the three experts utilized a different projection period in their analysis: Beaulne used a 5-year projection period; Bingham used a 6-year projection period; and Clarke used a 10-year projection period. In selecting the appropriate projection period, I balance ISN's current stage within its lifecycle, the length of time it will remain in that stage, and the reliability of the projections available to estimate future cash flows. While the experts agree that ISN was growing at the time of the Merger, the differences in their projection periods reflect disagreement regarding the remaining length of the Company's growth stage.
>
> . . .
>
> As their contrasting conclusions illustrate, the experts disagree on many other key assumptions and inputs. In light of my decision to use a 5-year projection period, I find it appropriate to start with Beaulne's DCF model as a framework. I have closely examined the disagreements among the experts and have adjusted Beaulne's DCF model to reflect my conclusions regarding those items. . . . To the extent an assumption or input is not mentioned below, I have considered the issue, and adopted Beaulne's input as the best indication of ISN's value, notwithstanding the fact that one of the Petitioners' experts projected a different value.

Opinion at 12-13. The Trial Court properly selected Mr. Beaulne's inputs as the best indication of ISN's value. *See id.*

Mr. Beaulne prepared a five-year projection, as "the most common approach for preparing a discounted cash flow projection." A396 at 1197:8-16; *see also Cede & Co. v. JRC Acq. Corp.*, 2004 WL 286963, at *4 (Del. Ch. Feb. 10, 2004) (observing that the "typical" projection period is five years); *Glob. GT LP v.*

*Golden Telecom*, 993 A.2d 497, 511 (Del. Ch.), *aff'd*, 11 A.3d 214 (Del. 2010) (same). Petitioners' experts, however, created six-year projections and ten-year projections. *See* A198 at 407:19-408:9; A272 at 701:2-5. Their use of non-standard projection periods was intentionally designed to increase value. *See* A198 at 407:19-408:9; A272 at 701:2-5; A198 at 408:1-9; A396 at 1197:17-1198:23. Of the three projection periods, the five-year period was the most appropriate under Delaware law.

ISN derives revenues from owners and contractors by charging a one-time set-up fee and an annual subscription fee. Mr. Beaulne determined that the contractor one-time set-up fee would remain constant for the projection period and the residual year. A625; A398 at 1205:1-9. Mr. Beaulne estimated a contractor annual fee adjustment of 9.9% in 2015 and an adjustment of 9.9% in the residual year. A398 at 1206:16-18. Those estimated price adjustments were consistent with ISN's historical practice of adjusting prices every three years and also, importantly, were in line with ISN's historical price adjustment trend. A398 at 1205-06.

Mr. Beaulne's projections, as described above, undercut Petitioners' argument that "ISN's growth did not slow leading up to the merger." Ans. Br. at 54. Mr. Beaulne's expert report clearly showed that, as of the Valuation Date, contractor growth rate was in fact slowing. A608. Contractor growth rate peaked

in 2006 to 2007 at 83% and fell to 19% in 2011 to 2012. *Id.* Contractors provide 90% of ISN's revenue. *Id.* It is axiomatic that slowing growth rates lead mathematically to slowing growth.

For Polaris to argue that ISN's growth would not slow controverts the results of Polaris' own diligence. AR1-6. Before purchasing ISN shares from Ad-Venture, Polaris conducted significant due diligence, the results of which were summarized in an internal investment memorandum, the September 21, 2012 Polaris Investment Memo. *Id.* That document discloses Polaris' belief that there would be "limited growth opportunities in domestic and international oil and gas markets" for ISN. AR2. Slowing growth rates and "limited growth opportunities" made it reasonable for the Trial Court to adopt a revenue projection with slowing growth.[10] *Id.*

Mr. Beaulne then forecasted ISN's projected operating expenses by considering the Company's historical EBITDA margins and observing the EBITDA margins of comparable companies in the industry. A400 at 1211:1-19. Mr. Beaulne observed that ISN "achieved its highest EBITDA margin ever"—20.1%—in 2012, a year in which the Company adjusted its prices. A400 at 1211:9-19. Although ISN was budgeting a higher EBITDA margin in 2013, Mr.

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[10] That said, the revenue forecast used by the Trial Court still forecast robust growth from 2012 through the residual year -- $78,333,142 in 2012 to $164,411,424 in the residual year. *See* Op. Br. Ex. 1. Those revenue projections are hardly artificially depressed.

Beaulne concluded that to be fair it was "appropriate to maintain the [2012] EBITDA margin in 2013." A400 at 1211:9-19; A423 at 1304:12-1305:19. Mr. Beaulne reached this conclusion based, in part, on ISN's historical EBITDA margins and his expectation that ISN's expenses would grow in the future due to attempts to expand into new markets, geographies and verticals (which attempts would be necessary to support forecasts of continued growth). *See* A423 at 1305:11-15; A425 at 1312:12-1313:18.

Mr. Beaulne next forecasted ISN's long-term EBITDA margin in two ways. First, he estimated that ISN's EBITDA margin would eventually approach an industry average of 15%, because "companies with higher-than-average operating profit margins [are] more likely to revert to the mean operating profit margins."[11] Second, Mr. Beaulne forecasted ISN's long-term EBITDA margin by ascertaining that at 15%, ISN's long-term EBITDA margin would approximate ISN's historic average of 14.5% into perpetuity (*see* A629). Selecting a beginning EBITDA margin of 20% and a long-term EBITDA margin of 15% is entirely consistent with ISN's operative reality on the Merger date.

[11] Shannon Pratt & Roger Grabowski, *Cost of Capital: Applications and Examples* 848 (5th ed. 2014) ("Cost of Capital"); *see also* Aswath Damodaran, *Closure in Valuation: Estimating Terminal Value* 17 (Apr. 28, 2009) (stating that "excess returns will fade over time, but moving them to or towards industry averages in stable growth seems like a reasonable compromise").

Based on the foregoing, the Trial Court properly exercised its discretion by selecting ISN's expert's inputs "as the best indication of ISN's value." *See* Opinion at 13.

## VI. THE TRIAL COURT PROPERLY EXERCISED ITS DISCRETION IN DETERMINING THE NUMBER OF SHARES IN ITS PER SHARE CALCULATION

### A. Question Presented

Whether the Trial Court properly exercised its discretion in determining the number of ISN shares in its per share calculation?

### B. Scope of Review

"In any appeal, the factual findings of a trial judge will not be set aside by a reviewing court unless those factual determinations are clearly erroneous." *Cede & Co. v. Technicolor, Inc.*, 758 A.2d 485, 491 (Del. 2000).

### C. Merits Of The Argument

Mr. Beaulne and Mr. Bingham (Polaris' expert) both calculated ISN's per share value based on 3,614 shares outstanding. *See* Opinion at 15 n.53. Ad-Venture's expert Mr. Clarke, on the other hand, reclassified vested, unexercised common stock options as "Restricted Employee Share Grants" and created a hypothetical mandatory repurchase program that forced employee and non-employee option holders to redeem their shares for $23,000 per share. B1964. As a result, Mr. Clarke assumed that there were only 2,900 shares outstanding. A269 at 691:10-14. Yet ISN had no right to purchase shares held after the exercise of options unless and until the employee was no longer employed. At such time, ISN was required to pay the fair value of such shares.

Petitioners' position is essentially that the option shares were worth $23,000 per share while all the other shares are worth $222,414 per share. At trial, Mr. Clarke conceded that this was "a huge difference." A269 at 692:13-18. Mr. Clarke's attempt to manipulate the number of outstanding shares and the value of employee shares to increase his per share valuation conclusion was appropriately rejected by the Trial Court because it has no support in the law or valuation literature.

In support of their contention, Petitioners rely on, and cite, for the first time in this case, *In re Appraisal of Ford Holdings, Inc. Preferred Stock*, 698 A.2d 973 (Del. Ch. 1997). The *Ford* case, however, concerned preferred stock in which holders agreed to accept a pre-determined value in case of an appraisal. This is not this case.[12]

The Petitioners next incorrectly claim that "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." Ans. Br. at 65. That is untrue. Both Julie Connelly and Saks Ishrat, ISN employee stockholders holding the so-called Restricted Shares, were treated precisely the same as Ad-Venture. They were allowed to retain their

[12] ISN has only one class of stock -- common stock. To have more than one class of stock would make ISN ineligible to be an S Corporation. The Restricted Shares terminology used by Petitioners is a fabrication.

shares and were given the right to seek appraisal. *See, e.g.*, AR7 (letter to ISN employee stockholders informing them of the Merger and their appraisal rights under Delaware law).

The Trial Court's decision to reject Mr. Clarke's hypothetical mandatory repurchase program that forces employee and non-employee option holders to redeem their shares for $23,000 per share was correct and should be affirmed.

## VII. THE TRIAL COURT PROPERLY EXERCISED ITS DISCRETION BY DENYING POLARIS' REQUEST FOR ADDITIONAL FEES

### A. Question Presented

Whether the Trial Court properly exercised its discretion by denying Polaris' request for additional fee shifting?

### B. Scope of Review

This Court reviews the Trial Court's "denial of attorneys' fees under the bad faith exception to the American Rule for abuse of discretion." *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 607 (Del. 2010). "When an act of judicial discretion is at issue, the appellate court 'may not substitute its own notions of what is right for those of the trial judge, if [that] judgment was based upon conscience and reason, as opposed to capriciousness or arbitrariness.'" *Id.* at 608 (alteration in original) (quoting *Dover Historical Soc'y, Inc. v. City of Dover Planning Comm'n*, 902 A.2d 1084, 1089 (Del. 2006)).

### C. Merits Of The Argument

The Trial Court properly exercised its discretion in denying Polaris' request for additional fee shifting in the amount of approximately $3.8 million -- all the fees that Polaris incurred in connection with the litigation. *See* Op. Br. Ex. B at 28-32. Polaris' request for fees here is in addition to the approximately $136,000 that the Trial Court previously shifted to ISN during the course of discovery. It is noteworthy, however, that Ad-Venture decided not to move for reargument or

appeal the Trial Court's denial of additional fee shifting (*see* AR8), even though Ad-Venture had originally joined Polaris in the request for additional fee shifting. Polaris contends that its fee shifting application is not precluded by this Trial Court's earlier decision to shift fees in connection with certain discovery motions. In support of this argument, Polaris contends that it is entitled to recover additional attorneys' fees and costs for a "broader pattern" of alleged conduct that "resulted in significant delays and expenses for Polaris." Polaris Ans. Br. at 27.

The Trial Court considered and properly rejected each of Polaris' purported grounds for additional fee shifting. The Trial Court observed that "[i]t is unusual to shift fees under the bad faith exception, and it's not just questionable litigation conduct that arises to bad faith, but actions that are antithetical to the pursuit of justice . . . is our standard." Op. Br. Ex. B at 28. The Trial Court's reasoning demonstrates that it judiciously exercised its discretion.

First, the Trial Court properly denied Polaris' request based on Mr. Addy's testimony at trial and purported discovery misconduct that the Trial Court had previously remedied:

> The argument is that Mr. Bill Addy's trial testimony engaged in spin, exaggeration and partisanship. I think it did, but if that were the standard for shifting fees, we would simply have the English rule under which the loser pays. The second category is the litigation category of discovery violations and spoliation. There was spoliation here. There were violations of the norms under which we must function. . . . I have already shifted fees with respect to those. . . . I

> think having already shifted fees for those, I don't need to further address them here.

*Id.* at 29.

Second, the Trial Court considered and properly rejected Polaris' argument that ISN's pre-litigation conduct warranted fee shifting, on multiple grounds:

> First of all, I don't think [the pre-litigation conduct was] a significant impediment to Polaris valuing its stock because it had just bought it, so I'm sure it had some idea of what it thought that valuation was. Certainly it should have as a prudent investor. Second, even if I accept that those letters and actions were meant to discourage the legitimate pursuit of appraisal, they were unsuccessful. There was an appraisal case. Despite the discovery problems, it did result in a valuation, and it resulted in a valuation that I think returned about 800 percent on the investment made shortly before the merger by Polaris. . . . [T]here is no direct harm that arose from those letters to Polaris.

*Id.* at 30-31.

Third, the Trial Court rejected Polaris' argument that the lack of process to set the Merger price warranted fee shifting.

> In another case, that might be quite telling to me in consideration of a request to shift fees, but I note here that as the case went forward, that Polaris' own expert valuation was two and a half times the ultimate valuation I determined. So, number one, it seems unlikely to me that with the best will in the world, we could have avoided an appraisal action here -- and it also indicates to me that I need not be too concerned about foregoing the deterrent value of some type of fee shifting because I don't think we want to encourage appraisal actions with valuations that are so overstated as those the plaintiff pursued here.

*Id.* at 31-32 ("So for all those reasons, while I am not condoning the way Mr. Addy priced ISN for the merger, I don't see any reason to shift fees beyond what I have already done. I exercise my discretion to deny that request.").

Having already shifted fees twice, the Trial Court's decision not to shift fees again fell comfortably within the established Delaware jurisprudence. "The bad faith exception applies only in 'extraordinary cases,' and the party seeking to invoke that exception must demonstrate by 'clear evidence' that the party from whom fees are sought . . . acted in subjective bad faith.'" *Lawson v. State*, 91 A.3d 544, 552 (Del. 2014) (citations omitted); *see also RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 876-79 (Del. 2015) (affirming Court of Chancery's denial of an application for fee shifting).

Moreover, "the bad faith exception does not apply to conduct that gives rise to the substantive claim itself." *Johnston v. Arbitrium (Cayman Is.) Handels AG*, 720 A.2d 542, 546 (Del. 1998); *see also Versata Enters.*, 5 A.3d at 607 ("Accordingly, 'an award of fees for bad faith conduct must derive from either the commencement of an action in bad faith or bad faith conduct taken during litigation, and not from conduct that gave rise to the underlying cause of action.'"). Here, the Merger gave rise to the substantive appraisal claim. Polaris' assertions concerning the process used by ISN's board of directors to effectuate the Merger

and the value paid in connection with the Merger cannot provide the basis necessary to shift fees.

Polaris relies on *Montgomery Cellular Holding Co. v. Dobler*, 880 A.2d 206 (Del. 2005). Polaris Ans. Br. at 29-30. None of the alleged conduct here rises to the level of egregious misconduct found to exist in *Montgomery Cellular*, in which the Delaware Supreme Court observed that the company's chief executive officer (i) set a merger price that "was not based on any legitimate valuation of" the company (*Montgomery Cellular*, 880 A.2d at 228); (ii) "lied under oath about the valuation method he had used to determine the merger price" (*id.* at 228-29); (iii) "testified falsely about his involvement in [a settlement], contending that he had no knowledge or involvement in that settlement, even though he had signed the settlement agreements" (*id.* at 229); (iv) "admitted that it destroyed . . . computers *after* the Court of Chancery had ordered their production" (*id.*); (v) proffered expert valuation testimony that was "fatally flawed" (*id.*); and (vi) hired an expert witness that "developed his expert testimony" to fit into a "predetermined valuation figure" (*id.*).

Polaris also relies on *In re Shawe & Elting LLC*, 2016 WL 3951339 (Del. Ch. July 20, 2016). In *Shawe*, the Court of Chancery, after a sanctions hearing which involved testimony from five fact witnesses and two expert witnesses, summarized the "unusually deplorable behavior" warranting sanctions as follows:

> (1) by intentionally attempting to destroy information on his laptop computer after the Court had entered an order requiring him to provide the laptop for forensic discovery, (2) by, at a minimum, recklessly failing to safeguard evidence on his phone, which he regularly used to exchange text messages with employees and which was an important source for discovery, and (3) by repeatedly lying under oath to conceal aspects of his secret extraction of information from Elting's hard drive and the deletion of information from his laptop.

*Shawe*, 2016 WL 3951339, at *13. Further, in *Shawe*, the Chancellor determined that approximately 40,000 files had been intentionally deleted after their production had been ordered. *Id.* at *14. In terms of false testimony, the Chancellor noted that the party's "pervasive false statements under oath concerning who assisted him in accessing [the opposing party's] hard drive and the deletions made to his laptop were made intentionally to conceal the truth of his surreptitious activities." *Id.* at *18. Polaris has failed to show any evidence, let alone clear evidence (because there is none), that even remotely suggests that the facts present here are analogous to those found in *Shawe*.

Instead, Polaris litters its brief with inaccurate recitations of the trial record. For instance, Polaris argues that "ISN structured the Merger to leave Ad-Venture's stock unaffected and to freeze Ad-Venture into its minority position, specifically to avoid the risk of having to pay fair value." Polaris Ans. Br. at 13. The board minutes from the meeting in which the ISN Board approved the Merger, however, demonstrate that ISN's Board was not trying to freeze Ad-Venture. *See* A538.

Rather, the Board desired to cash out Ad-Venture as well, but concluded that ISN had insufficient cash to do so. *See* A542. Polaris also contends that "Bill Addy sent another letter to Polaris and Ad-Venture, suddenly announcing that ISN had changed from cash basis to GAAP accounting" and that "[a]ll of this shows ISN's clear intention to interfere with Polaris's appraisal decision-making." Polaris Ans. Br. at 14. It is unclear how the provision of financial statements prepared in accordance with GAAP could deter Polaris, a multi-billion dollar fund, from demanding appraisal, particularly when Polaris' own brief argues that "Polaris would prefer to invest in companies with GAAP accounting." *Id.* at 8. Polaris also makes (unfortunately) unwarranted personal attacks on Bill Addy. Those inflammatory statements do nothing to demonstrate that the Trial Court abused its discretion. Accordingly, ISN will not burden this Court with rebutting each attack.

The Trial Court correctly held that Polaris failed to demonstrate any of the requirements for additional fee shifting, namely, ***clear evidence*** that this litigation is an ***extraordinary case*** in which ISN acted in ***subjective bad faith***. Moreover, Polaris has made no effort to explain why it is entitled to ***all*** of its attorneys' fees and costs. Even if each of Polaris' allegations were correct, most of the additional fees Polaris is seeking would have been incurred to litigate the merits of this action. The facts and law, as set forth herein, do not provide a basis for this Court to reverse the Trial Court's refusal to shift any additional portion of Polaris'

attorneys' fees and costs -- let alone all of its fees incurred during this course of this litigation.

# CONCLUSION

For the foregoing reasons and for the reasons set forth in ISN's Opening Brief, this Court should (i) reject Petitioners' cross-appeals; and (ii) reverse the judgment of the Trial Court and remand with the following instructions:

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

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

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

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

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

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

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