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

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| MERLIN PARTNERS, LP and AAMAF, LP, | ) |
| Petitioners-Below/ Appellants, | ) No. 295, 2017 |
| v. | ) CASE BELOW: |
| SWS GROUP, INC. and HILLTOP SECURITIES HOLDINGS LLC, | ) Court of Chancery of the State of Delaware Cons. C.A. No. 10554-VCG |
| Respondents-Below/ Appellees. | ) |

**APPELLANTS' OPENING BRIEF**

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## NATURE OF PROCEEDINGS

This appeal is from a statutory appraisal in which the trial court determined that the fair value of SWS Group, Inc. ("SWS") was $6.38 per share. This appraisal arises from Hilltop Holdings, Inc.'s ("Hilltop") acquisition of SWS (the "Merger"). Pursuant to the March 31, 2014 merger agreement, SWS stockholders were to receive 0.2496 shares of Hilltop common stock and $1.94 in cash in exchange for each share of SWS stock (the "Merger Consideration"). The Merger Consideration was worth $7.75 per share when agreed to by SWS and Hilltop but, because the value was not fixed and Hilltop's stock price subsequently dropped, was worth only $6.92 per share when the Merger closed on January 1, 2015 (the "Merger Date").

Petitioners argued at trial that Hilltop, as an insider and through its influence over SWS, exercised control over SWS to acquire SWS at less than fair value. In its May 30, 2017 Memorandum Opinion (the "Opinion" or "Op."), the trial court found "that Petitioners' critiques of the sales process, and Hilltop's influence on the process, are generally supported."[1] Nonetheless, the trial court held that the fair value of SWS was well below the negotiated value of the Merger Consideration.

[1] Op. 3.

In doing so, the trial court made errors in fact and law. For the reasons stated herein, this Court should reverse and remand the trial court's determination of SWS's fair value.

## SUMMARY OF ARGUMENT

1. In determining the discount rate to apply in its discounted cash flow ("DCF") analysis of SWS, the trial court placed equal weight on the respective size premium advocated by Petitioners (2.69%) and Respondents (4.22%). The size premium advocated by Petitioners, however, was the only evidence presented at trial that reflected SWS's operative reality as of the Merger Date. Specifically, the trial court held that warrant exercises which occurred after the announcement of the Merger but before the close of the Merger that increased the number of SWS shares outstanding by nearly 50%, "was part of the Company's operative reality as of the merger date."[2] By placing equal weight on the size premium advocated by Respondents, which did not account for the warrant exercise, the trial court contradicted its operative reality holding and erred as a matter of law.

2. The trial court did not include any of SWS's $194 million in excess capital in its valuation. Instead, the trial court assumed that to justify adding any such value to its DCF valuation, Petitioners had to prove that SWS would actually distribute excess capital to its stockholders.[3] The assumption is wrong as a matter of law and finance. The erroneous assumption led the trial court to defer to SWS management's dividend plans to support adopting Respondents' expert's DCF

[2] Op. 39, 47-49.

[3] Op. 40-41.

model as its own.[4] The trial court's deference to SWS management was an error of law, inadvertently imposing a minority discount on the dissenting shares. The trial court's DCF model is also a misapplication of law, ignoring elements of present value and principles of finance.

3. The trial court found "that Petitioners' critiques of the sales process, and Hilltop's influence on the process, are generally supported."[5] The trial court further found that there was a "problematic [sales] process" and the "existence of the Credit Agreement under which the acquirer exercised a partial veto power over competing offers" had a "probable effect on the deal price."[6] The trial court, however, did not consider these factual findings in its determination of SWS's fair value. The trial court cannot ignore a defective and unfair sales process and the price resulting from that process, just as it cannot ignore the price negotiated in a fair process. Each is a relevant factor that must be considered under the statutory mandate of 8 *Del. C.* § 262 ("Section 262"). The trial court's failure to consider all relevant factors was an error of law.

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[4] Op. 41.

[5] Op. 3.

[6] Op. 30.

## STATEMENT OF FACTS

### A. SWS and the Credit Agreement

SWS was a federally regulated bank holding company with banking (the "Bank") and broker-dealer (the "Broker") operations.[7] The Bank struggled during the Great Recession and was required to write down certain loans, impairing capital.[8] The write down led to a memorandum of understanding ("MOU") with regulators in 2010, which among other things, required SWS to raise capital.[9] SWS did so through a $100 million credit agreement (the "Credit Agreement") with Hilltop and Oak Hill in 2011. As part of the deal, Hilltop and Oak Hill each received a warrant for 8,695,652 shares of SWS common stock that could be exercised at $5.75 per share, converting the debt to equity.[10]

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[7] Op. 5.

[8] Op. 6. "Capital" supports a bank's operations by (a) providing a cushion to absorb losses and declines in asset values and (b) providing protection to uninsured depositors and debt holders. The federal government provides deposit insurance and other safety nets to banks, but regulates their levels of capital to ensure the safety of deposits. A bank's free cashflow is therefore only cashflow in excess of capital requirements set by financial ratios that show the bank is "safe and sound." *See, e.g.*, *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *26 (Del. Ch. Aug. 18, 2006).

[9] Op. 6-8.

[10] Op. 8; A1519.

The Credit Agreement was a powerful anti-takeover defense.[11] It included (i) a poison put which would put the loan in default if the SWS Board of Directors (the "Board") ceased to consist of a majority of "Continuing Directors" or if any other stockholder acquired more than 24.9% of SWS's stock[12] and (ii) a "covenant prohibiting SWS from undergoing a 'Fundamental Change,' which was defined to include the sale of SWS (the 'Merger Covenant')."[13] An Investor Rights Agreement also gave each Hilltop and Oak Hill a right to appoint an SWS Board member and a Board observer.[14]

The $100 million never left SWS's balance sheet. SWS used the $100 million as a capital cushion while it worked out its problem loans and restructured.[15] SWS put $20 million into the Bank and $30 million into the Broker; $20 million was used to reduce an intercompany payable SWS owed to the Broker; and $30 million sat for three years in a money-market account earning approximately 0.01% interest until it was lent to the Broker in 2014 at

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[11] At the same time SWS entered into the Credit Agreement, SWS refused to negotiate with Sterne Agee, Group, Inc., who had made offers to acquire SWS for up to $7.50 in cash. Op. 10-11; A1380.

[12] Op. 9 (citing A1437).

[13] Op. 9 (citing A2743-A2744). The loan could only be pre-paid if SWS's stock price exceeded $8.625 for twenty out of any thirty consecutive trading days. *Id*.

[14] A1389.

[15] A109-A110 at 250:6-251:12 (Edge).

approximately 1% interest.[16] All the while, SWS paid 8% interest on the loan to Hilltop and Oak Hill.[17]

### B. Hilltop Oversees the Restructuring Plan

Hilltop continued to invest in SWS, buying 1.475 million shares of stock while taking an active role in its management.[18] Hilltop is controlled by Jerry Ford[19] and his son, Jeremy. Jeremy worked directly with SWS management on budgeting and capital plans as Hilltop built SWS's three-year projection model.[20] Jeremy Ford and his subordinates met monthly with SWS management, were given monthly performance updates, and reviewed and commented on draft Board presentations.[21]

Robert Chereck ("Chereck"), who had worked with Jerry Ford since the early 1980's,[22] was hired at Hilltop's request to run the Bank in 2012.[23] Jeremy

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[16] A2023-A2024.

[17] A2578.

[18] A1615; A1627.

[19] *See* A3307-A3310 (overview and history of Jerry Ford and his relationships with Oak Hill and SWS directors).

[20] A3131-A3132 (Ford Dep.); A3116 at 71:11-72:19 (Hodges Dep.).

[21] A113-A114 at 266:10-267:23 (Edge); A162 at 354:21-355:13 & A170-A171 at 388:9-390:11 (Ford).

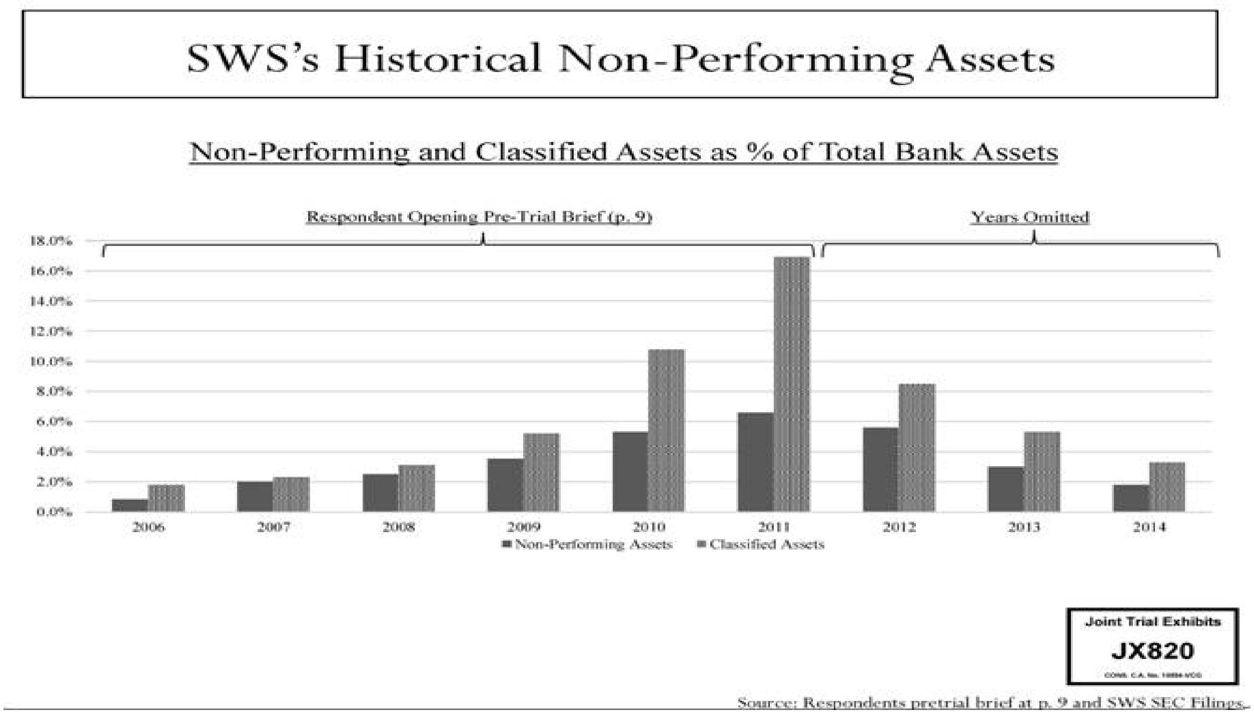
[22] A3110-A3111 (Chereck Dep.).

[23] Op. 12.

Ford met monthly with Chereck to discuss the Bank's loan review process.[24] Under Chereck's lead and Hilltop's guidance, the Bank "completely redid the entire credit approval process, completely restructured the overall review of loans, . . . set up credit approval processes that did not exist in the bank, and were what . . . regulators referred to as 'best practices in the industry.'"[25]

### C. The Restructuring Plan Results in Substantial Excess Capital

The Bank reduced problem loans from $273.4 million in 2010[26] to $67.6 million in 2013[27] and $39.9 million in 2014.[28]

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[24] A101 at 215:7-20 (Chereck).

[25] A3112 (Chereck Dep.); A100 at 211 (Chereck).

[26] A1518.

[27] A1677.

[28] A3074.

The Bank's provision for loan losses declined from $51 million in 2011[29] to $2.5 million in 2012.[30] The Bank reversed prior loan losses by more than $13 million in 2013 and 2014 combined.[31]

The Bank's capital ratios also increased, reflecting an accumulation of excess capital. Having "excess capital" means a bank is underutilizing its assets by holding cash or low-risk investments. SWS's capital ratios for fiscal years 2010 through 2014 were as follows:

| | **Tier I (core) Capital Ratio** | **Tier I Risk-Based Capital Ratio** | **Total Risk-Based Capital Ratio** |
|---|---|---|---|
| June 30, 2010[32] | 8.7% | 11.0% | 12.2% |
| June 30, 2011[33] | 9.9% | 14.3% | 15.6% |
| June 30, 2012[34] | 12.6% | 17.9% | 19.2% |
| June 30, 2013[35] | 13.5% | 23.6% | 24.9% |
| June 30, 2014[36] | 14.1% | 24.4% | 25.5% |

[29] A1562.

[30] A1863.

[31] A2393.

[32] A1592.

[33] *Id.*

[34] A1899.

[35] A2660.

[36] *Id.*

While a bank would not want to maintain minimum ratios required by regulators, the Bank held more capital than a "comfortable cushion." Petitioners' expert presented undisputed evidence at trial that, as of the Merger Date, SWS held more than $194 million in excess of a Tier I (core) Capital Ratio of 9% for the Bank and 7% for SWS:[37]

**Bank Capital Calculation**

| | Calculation | | 2014 ($000s) |
|---|---|---|---|
| Bank Assets | [A] | $ | 1,147,611 |
| Times: Tier 1 (core) Capital | [B] | | *9.0%* |
| Required Tier 1 Capital (Bank) | [C] = [A] * [B] | $ | 103,285 |
| | | | |
| Bank Capital | [D] | $ | 174,609 |
| Excess Capital | [E] = [D] - [C] | $ | 71,324 |

**SWS Capital Calculation**

| | Calculation | | 2014 ($000s) |
|---|---|---|---|
| End of Period Assets | [A] | $ | 3,278,889 |
| Times: Tier 1 (core) Capital | [B] | | *7.0%* |
| Required Tier 1 Capital | [C] = [A] * [B] | $ | 229,522 |
| | | | |
| Total Tier 1 Capital | [D] | $ | 423,783 |
| Excess Capital | [E] = [D] - [C] | $ | 194,261 |

The accumulation of "excess capital" was driven by the Bank's increased holdings in money market accounts and federal government and municipal securities, rather than issuing new loans. For example, loans decreased from an

[37] A3107-A3108; A359-A361. This was conservative. Respondents' expert assumed the Bank only required an 8.5% ratio for each year after 2018. A442.

average balance of $1.435 billion in 2010[38] to $547.5 million in 2014.[39] Investments in government securities for sale increased from $0.00 in 2010 to $527.4 million in 2014.[40]

### D. Projected Accumulation of Additional Excess Capital

Projections prepared by management in 2014 ("Management Projections")[41] did not project reinvestment of excess capital. The trial court, however, found it had "no way to judge, on the record, how much capital, if any, would actually be distributable" as of the Merger Date "*without* altering downward management's projections of cash flow as a result."[42] In so ruling, the trial court assumed that the excess capital, and in particular, capital raised by the Credit Agreement, had already been "deployed" by SWS.[43] SWS, however, projected that its capital ratios would continue to increase through the projected period. Though management did not project Tier I (core) Capital Ratio, it did project Tier I Risk-Based Capital Ratio and projected that ratio to increase to 35.61% by the end of 2017:[44]

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[38] A1830.

[39] A2567.

[40] *Id.*; A1830.

[41] *See* A2146-A2175.

[42] Op. 41 (emphasis in original).

[43] Op. 40.

[44] A2087. *See also PNB*, 2006 WL 2403999, at *26 (ruling a 15.3% Tier-1 Risk-Based Capital Ratio resulted in substantial excess capital).

## Downside Case (Model #2) Output

DRAFT

| Dollar Values in Thousands | Actual | Projections for Year Ending | | | |
|---|---|---|---|---|---|
| | 12/31/2013 | 12/31/2014 | 12/31/2015 | 12/31/2016 | 12/31/2017 |
| **BALANCE SHEET HIGHLIGHTS** | | | | | |
| Total Assets | $3,958,547 | $4,187,388 | $4,280,527 | $4,378,592 | $4,482,879 |
| *Asset Growth (%)* | (6%) | 6% | 2% | 2% | 2% |
| Total Securities | 2,978,231 | 3,102,249 | 3,074,073 | 3,090,134 | 3,120,301 |
| Net Loans | 514,302 | 649,671 | 720,428 | 789,683 | 855,648 |
| Total Deposits | 934,785 | 1,041,318 | 1,057,929 | 1,074,803 | 1,091,546 |
| Intangibles | 7,552 | 7,552 | 7,552 | 7,552 | 7,552 |
| Common Equity | 313,494 | 318,851 | 355,728 | 491,191 | 519,478 |
| Total Shareholders' Equity | 313,494 | 318,851 | 355,728 | 491,191 | 519,478 |
| **CAPITAL RATIOS** | | | | | |
| Tangible Common Equity / Tangible Assets | 7.75% | 7.44% | 8.15% | 11.06% | 11.49% |
| Tangible Equity / Tangible Assets | 7.75% | 7.44% | 8.15% | 11.06% | 11.49% |
| Tier 1 Leverage Ratio | 7.46% | 7.60% | 8.17% | 11.85% | 11.50% |
| Tier 1 Risk-Based Capital Ratio | 27.06% | 25.89% | 26.23% | 34.89% | 35.61% |
| Total Risk-Based Capital Ratio | 27.89% | 26.13% | 27.04% | 35.77% | 36.59% |
| **INCOME STATEMENT HIGHLIGHTS** | | | | | |
| Net Interest Income | $41,751 | $58,212 | $56,678 | $60,174 | $76,288 |
| Provision for Loan Losses | (8,559) | 165 | 4,031 | 4,652 | 4,575 |
| Total Noninterest Income (ex. Warrant Valuation) | 215,829 | 229,248 | 242,385 | 255,471 | 266,446 |

The required ratio was only 6%.[45]

The projected increase in SWS's capital ratios was a result of SWS maintaining an ultra-conservative balance sheet.[46] SWS projected its total securities portfolio, which was $600 million on September 30, 2014, to grow to $769 million in FY2016.[47] SWS also projected to maintain over $100 million in cash plus $185 million in assets segregated for regulatory purposes on its balance sheet.[48] As Jeremy Ford testified at trial, "the only thing [SWS] really had was cash" or the "potential to have cash" which SWS would need, in his view, "to repay that debt" owed to Hilltop and Oak Hill.[49]

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[45] A2660.

[46] A2147.

[47] *Compare id. with* A3079.

[48] A2146-A2175.

[49] A176 at 409:11-13 (Ford).

SWS's improved financial condition significantly eased its regulatory burden. The cease & desist order—which was the public version of the 2010 MOU—was terminated in January 2013[50] and replaced with an operating agreement, which itself was terminated in 2014.[51] Thus, by 2014, the Bank had substantial amounts of excess capital, projected the accumulation of even more capital, and no plans to deploy it. Hilltop did.

### E. Hilltop's Stealth Due Diligence

By October 2013, Jeremy Ford was analyzing the acquisition of SWS.[52] In doing so, he used the confidential SWS Board meeting materials he and his father received as a Board member and observer, SWS monthly reporting packages he received from SWS management,[53] and unfettered access to SWS management to inquire on all aspects of SWS's operations.[54]

The trial court found that SWS was unaware its confidential information was being used by Hilltop—an insider and competitor of SWS—to prepare a takeover

[50] Op. 12.

[51] A202 at 514:4-21 (Clarke).

[52] Op. 16.

[53] Hilltop continued to receive SWS's monthly financial reporting packages even after its January 9, 2014 bid to acquire SWS. A170-A171 at 388:9-390:11 (Ford); A2031-A2064; A2098-A2118; A2186-A2206.

[54] Op. 16; A162 at 354:21-355:13 (Ford).

bid.[55] Not only did Hilltop conceal what it was doing with SWS's confidential information, it also acquired additional information by deception. Specifically, Hilltop requested detailed loan tape information while falsely stating it was to help SWS's CFO (Mike Edge) with budgeting and planning.[56] Hilltop employees immediately circulated that information for use in Hilltop's acquisition analysis (titled "Project Dallas").[57] Similarly, Jeremy Ford obtained information on how SWS paid its brokers by falsely stating he needed it to "better understand" business plans and comment on a draft Board presentation.[58] As soon as Ford's team received the information, they provided it to Hilltop's investment banker[59] and also Hilltop's broker-dealer subsidiary, a competitor of SWS.[60] Hilltop concealed its acquisition intentions because it planned to launch a tender offer directly to SWS stockholders, at least until its lawyers advised against it.[61]

Jeremy Ford told Hilltop's board in January 2014 that with SWS, Hilltop was "[b]uying 3 Things – (i) Broker/Dealer, (ii) Bank, and (iii) Excess Capital."[62]

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[55] Op. 16.

[56] A1990.

[57] A1965; A166 at 370:9-372:1 (Ford).

[58] A1985; A167 at 373:20-374:22 (Ford).

[59] A719; A170 at 385:1-386:20 (Ford).

[60] A2005; A3134-A3135 (Ford Dep.).

[61] A165 at 365:22-367:3 & A170 at 387:1-388:7 (Ford).

[62] A844.

The excess capital was a vital element of value, providing "excess cash" to Hilltop even after accounting for $40.5 million in transaction costs[63] and the cash component of the Merger Consideration.[64] The amounts involved were substantial—Hilltop expected to have "over $150 million in freely usable cash"[65] post-Merger. Specifically, Hilltop, which had $218.4 million of excess cash, calculated that in an all-stock deal for SWS, it would end up with $312.9 million, a $94.5 million increase.[66] "Remaining excess cash" went down as the cash consideration to SWS went up:[67]

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63 A894.

64 A892 (identifying Parent Company Cash on pro forma basis of $172.5 million); A904 (identifying remaining excess cash on different percentage of stock component of Merger Consideration).

65 A843.

66 A884; A892; A894; A904.

67 A904.

## Pricing Considerations – Stock vs. Cash Mix

| | |
|---|---|
| **Price per Share** | $7.00 |
| Dallas Market Price (1/6/14) | $6.19 |

| | Dallas % Stock | | | | |
|---|---|---|---|---|---|
| | 0% | 25% | 50% | 75% | 100% |
| Pro Forma Tangible Book Value | $9.70 | $10.14 | $10.56 | $10.95 | $11.32 |
| Accretion (Dilution) | 3% | 8% | 12% | 16% | 20% |
| Pro Forma EPS | $1.82 | $1.76 | $1.71 | $1.66 | $1.61 |
| Accretion (Dilution) | 20% | 17% | 13% | 10% | 6% |
| % Ownership - SMU | 100% | 97% | 94% | 91% | 88% |
| Remaining Excess Cash | 32,097 | 102,313 | 172,528 | 242,744 | 312,959 |
| SMU IRR - Stand-Alone Case | 14.7% | 14.6% | 14.3% | 13.9% | 12.3% |
| SMU IRR - Pro Forma Case | 32.6% | 32.0% | 30.9% | 28.9% | 22.9% |

Hilltop knew SWS's cash was not needed for operations and could be used to fund transaction costs and the Merger price itself.[68]

While there is no doubt Hilltop hoped to profit greatly from synergies, Hilltop prepared standalone valuations of SWS and concluded that even if synergies failed to materialize, SWS was an economic target. *Excluding synergies* (but including $40.5 million in transaction costs), Hilltop expected a 14% IRR at $7.00 per share.[69] Hilltop's standalone valuation range confirmed that acquiring SWS for $7.00 to $8.00 per share was economic, even with zero synergies. Hilltop, however, was not interested in paying any more than SWS's standalone

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[68] A894.

[69] A1186 (expressed as a DCF valuation, this means that at a 14% discount rate, SWS was worth $7.00 per share).

value and instead stood ready to initiate a tender offer if SWS resisted its overture,[70] knowing it could veto competing offers.

### F. Hilltop's Offer

On January 9, 2014, Hilltop opened with an offer at the lowest value from its analysis—$7.00 per share, payable in 50% cash and 50% Hilltop stock.[71] Unbeknownst to the Board, the next day Jeremy Ford put his "communication" plan[72] into motion by making "tons of calls" to the most critical SWS employees, including "key salespeople & managers."[73] Hilltop also planned to continue to deliver "key messages to [SWS] employees and customers" in "real time" after making the offer.[74] The Board never instructed Hilltop not to speak with SWS employees, investigated what non-public information Hilltop had or was given, or stopped SWS management from continuing to meet monthly with and send reporting packages to Hilltop.[75]

The Board set up a special committee (the "Special Committee") that initially included Christie Flanagan, Jerry Ford's personal lawyer and former

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[70] *Supra* n.61.

[71] Op. 16.

[72] A801-A837.

[73] A171 at 390:12-391:16 (Ford); A2058; A815.

[74] A812.

[75] A2028; *supra* p. 14.

general counsel.[76] That individual was not removed until after the Special Committee hired Sandler O'Neill & Partners ("Sandler"), a financial advisor that provided services to Jerry Ford and his entities for over a decade.[77] Sandler called and emailed Jeremy Ford the morning Hilltop made its offer.[78] Sandler was eventually retained by SWS and paid $750,000, primarily for issuing a fairness opinion.[79] But, as soon as the Merger closed, Sandler was back to representing Hilltop in its $150 million public bond offering, for which it was paid $900,000.[80]

### G. Negotiations with Hilltop

Price negotiations with Hilltop were completed quickly. On March 3, 2014, the Special Committee determined that "Hilltop's offer of $7.00 per share undervalued [SWS] and was inadequate."[81] The Special Committee countered at tangible book value ($8.15/share at the time)[82] and reached a "handshake" deal on March 20, 2014 at $7.75 per share payable with 75% Hilltop stock and 25% cash.[83]

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[76] A2072.

[77] A50-A51 at 60:18-62:11 (Sterling).

[78] A2027.

[79] A51 at 63:13-64:5 (Sterling).

[80] A51 at 62:12-22 (Sterling).

[81] A2121.

[82] A2820; A2122.

[83] A2249; A89 at 169:19-22 (Miller).

This mix meant that SWS's cash would fund transaction costs[84] and the cash component of the Merger Consideration.[85] The Special Committee did not negotiate a price collar or any value protection for the Merger Consideration, even though Hilltop's stock was trading at an all-time high. Nor did the Special Committee perform due diligence on Hilltop until after March 20, despite the bulk of the consideration consisting of Hilltop stock.[86]

In the end, Hilltop paid nothing for its estimated synergies. On a standalone basis—*without synergies and including transaction costs*—Hilltop projected an 11.7% IRR if it paid $7.75 per share.[87] Hilltop's contemporaneous valuation was based on due diligence it completed before making any offer.[88] Yet, the Special Committee's chairman inexplicably testified that it "knew there were very, very strong synergy values already partly reflected" in the initial $7.00 per share offer.[89]

### H. Stifel

After Hilltop's $7.00 per share offer was made public, several potential buyers were contacted, including Stifel Nicolaus ("Stifel"), who was contacted at

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[84] A894.

[85] A1054.

[86] A89 at 169:23-170:2 (Miller).

[87] A1029; A1066.

[88] A838; A910.

[89] Op. 17.

the Special Committee's instruction on February 18, 2014.[90] Stifel, however, was told SWS was worth no more than its TBV of $8.15 per share[91] and Hilltop could veto a competing bid with its Merger Covenant.[92] Stifel still recognized SWS was being undervalued, and responded with interest.[93] At trial, Respondents contended that Stifel's interest was not genuine, but rather a front to poach employees.[94] In support, Respondents argued that Stifel insisted on "unusually personalized diligence."[95] In contemporaneous emails, however, SWS management said of Stifel's due diligence list:

> The list certainly includes the things we would ask for and I can understand how most every item is critical in determining the value of a deal. There is nothing on the list that we see right off as unreasonable.[96]

Drafts of the non-disclosure agreement ("NDA") also contained anti-solicitation provisions to protect SWS from any possible employee poaching. Still, negotiations over the NDA with Stifel were strung out while a deal was negotiated

[90] A2818. Esposito Global ("Esposito"), with the backing of Triumph Bancorp, also emerged unsolicited with an offer $8.00 per share. *Id.*; A2091. It was "stiff-armed" by Sandler and the Special Committee and did not make a final binding bid. Op. 19; A2077; A2093.

[91] A2070; A43 at 30:8-32:22 & A52-A53 at 68:15-69:4 (Sterling).

[92] A59 at 94:1-12 (Sterling).

[93] *See* Op. 20.

[94] Op. 20.

[95] A3424.

[96] A2130.

with Hilltop.[97] The Special Committee told Stifel that even if it signed the NDA, Stifel would not receive half the information it requested.[98] The Special Committee then ignored Stifel, even after receiving Stifel's signed NDA, and only responded after a "handshake" with Hilltop at $7.75 per share was reached.[99]

Unaware a deal with Hilltop had been reached, Stifel persisted and told Sandler it was willing to pay more than it previously indicated.[100] Left with no option but to at least create an appearance of engagement with a higher bidder, the Special Committee informed Jerry Ford on March 24, 2014 that it wanted to sign an NDA with a third-party that offered a price above $7.75 per share. Jerry Ford "blew his top."[101] He demanded a signed merger agreement by March 31, 2014 and threatened to revoke Hilltop's offer, resign from the Board, and force SWS to pay back the $100 million loan.[102] Jeremy Ford called to reiterate that Hilltop would not waive the Merger Covenant for a competing deal at any price.[103] Sandler waited two and a half days before telling Stifel about the deadline.[104]

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[97] A2119; A2120; A2141.

[98] A2124-A2128; A2133-A2138.

[99] Op. 20-21.

[100] A2220; A55 at 79:17-24 (Sterling).

[101] Op. 21.

[102] Op. 21.

[103] A2221.

[104] A57 at 85:19-86:2 (Sterling).

Stifel made the most of the four days it was given to perform due diligence. It put its $8.65 per share offer in writing,[105] responded promptly to middle-of-the-night information requests,[106] sent twenty employees and advisors to Dallas,[107] and had a team in St. Louis review information electronically.[108] Stifel, however, was denied access to much of the information Hilltop had acquired by subterfuge, including payout models and compensation schedules, a list of advisor locations (without names), sales and commission grids, and bank loans.[109] On Friday, March 28, Stifel was told it would not receive the information it requested and should prepare for SWS "to go down an alternate path."[110]

Stifel confirmed it was "confident that our ultimate price will be higher than $8.65 per share."[111] The Special Committee demanded $9.00 per share.[112] With

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105 A2234.

106 A2236; A2237; A2238-A2244.

107 A58 at 90:4-91:1 (Sterling).

108 A2239.

109 A2223; A2224-A2228. Hilltop had superior information obtained with no resistance from SWS. *See supra* pp. 14-15; A3137-A3138 (Ford Dep.); A2232; A2245-A2246. The Special Committee had no idea whether Stifel was provided access to the same information as Hilltop (A90 at 173:1-18 (Miller)); did not oversee or know who was responsible for the population of the data room (*id*. at 174:7-18); and did not know who decided what data a party would have access (A91 at 175:6-24 (Miller)).

110 A2247.

111 *Id.*

112 A2254.

information restricted and diligence ongoing, Stifel was unwilling to agree to the higher price. On March 31, Stifel requested a couple more days to finish due diligence,[113] and said it was confident that $8.65 per share would be its ultimate price.[114] Despite Stifel's offer to pay more than Hilltop and for the value it paid to be *fixed*, the Special Committee resolved to accept Hilltop's lower (*non-fixed*) offer.[115]

### I. The Special Committee Moves the Record Date to Benefit Hilltop; Closes on Merger

Over the months that followed, Hilltop's stock price tumbled. Because the Special Committee did not negotiate for a fixed value and failed to negotiate for any value protection, the value of the Merger Consideration dropped from $7.75 to $6.87 per share.[116] Stockholder opposition mounted and Lone Star Value nominated a slate of directors to challenge the Board at the 2014 annual meeting.[117] Rather than reconsider its recommendation,[118] the Board instead collaborated with Hilltop to analyze stockholder voting scenarios, and concluded that Hilltop and

[113] A58 at 91:2-10 (Sterling).

[114] A2264.

[115] A2262-A2263.

[116] A89 at 167:24-169:9 (Miller).

[117] A2312-A2326.

[118] A90 at 171:3-172:6 (Miller); A3118-A3119 (Ross Dep.).

Oak Hill would need to exercise their warrants before a stockholder meeting and vote their shares for the Merger to have a chance at passing.[119]

With the vote in doubt, on September 4, 2014 the Special Committee met for the sole purpose of changing the record date.[120] As Sandler testified, "I recall conversations with the special committee or members of it that - - that they wanted to ensure that they got the vote. That there was a view that pushing back the record date would help facilitate that and then requested to coordinate with Hilltop so, yes."[121] The record date was changed, but stockholders were not told the real reason why.[122] On September 26, 2014, Oak Hill exercised its warrant for 6,521,739 shares of common stock.[123] On October 2, 2014, Hilltop exercised its warrant for all 8,695,632 shares of common stock.[124] The Merger was approved at the November 21, 2014 stockholder meeting and closed on January 1, 2015.

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[119] A2297-A2307.

[120] A2362-A2363.

[121] A3128-A3129 (Sterling Dep.).

[122] A2511-A2514.

[123] A2682; A2683-A2719.

[124] A2720-A2721.

### J. The Litigation

Petitioners collectively demanded appraisal of 7,438,453 shares and the appraisal petitions were consolidated into the present action.[125] The initial petition was filed in January 2015. A four day trial was held in September 2016. At trial, Petitioners' expert, David Clarke, opined that SWS's fair value was $483 million, or $9.61 per share.[126] Respondents' expert, Richard S. Ruback, opined that SWS's fair value was $260 million, or $5.17 per share.[127] After post-trial briefing and argument, the trial court determined the fair value of SWS was $6.38 per share. In doing so, the trial court mostly adopted Ruback's DCF model, except the trial court used a discount rate of 12.76%[128] and adjusted Management Projections for interest expenses that would not be incurred by SWS as a result of the warrant exercise.

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[125] Stockholder class actions were filed challenging the Merger. A non-monetary settlement was abandoned after Prickett, Jones & Elliott, P.A. entered an appearance in that action and informed counsel that it would object if the parties proceeded with the settlement. *See* Stipulation of Dismissal *In re SWS Group, Inc. Stockholder Litig.*, Consol. C.A. No. 9516-VCG (Del. Ch. Feb. 25, 2016).

[126] Op. 26.

[127] *Id*.

[128] The trial court used the beta (1.10) and supply side equity risk premium (6.21%) advocated by Petitioners and gave equal weight to Petitioners' (2.69%) and Respondents' (4.22%) size premium in using 3.46%. Op. 46, 47, 49.

## ARGUMENT

### I. THE TRIAL COURT ERRED BY ASSIGNING EQUAL WEIGHT TO A SIZE PREMIUM THAT CONTRADICTED ITS FINDING OF SWS'S OPERATIVE REALITY ON THE MERGER DATE

#### A. Question Presented

Did the trial court err as a matter of law in determining SWS's fair value by assigning weight to a size premium that contradicted its finding of SWS's operative reality as of the Merger Date? *See* A3204-A3208; A3368-A3370; A3532-3535; A3551; A3671-A3672; A3834-3835; A3838-A3839.

#### B. Scope of Review

This Court's review of the trial court's assignment of weight to a size premium that did not reflect SWS's operative reality as of the Merger Date is *de novo*. "Delaware law requires that in an appraisal action, a corporation 'must be valued as a going concern based on the 'operative reality' of the company as of the time of the merger.'" *Montgomery Cellular Holding Co. v. Dobler*, 880 A.2d 206, 222 (Del. 2005) (citation omitted). "The interpretation and application of the mandates in Section 262 to [an] appraisal proceeding presents a question of law." *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 524 (Del. 1999).

#### C. Merits of Argument

The trial court held that SWS's operative reality as of the Merger Date included the 15,217,391 shares issued to Hilltop and Oak Hill upon exercise of the warrants.[129] The shares issued upon exercise of the warrants were included in determining the fair value of a SWS share at the time of the Merger.[130]

The trial court, however, placed equal weight on the respective size premiums advocated by Petitioners (2.69%) and Respondents (4.22%) in applying a size premium of 3.46%. Respondents' size premium was not based on SWS's operative reality on the Merger Date, because it excluded the warrant exercise. By giving Respondents' size premium equal weight, the trial court contradicted its finding that the warrant exercise "was part of the Company's operative reality as of the merger date."[131]

Respondents' expert (Ruback) selected a size premium of 4.22%, because SWS's market capitalization prior to Hilltop's offer on January 4, 2014, nearly a year before the Merger, was $198.5 million.[132] The trial court admitted that Ruback's "market capitalization figure excludes the warrant exercise which I have found was part of the Company's operative reality."[133] Ruback's size premium assumed SWS had only 32,747,990 shares outstanding, when the operative reality

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[129] Op. 37-39.

[130] Op. 38-39.

[131] Op. 39, 47-49.

[132] Op. 48.

[133] Op. 48 n.247.

on the Merger Date was that the warrant exercise had increased the number of shares outstanding by 15,217,371.

Ruback conceded that if he included the warrants, he would be pushing himself into the wrong decile.[134] He testified that whether events after Hilltop's offer should be considered in selecting a size premium would be a legal question and he "would ask instruction for [sic] counsel."[135] The instruction Ruback received was that "any impact of this early exercise must be excluded from the valuation."[136] The trial court's ruling that the exercise of the warrants must be considered in determining fair value rendered Ruback's size premium wrong. Nevertheless, the trial court erroneously gave 50% weight to a size premium that was not based on the operative reality of SWS's capitalization at the time of the Merger.

Clarke selected a size premium of 2.69% after taking into consideration that Hilltop and Oak Hill exercised warrants for 15,217,391 shares months before the Merger closed, materially changing SWS's capital structure from the time its unaffected market capitalization was known.[137] Clarke also considered that all of the shares underlying the warrants were in the money and constituted a substantial

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[134] A283 at 730:11-16 (Ruback).

[135] A3142-A3145 (Ruback Dep.).

[136] A595.

[137] A365; A541-A542.

portion of SWS's equity (34% post-exercise) and the warrant exercise eliminated debt and the drag SWS management believed the warrant exercise price caused on the stock price, which would likely cause SWS's stock price to increase.[138] Clarke followed the instruction of Duff & Phelps and performed iterative calculations, which confirmed his selected size premium was appropriate.[139]

The trial court noted criticism of the iterative approach and cited *Merion Capital, L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896 (Del. Ch. July 8, 2013) and *In re Appraisal of DFC Glob. Corp.*, 2016 WL 3753123 (Del. Ch. July 8, 2016).[140] The experts in those cases, however, did not use the iterative approach that Clarke used and the justifications for not using the market capitalization were different. In *3M Cogent*, respondent's expert deducted the company's cash from its market capitalization in selecting a size premium, which the court rejected. 2013 WL 3793896, at *19-20. In *DFC*, respondent's expert found a negative earnings announcement after the merger announcement would have reduced the stock trading price, which the court accepted. 2016 WL 3753123, at *13-14.

Neither of these cases support rejecting the use of an iterative approach when there is a material change in a company's capital structure like the warrant exercise experienced by SWS. To the contrary, the *DFC* court noted that the

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[138] A541-A544.

[139] A365-A366; A544.

[140] Op. 48 n.252.

iterative approach can be used for non-public or closely held companies where there is a not a publicly known market capitalization. *Id.* at *13. In this case, Ruback admitted that SWS's warrant structure was not typical of a public company and "exist[s] in, I think private equity firms, venture capital companies [and] some other private instruments."[141]

The fact that SWS's common stock was publicly traded does not end the analysis or justify ignoring its operative reality, which the trial court found included the warrant exercise. The trial court erred as a matter of law by not selecting Clarke's size premium, the only size premium evidence presented at trial that reflected SWS's operative reality as of the Merger Date.[142] This Court should reverse and rule that, for purposes of calculating a discount rate for SWS to determine its fair value in accordance with Section 262, the appropriate size premium is 2.69%.

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[141] A3146 (Ruback Dep.).

[142] Op. 48.

## II. THE TRIAL COURT ERRED IN ITS TREATMENT OF SWS'S EXCESS CAPITAL

### A. Question Presented

Did the trial court err as a matter of fact in assuming that SWS did not have any distributable excess capital as of the Merger Date, and did the trial court err as a matter of law by (i) imposing a minority discount on the dissenting stockholders; and (ii) misapplying *PNB* in its adoption of Respondents' expert model? *See* A3199-3204; A3353-A3357; A3360-A3363; A3382; A3509-A3514; A3519; A3660-A3664; A3835.

### B. Scope of Review

This Court reviews findings of fact by the trial court for abuse of discretion. *M.P.M Enterprises, Inc. v. Gilbert,* 731 A.2d 790, 795 (Del. 1999). The trial court "abuses its discretion when either its factual findings do not have record support or its valuation is not the result of an orderly and logical deductive process." *M.G. Bancorporation*, 737 A.2d at 526. The construction of Section 262 and application of a minority discount are questions of law, which this Court reviews *de novo*. *Id*. at 524; *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989). This Court also reviews the application of legal precepts *de novo*. *Rapid-Am. Corp. v. Harris*, 603 A.2d 796, 804 (Del. 1992).

### C. Merits of Argument

The trial court did not include <u>any</u> of SWS's $194 million in excess capital in its valuation. Instead, the trial court erroneously assumed that a "distributable" asset was the same as "distributing an asset" to stockholders, rejected Clarke's conclusion that SWS had at least $117.5 million of excess capital that was "distributable" without support, and adopted Ruback's valuation model based on assumptions as to how the Board would exercise its control over dividend policy. In doing so, the trial court erred as a matter of law by (i) inadvertently imposing a discount on dissenting shares for lack of control and (ii) misapplying *PNB* and thereby destroying the present value of SWS's excess capital.

#### 1. The Trial Court's Erroneous Assumptions

The trial court made several erroneous assumptions with regard to SWS's excess capital.

The trial court erroneously assumed that for excess capital to be added to its DCF valuation, Petitioners had to prove that SWS would actually distribute the excess capital to its stockholders.[143] Specifically, the trial court stated, "Clarke's valuation model, which distributes over $117 million in three years . . . is hard to accept on its face: it assumes that SWS would <u>distribute to shareholders</u> over half

[143] Op. 40-41.

of its pre-merger market capitalization . . . ."[144] The trial court further stated that "the record makes me doubtful, in light of SWS's recent emergence from major regulatory intervention, and its continuing business line in a highly regulated industry, that such a massive distribution would be possible from a regulatory prospective."[145]

SWS's excess capital, however, was excess to its operations regardless of whether it was paid to stockholders or remained within the company and must be added to the DCF valuation regardless of proof that a payment to stockholders would occur. *In re Radiology Assoc., Inc. Litig.*, 611 A.2d 485, 495 (Del. Ch. 1991); *Neal v. Alabama By-Prod. Corp.*, 1990 WL 109243, at *16 (Del. Ch. Aug. 1, 1990); *Gholl v. Emachines, Inc.*, 2004 WL 2847865, at *13 (Del. Ch. Nov. 24, 2004). Delaware law does not require proof that a non-operating asset is planned to be liquidated and distributed to stockholders to be included in a company's going-concern value. *See, e.g.*, *Berger v. Pubco Corp.*, 2010 WL 2025483, at *2 (Del. Ch. May 10, 2010) (adding full value of securities portfolio despite no "evidence that a particular asset would be sold on the merger date or on any particular date thereafter").

[144] Op. 41-42 (emphasis added).

[145] Op. 42 (emphasis added).

Whether cash flow in a DCF model is reinvested in the company at its cost of capital, or distributed to stockholders, it has the same present value.[146] In this respect, the value of non-operating assets like SWS's excess capital are no different. Indeed, Ruback's model is indifferent as to whether SWS's net income will be paid to stockholders as dividends or reinvested at the cost-of-capital.[147] Ruback did not know "what [management] was imagining for dividends,"[148] but it does not matter because the projected cash flows have the same present value whether they are reinvested or distributed as dividends. By contrast, the trial court's treatment of excess capital was equivalent to treating projected cash flows as valueless until actually in the stockholders' pockets. This contradicts generally accepted principles of finance and is unsupported by the evidence.

The trial court found the warrant exercise "created some additional excess regulatory capital."[149] The trial court, however, made no adjustment for any excess capital after erroneously concluding that because management assumed a warrant exercise in 2016 but did not project a "bulk" stockholder distribution thereafter, management's "implied judgment" was that all excess capital would be needed for

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[146] A216 at 570:7-19 (Clarke); A295 at 778:12-779:10 (Ruback).

[147] A295 at 778:19-20 (Ruback) ("It's – it's cash flows that's either going to be paid out or reinvested.").

[148] A296 at 782:2 (Ruback).

[149] Op. 39.

operations.[150] The purpose of the Management Projections, however, was "projecting the Company's cashflows,"[151] not future cash distributions. That management did not "assume a bulk distribution" is irrelevant.[152]

Moreover, the trial court's assumption that because excess capital was not distributed in bulk, it was therefore "deployed" in the Management Projections was incorrect. As shown below, management projected Tier I Risk-Based Capital Ratios to increase.

DRAFT

## Downside Case (Model #2) Output

| Dollar Values in Thousands | Actual | Projections for Year Ending | | | |
|---|---|---|---|---|---|
| | 12/31/2013 | 12/31/2014 | 12/31/2015 | 12/31/2016 | 12/31/2017 |
| **BALANCE SHEET HIGHLIGHTS** | | | | | |
| Total Assets | $3,958,547 | $4,187,388 | $4,280,527 | $4,378,592 | $4,462,879 |
| *Asset Growth (%)* | (6%) | 6% | 2% | 2% | 2% |
| Total Securities | 2,978,231 | 3,102,245 | 3,074,073 | 3,090,134 | 3,126,301 |
| Net Loans | 554,302 | 649,671 | 729,428 | 789,583 | 855,648 |
| Total Deposits | 934,765 | 1,041,318 | 1,057,529 | 1,074,803 | 1,091,546 |
| Intangibles | 7,552 | 7,552 | 7,552 | 7,552 | 7,552 |
| Common Equity | 313,404 | 318,653 | 355,726 | 491,191 | 519,478 |
| Total Shareholders' Equity | 313,404 | 318,653 | 355,726 | 491,191 | 519,478 |
| **CAPITAL RATIOS** | | | | | |
| Tangible Common Equity / Tangible Assets | 7.75% | 7.44% | 8.15% | 11.86% | 11.49% |
| Tangible Equity / Tangible Assets | 7.75% | 7.44% | 8.15% | 11.86% | 11.49% |
| Tier 1 Leverage Ratio | 7.40% | 7.60% | 8.17% | 11.85% | 11.50% |
| Tier 1 Risk-Based Capital Ratio | 27.06% | 25.89% | 26.23% | 34.88% | 35.61% |
| Total Risk-Based Capital Ratio | 27.89% | 26.13% | 27.04% | 35.77% | 36.55% |
| **INCOME STATEMENT HIGHLIGHTS** | | | | | |
| Net Interest Income | $42,751 | $58,232 | $56,678 | $60,174 | $76,388 |
| Provision for Loan Losses | (8,559) | 185 | 4,031 | 4,652 | 4,975 |
| Total Noninterest Income (ex. Warrant Valuation) | 215,829 | 229,248 | 242,265 | 255,471 | 266,446 |

The higher the ratio, the greater the excess capital. Thus, the record showed that excess capital was projected to grow, not be "deployed." Management projected the ratio to increase from 26.23% in 2015 to 34.88% in 2016 (following the

[150] Op. 41-42.

[151] Op. 41.

[152] Op. 41.

warrant exercise) and reach 35.61% in 2017.[153] Federal regulators require a ratio of only 6% and the *PNB* court found a ratio of 15.3% resulted in substantial excess capital that required adjustments to projections. 2006 WL 2403999, at *26. In *PNB*, the court assumed PNB would "preserve sufficient cash to avoid dropping below a [ratio] of 8.5%, then pay-out the rest." *Id.* at *27.

The trial court stated "[t]he evidence on which to perform a similar calculation here is lacking on this record."[154] The trial record, however, contains expert evidence of federal regulatory ratios and SWS's assets, which included substantial amounts of cash and government securities.[155] The trial record shows that Hilltop's strategy in acquiring SWS included "Buying . . . Excess Capital."[156] The trial record shows that Hilltop expected to use SWS's $135 million cash to pay transaction costs and the Merger Consideration, supporting Clarke's opinion that $117.5 million was not necessary for SWS's operations.[157] Jeremy Ford even testified that, "the only thing [SWS] really had was cash" or the "potential to have

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[153] A2087.

[154] Op. 43 n.227.

[155] A359-A361; A442; A531-A532; A2146-A2175.

[156] A844.

[157] A843; A894; A904.

cash" which SWS would need, in his view, "to repay that debt" owed to Hilltop and Oak Hill.[158]

The trial court's conclusion that it had "no way to judge on the record, how much capital, if any, would actually be distributable as of the merger date . . . *without* altering downward management's projections of cashflow as a result" was also incorrect.[159] Again, the trial court focused on distributions, not excess capital. But in any event, SWS maintained significant cash and low yield investments, so as Clarke testified, any distribution would have a *de minimis* effect on net income.[160]

The trial court made incorrect assumptions based on what it perceived as management's "implied judgment" that all excess capital would be needed to fund operations. This speculation was not supported by the trial record nor the result of an orderly and logical deductive process, and was therefore an abuse of discretion and should be reversed.

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[158] A176 at 409:11-13 (Ford).

[159] Op. 41.

[160] A3148 (Clarke Dep.).

### 2. The Trial Court's Focus on Planned Dividends Imposed an Impermissible Minority Discount on the Dissenting Shares

The trial court recognized that Ruback's model, as it pertained to SWS's substantial excess capital, was "somewhat problematic."[161] The trial court, however, was "persuaded that [Ruback's] approach [wa]s correct given the treatment of cash flows in the management projections."[162] Specifically, as discussed above, the trial court relied on Respondents' red-herring argument that the Management Projections did not assume the payment of dividends.[163] In doing so, the trial court effectively applied a dividend valuation model to the excess capital. By allowing the lack of a projected dividend to dictate its treatment of excess capital, the trial court inadvertently and impermissibly imposed a minority discount on the dissenting shares.

The trial court's mistake is not simply an error of calculation. It is an error of law. Delaware courts have explicitly rejected dividend valuation models and instead rely on DCF models, because the DCF model is consistent with Section 262. *PNB*, 2006 WL 2403999, at *26 (rejecting valuation model because it "calculated a minority share valuation using PNB's expected dividends rather than a DCF that was consistent with § 262"). Well-settled principles of Delaware law

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[161] Op. 41.

[162] Op. 41.

[163] Op. 41.

provide the petitioner in an appraisal is entitled to "her pro rata share of the appraised company's value as a 'going concern.'" *DFC Glob. Corp. v. Muirfield Value Partners, L.P.*, 2017 WL 3261190, at *16 (Del. Aug. 1, 2017) (citing *Cavalier Oil*, 564 A.2d at 1144). "By requiring that petitioners be afforded pro rata value, the Court require[s] that any minority discount be ignored in coming to a fair value determination." *Id.*; *see also In re Orchard Enterprises, Inc.*, 2012 WL 2923305, at *8 (Del. Ch. July 18, 2012), *aff'd sub nom. Orchard Enterprises, Inc. v. Merlin Partners LP*, 2013 WL 1282001 (Del. Mar. 28, 2013) (Table) ("Although Delaware law putatively gives majority stockholders the right to a control premium, *Cavalier Oil* tempers the realistic chance to get one by requiring that minority stockholders be treated on a pro rata basis in appraisal.").

Dividend valuation models fly in the face of this requirement by placing the value received by minority stockholders at the mercy of the board's (or a controlling stockholder's) control over dividend policy. The control value of SWS's excess capital is readily apparent in Hilltop's internal analyses. As discussed above, Hilltop explicitly accounted for and valued SWS's excess capital in its pricing strategy.[164] Thus, the trial court's dividend approach allowed Hilltop to retain <u>all</u> of the control value of SWS's excess capital, and denied the dissenting

[164] A894-A904.

stockholders their *pro rata* share in that valuable asset in contradiction to Delaware law. The trial court's determination of fair value must therefore be reversed.

### 3. The Trial Court's Analysis is Contrary to Delaware Law and Ignores Elements of Present Value

As of the Merger Date, SWS held $194 million of capital in excess of regulatory requirements. Delaware courts have accounted for excess capital in two ways. In *PNB*, the court held it was improper to assume the company "would retain cash simply to remain well above the well-capitalized threshold" into perpetuity. 2006 WL 2403999, at *27. The court instead adjusted the projected period cash flows so that *PNB* would not remain "well above the well-capitalized threshold" into perpetuity. In *Dunmire v. Farmer's & Merchants Bancorp of W. Pa., Inc.*, 2016 WL 6651411, at *16 (Del. Ch. Nov, 2016), where no credible evidence was proffered that excess capital drove the company's projected net income, the court simply added it to the DCF valuation of the operating assets just as Delaware law does for any other non-operating asset. *See, e.g.*, *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 476-76 (Del. Ch. 2011) (adding appraised value of land owned by the company but not used to drive the creation of income for the company); *Radiology Assocs.*, 611 A.2d at 495 ("This Court clearly must add the value of non-operating assets to an earnings based valuation analysis."); *Neal*, 1990 WL 109243, at *15-16. In effect, both *PNB* and *Dunmire* recognize that once reserve capital has reached a percentage that is above well-capitalized, additional capital above that level is value that should be added to the DCF value. *PNB*, 2006 WL 2403999, at *27; *Dunmire*, 2016 WL 6651411, at *16.

Clarke's valuation model followed both recognized approaches, accounting for $87.5 million of excess capital as of the Merger Date,[165] as in *Dunmire*, and accounting for an additional $30 million during the projected period,[166] as in *PNB*. Also, as in *PNB*, by only accounting for $117.5 million of SWS's $194 million in excess capital, Clarke's model left SWS well-capitalized into perpetuity.[167]

The trial court, however, adopted Ruback's model, which followed neither *Dunmire* nor *PNB*. Instead, Ruback's model assumes SWS will almost entirely destroy the present value of its excess capital, continuously distributing all of its net income, while funding its regulatory capital requirements into perpetuity with the excess capital it held as of the Merger Date.[168] Petitioners provided expert evidence that Ruback's methodology effectively zeroed out the present value of SWS's excess capital by reducing it from $1.45 per share to $0.07 per share. The methodology is irreconcilable with *PNB* and *Dunmire*, and runs contrary to fundamental principles of finance. Richard A. Brealey et al., *Principles of Corporate Finance* (11th ed. 2014) ("*a dollar today is worth more than a dollar*

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[165] A360.

[166] A361.

[167] *Id.*

[168] A492.

*tomorrow* . . . . Any investment rule that does not recognize the *time value of money* cannot be sensible.") (A3846); *see also DFC*, 2017 WL 3261190, at *1 (a determination of fair value must have a "reasonable basis in the record and in accepted financial principles").

## III. THE TRIAL COURT ERRED BY NOT TAKING INTO ACCOUNT ALL RELEVANT FACTORS, INCLUDING EVIDENCE OF UNFAIR DEALING PRESENTED AT TRIAL

### A. Question Presented

Did the trial court err as a matter of law in its statutory determination of SWS's fair value pursuant to Section 262 by not taking account of all relevant factors, including evidence of unfair dealing presented at trial? *See* A3175-A3190; A3322-A3339; A3386-A3391; A3484-A3508.

### B. Scope of Review

Section 262(h) mandates that the trial court "shall take into account all relevant factors" in determining fair value. "The interpretation and application of the mandates in Section 262 to [an] appraisal proceeding presents a question of law." *M.G. Bancorporation*, 737 A.2d at 524. This Court's review of questions of law is *de novo*. *Id*.

### C. Merits of Argument

The trial court found "that Petitioners' critiques of the sales process, and Hilltop's influence on the process, are generally supported."[169] The trial court further found there was a "problematic process" and the "existence of the Credit Agreement under which the acquirer exercised a partial veto power over competing

[169] Op. 3.

offers" had a "probable effect on the deal price."[170] Despite these findings of fact, the trial court gave no consideration of the unfair process or the $7.75 per share deal price itself in determining fair value.[171] These were relevant factors the trial court was required to consider.

A bedrock proposition of Delaware law is that "[a] fair process usually results in a fair price." *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1244 (Del. 2012). "Evidence of fair dealing has significant probative value to demonstrate the fairness of the price obtained." *Id.* Indeed, this Court recently and strongly reaffirmed that the best evidence of fair value of a corporation is the market price set in a fair and robust sales process. *DFC*, 2017 WL 3261190, at *1.

Delaware courts have repeatedly acknowledged that "[t]he converse is equally true: process can infect price." *Reis*, 28 A.3d at 467 (citing *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997)). In a different but related context, this Court observed that "the unfairness of the process . . . infects the fairness of price." *Bomarko, Inc. v. Int'l Telecharge Inc.*, 794 A.2d 1161, 1183 (Del. Ch. 1999), *aff'd*, 766 A.2d 437 (Del. 2000); *see also In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 78 (Del. Ch. 2013) ("As the Delaware Supreme Court has recognized, an unfair

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[170] Op. 30.

[171] *See* Op. 3. ("Because I do not find the merger price reliable on the unique facts here, I decline to focus extensively on the record as it relates to the sales process.").

process can infect the price . . . ."). A price infected by an unfair process, however, is not irrelevant to fair value – as if derived by random chance. Rather, an unfair process leads to a systematically lower price, as compared to a robust and competitive, arm's-length process. *See, e.g.*, Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L. J. 2 (2005); *In re Nine Sys. Corp. S'holders Litig.*, 2014 WL 4383127, at *47 (Del. Ch. Sept. 4, 2014) ("the fair price inquiry presented at trial was severely hampered by the unfairness of the process"). That is why Delaware law has stressed procedural safeguards in conflicted transactions. *See Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

The sales process and transaction price are relevant factors that the court must consider under Section 262. *DFC*, 2017 WL 3261190, at *3. The trial court cannot ignore the straightforward implications of an unfair and defective process and the price resulting from that process just as it cannot ignore a fair process and the price negotiated through that process. *Id.* By doing so here, the trial court erred as a matter of law.

**1. Summary of Evidence Presented on Unfair Process**

Petitioners undermined how the Merger was "initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); *accord Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 248

(Del. 2001) ("We recognize that these are the types of issues frequently raised in entire fairness claims, and we have held that claims for unfair dealing cannot be litigated in an appraisal. But our prior holdings simply explained that equitable claims may not be engrafted onto a statutory appraisal proceeding; stockholders may not receive recessionary relief in an appraisal. Those decisions should not be read to restrict the elements of value that properly may be considered in an appraisal."). Petitioners further presented evidence at trial that the Special Committee—at best—labored under a "controlled mindset," and—at worst—actively collaborated in enabling Hilltop's control. *See In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 798 (Del. Ch. 2011), *aff'd*, 51 A.3d 1213 (Del. 2012).

**a. Hilltop Timed and Initiated the Merger**

Hilltop made an unsolicited offer after months of "us[ing] confidential company information for [its] purposes without permission." *Hollinger Int'l Inc. v. Black*, 844 A.2d 1022, 1029 (Del. Ch. 2004).[172] Hilltop intentionally deceived SWS management to acquire more information for purposes of analyzing the acquisition of SWS.[173] Hilltop made its offer just before (i) SWS's stockholders

[172] *See supra* pp. 14-15; A165 at 367:4-368:3 (Ford); A910.

[173] A170 at 387:1-4 (Ford); A3136 (Ford Dep.).

could realize any benefit from its Bank restructuring and reorganizing[174] and (ii) anticipated increases to Federal Reserve discount rates that would have significant impact on SWS's profitability.[175] Immediately following its offer, Hilltop contacted key SWS employees – something other bidders were not permitted to do – to garner their support.[176] These acts put Hilltop ahead of the Special Committee and competing bidders and gave it a strategic advantage that no one could overcome.

### b. Hilltop Structured the Merger

Hilltop structured the Merger with a substantial stock component and fixed exchange ratio. In contrast, the Special Committee insisted that Stifel make an offer with a fixed value.[177] Hilltop's stock was trading at a (temporary) all-time high, which provided cheap currency to acquire SWS.[178] Its drop in value resulted in stockholders receiving $1.73 per share less than the fixed value Stifel offered.[179]

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[174] A1948; A108 at 44:14-46:18 & A115 at 273:2-23 (Edge).

[175] A379; A844; A896; A910.

[176] A2028.

[177] A2256.

[178] Hilltop initially proposed the fixed exchanged ratio. A89 at 167:24-168:21 (Miller).

[179] [($8.65 - $6.92) / $8.65].

Hilltop also "insist[ed]" on the inclusion of a force-the-vote provision and refused to include a majority of the minority provision.[180]

#### c. Hilltop Dominated and Controlled the Negotiations

Hilltop dominated the process. Hilltop had a veto over competing bids thanks to the Merger Covenant, and it refused to waive that covenant for any other deal at any price. Hilltop used the Merger Covenant as a sword to compel acceptance of its lower bid and a shield to block any other bid.[181] Second, when Stifel emerged with a higher bid, Hilltop responded by making threats and "shorten[ing] the time [the Special Committee] had for deliberation." *Hollinger*, 844 A.2d at 1085 (where board adopted poison pill to ensure time to complete its strategic process in face of a controlling stockholder's threatening transaction); *see also DFC*, 2016 WL 3753123, at *23 (noting that the short six-day window afforded for considering an offer may have negatively affected the sales price); *Mills Acq. Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279-88 (Del. 1989).

The Special Committee was ineffective and failed to maximize value for SWS stockholders. It hired a conflicted financial advisor,[182] who stiff-armed one higher bidder entirely.[183] The other higher bidder—Stifel—was ignored,[184]

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[180] A2252; A2233.

[181] A52 at 68:4-14 & A55 at 80:11-81:4 (Sterling).

[182] A50 at 60:18-64:5 (Sterling).

[183] Op. 19.

stalled,[185] given four days and limited information to complete due diligence and then "kicked" off the premises when it asked for a few more days to finalize a deal for at least $8.65 per share.[186] As compared to Hilltop—already an insider—taking 3 months to prepare internal valuations,[187] the disadvantage the Board and Special Committee put upon other aspiring bidders was severe.[188] These tactics resulted in a one-sided negotiation where the only outcome would be a Merger with Hilltop.

**d. The Post-Signing Process Inhibited Price Discovery**

The Board's conduct after the Merger Agreement was signed further shows the Merger was a foregone conclusion. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 938 (Del. 2003) ("The directors of a Delaware corporation have a continuing obligation to discharge their fiduciary responsibilities, as future circumstances develop, after a merger agreement is announced."); *see also Southern Peru*, 52 A.3d at 811 ("To my mind, the fact that none of these developments caused the Special Committee to consider renegotiating or re-evaluating the Merger is additional evidence of their controlled mindset.").

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[184] A2177; A2180; A2183.

[185] Op. 20 (citing A2177; A54 at 74:15-A55 at 79:16 (Sterling)).

[186] Op. 21.

[187] A165 at 367:4-368:3 (Ford).

[188] A3140-A3141 (Ruback Dep.).

Nothing was done to protect SWS stockholders. The Board never asked Sandler to update its financial analysis or if the Merger was still fair to SWS stockholders when Hilltop's stock price dropped.[189] When SWS management performed voting analyses that showed that stockholder approval was at risk,[190] the Special Committee gave the analyses to Hilltop and then changed the record date so Hilltop and Oak Hill could exercise their warrants and dilute the minority stockholders' voting power.[191]

The Board also made materially misleading and incomplete disclosures. For example, it falsely stated that other bidders had been provided with the same opportunity for due diligence as Hilltop.[192] Hilltop was given or took information Stifel was denied and also instructed SWS management to withhold sensitive information from the dataroom.[193] The Board also concealed the true reason for changing the record date—to allow Hilltop and Oak Hill to exercise their warrants in time to vote on the Merger.

The sum of the process, the Merger, and its approval was a Board and Special Committee operating under a "controlled mindset." *See, e.g., Southern*

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[189] A51 at 66:7-21 (Sterling).

[190] A2297-A2307; A2347-A2348; A2364-A2366.

[191] A3128-A3129 (Sterling Dep.); *see supra* pp. 24-25.

[192] A2831.

[193] A2229.

*Peru*, 52 A.3d at 798 ("[f]rom inception, the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the Merger"); *see also In re MONY Grp., Inc. S'holder Litig.*, 853 A.2d 661, 674 (Del. Ch. 2004).

### 2. External Markers of Value Confirm That the Unfair Process Affected the Transaction Price

The Special Committee negotiated for $7.75 per share and the evidence shows this was affected by the unfair process. The trial court found that "certain structural limitations unique to SWS make the application of the merger price not the most reliable indicia of fair value. . . . Here, because of the problematic process, including the probable effect on deal price of the existence of the Credit Agreement under which the acquirer exercised a partial veto power over competing offers, I find it inappropriate to rely on deal price."[194] These "structural limitations" and the "problematic process" did not cause Hilltop to *overpay* for SWS. Unsurprisingly, the evidence established just the opposite. The trial court did not attempt to reconcile how its concluded value of $6.38 per share fit within other valuation evidence prepared contemporaneously with the process, in contravention to Section 262.

First, the trial court did not consider that its concluded value of $6.38 per share was well below the $7.00 to $8.00 range that Hilltop calculated for SWS on a

[194] Op. 30.

stand-alone basis and presented to its board to approve the Merger at $7.75 per share. Indeed, on a stand-alone basis—excluding synergies—using a discount rate of 12% to 13%, Hilltop valued SWS at $7.50 to $7.75 per share, respectively.[195] This valuation was prepared contemporaneously after Hilltop, with industry expertise, performed extensive due diligence on SWS.[196] Notably, Hilltop's stand-alone valuation of SWS also accounted for $40.5 million in transaction costs, which amount to $0.80 per share.[197] Hilltop's contemporaneous stand-alone valuation of SWS is not referenced once in the Opinion.

Second, the trial court did not consider that its concluded value of $6.38 per share was well below Hilltop's $7.00 per share initial offer that the Special Committee rejected. The minutes of the Special Committee state explicitly that "Following discussion, the Special Committee concluded that Hilltop's offer of $7.00 per share undervalued the Company and was inadequate . . . ."[198] SWS stated the exact same thing to stockholders in the proxy.[199]

Third, the trial court did not consider SWS's tangible book value ("TBV") of $8.42 or that its $6.38 per share value was equal to approximately 0.76x of TBV.

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[195] A896; A903; A160-A161 at 348:11-350:17 (Ford). The trial court's concluded WACC, giving 50% weight to Ruback's size premium, was 12.76%

[196] *See supra* pp. 14-17; A910; A1042.

[197] A894 ($40.5 million / 50.290 million shares).

[198] A2120.

[199] A2820.

TBV is not mentioned once in the Opinion. The evidence established that the Special Committee told Hilltop and other potential bidders that SWS was worth "at least" TBV,[200] and SWS's TBV was backed by legitimate assets; cash, marketable treasury securities and loans.[201] Petitioners' expert testified that TBV was the floor to value a bank holding company, particularly with the asset composition of SWS. Respondents' second expert (Roth) considered 33 transactions from 2009 through 2014 and the median TBV paid in those transactions was 1.4x.[202]

The trial court noted its valuation was below "merger price" and this could be explained by expected synergies. The trial court, however, did not specify what it considered to be the "merger price"—the $7.75 per share value negotiated by the Special Committee or $6.92 per share that the Merger Consideration was worth when the Merger closed. Moreover, the trial court performed no analysis to support the assumption, and it cannot be reconciled with Hilltop's contemporaneous stand-alone valuation of SWS.

* * *

The trial court's opinion of fair value for SWS is substantially below (i) Hilltop's contemporaneous stand-alone valuation of SWS, (ii) the $7.00 per share

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[200] A2820; A2122; A2065-A2071.

[201] *See* A2620.

[202] *See* A570. *See also* A404. A "substantial discount to SWS's book value" was the reason SWS rejected Sterne Agee's $7.50 per share cash offer in 2011, when SWS was notably in much worse financial condition. Op. 11.

offer rejected by the Special Committee because it undervalued SWS,[203] (iii) market evidence for the valuation of financial services companies, and (iv) a higher bid by a third-party quashed by an unfair sales process. By not considering contemporaneous evidence of the unfair process in its determination of fair value, the trial court failed to consider "all relevant factors" as required by Section 262 and should be reversed.

[203] A2121.

## CONCLUSION

For the reasons set forth herein, the trial court's $6.38 fair value determination should be reversed and remanded.

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Dated: September 5, 2017

## CERTIFICATE OF SERVICE

I, Marcus E. Montejo, do hereby certify on this 5th day of September, 2017, that I caused a copy of Appellants' Opening Brief to be served via eFiling through File & Serve*Xpress* upon the following counsel of record:

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