IN THE

Supreme Court of the State of Delaware

MERLIN PARTNERS, LP and AAMAF, LP,

Petitioners-Below,
Appellants/Cross-Appellees,

v.

SWS GROUP, INC. and HILLTOP SECURITIES HOLDINGS LLC,

Respondents-Below,
Appellees/Cross-Appellants,

v.

LONE STAR VALUE INVESTORS, LP and LONE STAR VALUE CO-INVEST II, LP,

Petitioners-Below,
Cross-Appellees.

No. 295, 2017

CASE BELOW:

COURT OF CHANCERY OF THE STATE OF DELAWARE,
C.A. No. 10554-VCG

APPELLEES/CROSS-APPELLANTS' ANSWERING BRIEF ON APPEAL AND OPENING BRIEF ON CROSS-APPEAL

Of Counsel:

William Savitt
Andrew J.H. Cheung
Noah B. Yavitz
WACHTELL, LIPTON, ROSEN & KATZ
51 West 52nd Street
New York, New York 10019
(212) 403-1000

October 5, 2017

ROSS ARONSTAM & MORITZ LLP

Garrett B. Moritz (Bar No. 5646)
Eric D. Selden (Bar No. 4911)
Nicholas D. Mozal (Bar No. 5838)
100 South West Street, Suite 400
Wilmington, Delaware 19801
(302) 576-1600

Attorneys for Respondents-Below, Appellees/Cross-Appellants SWS Group, Inc. and Hilltop Securities Holdings LLC

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Cases **Page**

<u>Rules and Statutes</u>

NATURE OF PROCEEDINGS

This appraisal arose from the 2015 acquisition of SWS Group, Inc. ("SWS") by Hilltop Holdings Inc. ("Hilltop") for consideration worth $6.92 per share.

SWS was a bank holding company, listed on the New York Stock Exchange, that operated a broker-dealer and a small bank. In 2011, Hilltop and Oak Hill Advisors, L.P. ("Oak Hill") provided SWS with $100 million in emergency funding to stave off a capital crisis. The evidence at trial established that SWS "was a struggling bank" that suffered from "structural problems" and had "consistently underperformed management projections."[1] The evidence at trial also established Hilltop's acquisition was driven by anticipated synergies.[2]

At trial, each party relied upon a discounted cash flow ("DCF") analysis to establish SWS's fair value. Petitioners' expert valued SWS at $9.61 per share, a price that far exceeded not only the merger price but any indication of what anyone was ever willing to pay for SWS. Respondents' expert valued SWS at $5.17 per share, a price consistent with the available market evidence. Accepting neither party's DCF, the Court of Chancery appraised SWS at $6.38 per share. The court observed that "the fact that [its] DCF calculation resulted in a value below the merger price is not surprising: the record suggests that this was a synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."[3]

---

[1] Op. 2-3.

[2] Op. 16, 49-50.

[3] Op. 49-50.

SUMMARY OF ARGUMENT

The appeal and cross appeal present five issues.

(1) **Size premium** (DENYING Petitioners' Issue 1; Respondents' Cross-Appeal Issue 1). Both parties appeal the Court of Chancery's determination of the size premium included in SWS's cost of equity. SWS's unaffected pre-offer market capitalization was $198.5 million. This is undisputed. Also undisputed is that this market capitalization places SWS within the decile grouping correlating to a 4.22% size premium in the definitive published studies routinely relied upon by Delaware courts. Petitioners nevertheless advocated below what their expert called a "circular approach" to determining SWS's size premium, which assumes the valuation conclusion and then backsolves for the size premium. Using the circular approach, Petitioners sponsored a size premium of 2.69%.

The Court of Chancery declined to employ the customary 4.22% size premium and instead averaged the customary size premium with the 2.69% figure derived through the circular approach. This was error. The "circular approach" is proper, if ever, only for private companies whose actual market capitalization cannot be observed on liquid markets. SWS is not such a company. Petitioners' contention that employing a size premium based on observed market capitalization is improper when valuing companies with convertible debt is without merit. The published studies calculate size premiums on the basis of observed market capitalization, without regard to warrants or convertible debt. Petitioners have cited no law and no economic evidence justifying reliance on the "circular approach" here. 4.22% was the proper size premium.

(2) **Equity risk premium** (Respondents' Cross-Appeal Issue 2). In the trial court, Petitioners' proposed valuation used a supply-side equity risk premium while Respondents used the historical risk premium. Respondents presented evidence showing that the prevailing weight of economic evidence favors the historical risk premium. Petitioners did not present evidence capable of sustaining the conclusion that the supply-side approach represents current best practices. The trial court nevertheless sided with Petitioners. This was error in view of the evidentiary record as to the current state of learning in the valuation community.

(3) **Excess regulatory capital** (DENYING Petitioners' Issue 2). Petitioners argued below that SWS had over $100 million of "distributable" excess regulatory capital that should have been included in SWS's valuation as a non-operating asset. Rejecting this contention, the trial court credited evidence showing that SWS could not reduce its regulatory capital "without effect on the Company's ability to generate cash flow consistent with the projections."[4] The trial court thus found "'no basis in equity' to add to the DCF analysis a one-time dividend of excess regulatory capital."[5] On appeal, Petitioners insist that SWS's projected capital levels were excessive and disguised distributable assets. This contention is inconsistent with the trial court's well-supported factual findings and implausibly suggests that SWS — which the court found "was continuing to lose

[4] Op. 42.

[5] Op. 42-43 (quoting *In re PNB Holding Co. S'holders Litig.*, 2006 WL 2403999, at *26-27 (Del. Ch. Aug. 18, 2006)).

money on declining revenues" on the eve of the merger[6] — should have projected an even greater return on its total capital.

(4) **Warrant exercise** (Respondents' Cross-Appeal Issue 3). The Court of Chancery determined that Hilltop and Oak Hill each exercised warrants for the purpose of voting in favor of the merger and that these warrants were exercised in expectation of the merger. Despite finding that the warrants were exercised in expectation of the merger, and would not have been exercised absent the merger, the trial court counted the exercise, and resulting change in SWS's capital structure, among the "known elements of value, including those which exist on the date of the merger" that should be included in the determination of SWS's fair value.[7] The trial court's decision departs from the language of Section 262 (which excludes elements of value arising from the expectation of a merger) and from well-founded precedent (under which merger-related changes in capital structure are excluded from fair valuation as elements of value arising from the expectation of the merger).

(5) **The transaction price** (DENYING Petitioners' Issue 3). In the trial court, neither party relied on the transaction price to establish SWS's fair value. On appeal, Petitioners contend that "an unfair process leads to a systematically lower price" below fair value, and the Court of Chancery thus erred by finding a fair value below the transaction price.[8] The argument fails on multiple grounds.

---

[6] Op. 35.

[7] Op. 37-38.

[8] Petitioners' Opening Brief ("POB") 44-45.

Petitioners never raised any such argument below and it is waived. Moreover, the Court of Chancery did not find that the process was unfair, but rather that the "structural limitations" imposed by the standard terms of SWS's $100 million loan from Hilltop and Oak Hill — the merger covenant that provided Hilltop a partial veto right over some transactions during some of the time leading up to the merger — rendered the merger price "not the most reliable indicia of fair value."[9] Notwithstanding the terms of the credit agreement, SWS conducted a multi-party auction which yielded no bidder other than Hilltop at any price. Moreover, in the period before the merger closed, the merger covenant fell away and any bidder could have made an offer for SWS subject only to a low termination fee, but none expressed any interest at any price.

All the objective evidence indicates that SWS was worth far less than the merger price. SWS shares did not trade anywhere near the merger price. SWS was in long-term decline and its performance sagged badly in the period preceding the merger. No one but Hilltop was willing to make a bid. And Hilltop bid only in the expectation of capturing synergies, ultimately agreeing to a premium price that shared those synergies with SWS's stockholders. As the Court of Chancery found, those synergies implied a fair valuation below the transaction price.

---

[9] Op. 30.

COUNTERSTATEMENT OF FACTS

A. SWS's business

SWS was a Texas-based bank holding company that traded on the New York Stock Exchange.[10] It operated two general business segments: traditional banking (the "Bank") and brokerage services.[11] Unlike a traditional bank, SWS had "minimal retail deposits." Nearly 90% of its deposits were derived from the overnight sweep accounts held by brokerage clients.[12]

In late 2009, the Bank's non-performing assets spiked as the Great Recession hit the North Texas real estate market.[13] Although the Bank still had enough "excess capital" over regulatory minimums to qualify as a "well capitalized" institution under federal regulations,[14] federal regulators imposed a Memorandum of Understanding on the Bank in July 2010, followed by a Cease and Desist Order in February 2011, each restricting the Bank's activities and requiring the Bank to improve its capital position.[15]

SWS thus needed a capital infusion. It first tried to raise capital through a public offering of convertible unsecured debt. That offering failed for lack of market interest, causing SWS's stock price to fall below $4.00 per share.[16] SWS

---

[10] Op. 5.

[11] *Id.*

[12] Op. 6.

[13] *Id.*

[14] A1541.

[15] Op. 6-7.

[16] Op. 7-8.

then negotiated a cash infusion from Hilltop and Oak Hill, an investment firm (memorialized in a "Credit Agreement"), which was approved by a stockholder vote in May 2011.[17]

Under the Credit Agreement, Hilltop and Oak Hill each loaned SWS $50 million through a senior unsecured credit facility, bearing 8% interest annually and due to be repaid in July 2016.[18] The lenders received warrants covering the value of their principal, exercisable at $5.75 per share. The Credit Agreement provided Hilltop and Oak Hill the right to appoint one director (and one observer) to the SWS board. A covenant in the Credit Agreement restricted SWS from entering a merger transaction under certain circumstances while any principal remained outstanding.[19] Because the Credit Agreement allowed SWS to prepay the loan if SWS's common stock price exceeded $8.625 for 20 out of 30 trading days, the merger covenant could not block a merger proposal valued over that amount and a potential acquirer willing to pay that much could essentially prepay the loan.[20]

---

[17] Op. 8-9. Petitioners claim that SWS refused to negotiate with Sterne Agee as a potential acquirer during its capital crisis. POB 6 n.11. The evidence at trial showed that Sterne Agee could not then buy SWS because it was not a bank holding company. A38 at 11:24-12:3 (Sterling); A104-05 at 230:23-231:9 (Edge). During the SWS sale process in 2014, Sterne Agee said it "w[as] not interested in buying the company." A43 at 30:24-31:1 (Sterling).

[18] Op. 8-9.

[19] *Id.*

[20] Op. 9-10.

B. SWS's failed turnaround

With the loan in hand, SWS sought to clean up its operations.[21] Although SWS managed to improve the Bank's capital adequacy ratios, SWS did not have pools of undeployed capital on its balance sheet. To the contrary, the full deployment of SWS's capital was not only a considered element of management's operating plan, but also the subject of negotiation with federal regulators. In January 2013, federal regulators agreed to terminate the Cease and Desist Order, but required that SWS commit to a "written business and capital plan" negotiated with the government.[22] The regulatory plan called for the Bank to retain all of its capital and allowed no more than 10% growth per year.[23] The plan also included "the continued diversification of the balance sheet and conservative growth strategies" and management of a "tiered investment portfolio designed to provide

---

[21] Op. 12.

[22] A2660; Op. 12. While regulators agreed to terminate SWS's operating agreement in late 2014 in advance of the merger closing, SWS understood that its capital plan would regardless remain under close supervision by regulators. *See* A110-11 at 254:10-255:11 (Edge); B15 at 58:18-59:1 (Chereck Dep.).

[23] A98 at 204:15-205:8 (Chereck); A112 at 262:12-21 (Edge). Of course, the Bank was in fact unable to grow at all, let alone by 10% annually. A2566-67.

cash flows for loan originations."[24] SWS's business plan was thus premised on the full deployment of its capital to fund projected growth.[25]

Despite management's projections of growth, SWS continued to struggle. SWS "*never* met its budget between 2011 and 2014"[26] and "continued to lose money on declining revenues."[27] Although non-performing loans declined, the Bank "overall, produced 'very, very disappointing results'" while the broker-dealer business was "stagnant."[28] In June 2013, SWS made an accounting decision to write down approximately $30 million of its net operating losses, because management did not believe SWS would generate income in the coming years against which it could apply the net operating losses.[29] The Court of Chancery found that this audited accounting determination indicated that management's growth and profitability projections were optimistic.[30]

---

[24] A2554-55.

[25] Op. 40 n.217 (citing A98 at 205:17-206:19 (Chereck)), 41-42. Petitioners distort Ford's testimony that the "only thing" SWS had at the holding company level "was cash . . . potential to have cash," apparently to imply that SWS held undeployed capital in cash. POB 12. Ford was explaining that the excess capital at SWS was necessarily operating capital "in the subsidiaries," and not capital in the holding company, which had no operations. The holding company only had the "potential to have cash" derived from its broker-dealer and bank subsidiaries. A176 at 409:1-13 (Ford).

[26] Op. 12 (emphasis in original).

[27] *Id.*

[28] *Id.*

[29] Op. 13.

[30] *Id.*

In August 2013, in a further effort to reduce SWS's expense base and improve margins, the board directed SWS's CEO to cut costs by 10% within 30 days.[31] Meanwhile, Federal Reserve regulators expressed concern about SWS's ability to repay the $100 million loan from Hilltop and Oak Hill and cautioned management not to assume it would be able to reduce capital levels at the Bank to fund repayment.[32] The board was also concerned about SWS's ability to pay back the loan because SWS "did not have a plan" for repaying this debt and had "few options available."[33] SWS's auditors informed the board that it might be necessary to flag the next audit with a "going-concern qualification," reflecting serious doubt that SWS could be able to continue over the following year.[34]

The Court of Chancery found that SWS would "continue to face an uphill climb to compete at its size going forward."[35] SWS was "subscale in every area," and industry-wide increases in regulatory, technology, and back-office expenses placed it at a disadvantage compared to its larger competitors, because it had had a smaller base across which to spread those costs.[36] Due to its inadequate scale and

[31] Op. 14-15.

[32] Op. 15; A110-11 at 254:10-255:11 (Edge); B703 at 103:17-104:9 (Edge Dep.).

[33] Op. 15.

[34] A74 at 108:5-12 (Miller).

[35] Op. 14.

[36] Op. 13.

well-publicized regulatory and capital problems, SWS struggled to attract and retain the revenue-generating employees that drove its performance.[37]

C. The market anticipates an acquisition of SWS

In the time leading up to its sale, there was active market speculation that SWS was a likely acquisition target, and that Hilltop, which had recently become a bank holding company, was a likely fit for a synergies-driven transaction.[38] Petitioners themselves invested in SWS based on the thesis that Hilltop was likely to make a synergies-based bid for SWS.[39] SWS's stock price "traded higher upon this speculation."[40]

D. Hilltop submits an unsolicited offer of mixed cash and stock valued at $7.00 per share

In late 2013, Hilltop began to evaluate a potential acquisition of SWS.[41] Hilltop determined that it could achieve substantial cost-savings through a merger because its recently acquired banking subsidiary, PlainsCapital, operated in

---

[37] Op. 14.

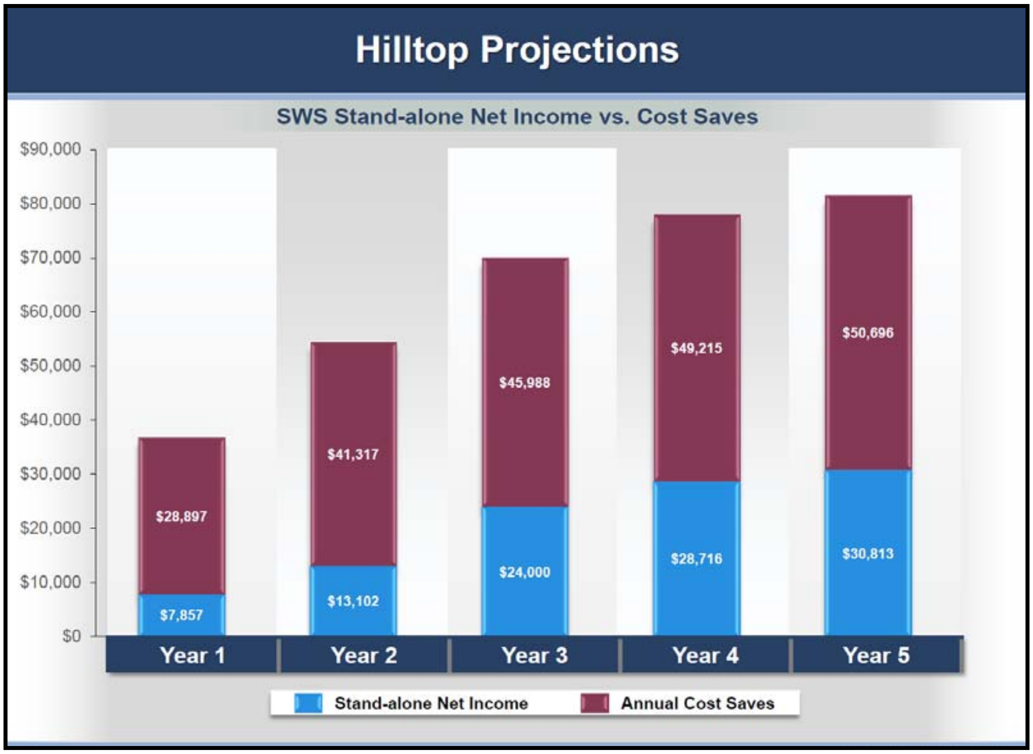
[38] Op. 15.

[39] Op. 15 n.87.

[40] Op. 15.

[41] Op. 16.

overlapping lines of business with SWS.[42] As the Court of Chancery found, "an SWS acquisition would derive much of its benefits from cost-savings in reduction of overhead rather than SWS's stand-alone performance,"[43] as reflected in the chart below, derived from Hilltop's stand-alone projections for SWS:[44]



[42] Op. 16; *see* A157 at 335-36 (Ford); A123 at 304 (Roth); A125 at 311:5-11 (Roth); B1288 (Hilltop acquisition model). The Hilltop projections incorporated information that Hilltop CEO Jeremy Ford received from SWS as an observer on SWS's board. Ford's confidentiality agreement with SWS permitted him to receive that information. Petitioners falsely suggest that Ford improperly used SWS information. The confidentiality agreement did not restrict Ford from using that information to analyze a Hilltop bid, and expressly permitted him to share the information with "[Hilltop] and [Hilltop's] directors, employees, and officers," and with Hilltop's "financial advisors, attorneys and accountants." B1289.

[43] Op. 16 (citing A1180-82); A1186; A158-59 at 340:4-341:11 (Ford); A484 (calculating Hilltop's expected savings per share).

[44] Op. 16. *Compare* A1181 *with* A1180.

Indeed, Hilltop's analysis indicated that SWS was worth less than $5.00 per share on a stand-alone basis.[45] Thus, any deal for SWS made sense only because of the annual cost saves.

Hilltop made an opening offer on January 9, 2014 to acquire SWS for $7.00 per share, to be paid half in cash and half in Hilltop stock.[46] As of that date, Hilltop owned just 4.4% of SWS's shares.[47] Hilltop had a single representative on SWS's 10-person board, and that representative recused himself from all deliberations related to the merger.[48] There is no evidence that any other director had financial ties to Hilltop or that any member of SWS management was beholden to Hilltop.[49]

---

[45] A159 at 341:5-11 (Ford). Hilltop's internal rate of return ("IRR") analysis for an SWS deal confirmed that Hilltop projected to lose money at its offer price absent synergies. A1186.

[46] Op. 16. Petitioners insinuate that Jeremy Ford improperly contacted SWS employees after the public announcement of Hilltop's offer. POB 17. The trial testimony shows only that Ford contacted people he had failed to call back in the run-up to the announcement of the transaction. A171 at 390:12-391:11 (Ford).

[47] A2743.

[48] B1294; A2072; B1298; B1302; B1304; B1306.

[49] A3582-83 (Respondents' Post-Trial Answering Brief).

E. SWS conducts a broad sales process

After receiving Hilltop's offer, the board formed a Special Committee to consider the possible sale, with independent director Tyree Miller as its chair.[50] The Special Committee retained Sandler O'Neill as its financial advisor and Davis Polk as its legal advisor.[51] Over the following months, the Committee met more than 20 times.

The Special Committee "'knew there were very, very strong synergy values already partly reflected'" in the Hilltop offer but wanted to "'convince Hilltop' to share more of the synergies with SWS shareholders."[52] To facilitate the sale process, Sandler O'Neill asked SWS's management to update its most recent strategic plan, which covered June 2014 through June 2016, and extend it through calendar year 2017.[53] Management's revised forecasts (the "Management Projections") rested on what the Court of Chancery found to be "favorable assumptions"[54] that predicted an immediate return to consistent profitability,

---

[50] Op. 17 (citing B1314); B1294 (January 15 board meeting minutes). Independent SWS director Christie Flanagan initially served on the Special Committee but later resigned. Petitioners characterize him as the "personal lawyer" to Hilltop Chairman Gerald Ford. POB 17. The trial court did not credit this claim of conflict, which is false. B771 at 75 (G. Ford Dep.).

[51] B1314 (January 22 Special Committee meeting minutes). Petitioners suggest that Sandler O'Neill was conflicted because it had previously worked with Gerald Ford and later assisted Hilltop with a bond offering. POB 18. The trial court did not credit these inaccurate claims of conflict which are unsupported in the record.

[52] Op. 17 (quoting A76 at 115:2-6 (Miller)); B1315.

[53] Op. 17 (citing A39 at 15:6-16:14 (Sterling)).

[54] Op. 18.

despite four straight years of losses and management's recent accounting determination that it was likely to keep losing money in the coming years.[55]

Beginning in early February 2014, Sandler O'Neill conducted a broad canvass of merger partners, contacting the 17 bidders identified as the most likely potential buyers.[56] Fourteen turned Sandler down flat. Aside from Hilltop, only two parties expressed interest in an acquisition of SWS: Esposito and Stifel.[57]

1. Esposito

Esposito was a Dallas-based broker-dealer that had only about $10 million in capital.[58] At the urging of Lone Star (a Petitioner in this action),[59] Esposito contacted Sandler O'Neill on February 12, 2014 to express interest in buying some or all of SWS, eventually indicating an interest in acquiring the company for $8.00 per share, subject to what the Court of Chancery characterized as a "slew of conditions," including the availability of financing.[60] While Esposito's internal

---

[55] Op. 13; *see also* B1336.

[56] Op. 18 (citing A2818).

[57] Op. 18-20.

[58] Op. 18 (citing A76-77 at 118:6-119:2 (Miller)).

[59] Op. 19 n.107 (citing A2077; B1350).

[60] Op. 19 (citing A2091); *see also* A41 at 22:23-23:4 (Sterling); B1351.

documents reveal that it performed little analysis before contacting SWS,[61] its $8.00 per share indication reflected substantial anticipated synergies.[62]

None of the Special Committee members had ever heard of Esposito, despite decades of experience in the Dallas banking community.[63] Furthermore, the Special Committee and Sandler O'Neill were skeptical that Esposito could actually acquire SWS, among other reasons because Esposito was not a bank holding company and did not have the necessary capital. SWS nevertheless engaged Esposito in hopes of developing a credible offer. As its internal documents demonstrate, Esposito came to the conclusion that SWS was "a dead man standing"[64] and it never made an offer to buy SWS at any price.[65]

2. Stifel

The only other party to express any interest in an acquisition of all of SWS was Stifel, a diversified bank/broker-dealer. The Court of Chancery noted the parties' "heav[y] dispute" regarding whether Stifel's interest was genuine but declined to resolve the dispute, finding it not relevant to its ultimate value determination.[66]

---

61 *See, e.g.*, B1353 (Esposito principal Mark Esposito asking "[w]hy does SWS lose so much money?" after reviewing SWS public filings); B1354 (a prospective financing partner concluded that Esposito "had no plan" as of February 2014).

62 B1356 (noting that expected synergies accounted for almost half of expected net income).

63 Op. 19.

64 B1357.

65 Op. 19.

66 Op. 17, 20-22.

What the trial court did find is that Stifel made a non-binding indication of interest "driven significantly by synergies"; agreed to complete due diligence to confirm a bid by March 31, 2014; then asked for an extension of that deadline to conduct more due diligence and was turned down; and ultimately declined to make a bid at any price.[67]

F. The Special Committee negotiates with Hilltop for more money and makes a final try with Stifel

In early March 2014, two months after Hilltop's offer, the Special Committee rejected Hilltop's initial $7.00 offer and told Hilltop that SWS had received additional indications of interest at higher prices.[68] Sandler O'Neill told Hilltop that even though "SWS [did]n't make money on its own," Hilltop could pay more than $7.00 because the "significant synergies both taking out costs as well as some revenue enhancements" would make a transaction accretive to Hilltop even at a higher price.[69]

On March 19, 2014, Hilltop increased its offer to $7.50 per share, composed of 25% cash and 75% Hilltop stock.[70] The Special Committee countered at $8.00 per share.[71] Jeremy Ford rejected this and declined even to counter, telling Sandler

[67] Op. 21-22.

[68] A2122 (March 5 Special Committee meeting minutes).

[69] A49 at 53:18-54:3 (Sterling); B1367-71.

[70] Op. 22.

[71] *Id.*

O'Neill that Hilltop was "out of money."[72] The Special Committee then authorized Sandler to go over Jeremy Ford's head to Gerald Ford and seek a deal at $7.75. Gerald Ford said Hilltop would do a deal at $7.75, while making clear that that was its best and final offer. Hilltop understood the parties to have a "handshake" deal at that price.[73]

On March 24 — after Stifel executed a non-disclosure agreement — the Special Committee told Hilltop that another party was seeking to participate in the process at a price above Hilltop's offer, and that the Special Committee intended to sign a non-disclosure agreement to govern due diligence by that party.[74] Hilltop viewed this as a "retrade" and suspected it was a negotiating tactic.[75] Hilltop reiterated that it would not increase its bid and would not waive the merger covenant and set a March 31 deadline for SWS to either accept or reject its $7.75 offer.[76]

Stifel, meanwhile, had undertaken to confirm a higher bid by March 31, notwithstanding Hilltop's merger covenant.[77] But as the deadline approached,

---

[72] A49 at 55:23-56:5 (Sterling); Op. 23 (citing A159 at 343:1-344:10 (Ford)); B1372 (March 20 Special Committee meeting minutes).

[73] Op. 23; *see also* B1372; A159 at 343:7-10 (Ford).

[74] A2220-22 (March 24 Special Committee meeting minutes).

[75] Op. 23.

[76] Op. 23. Petitioners assert that Hilltop threatened to force SWS to repay its $100 million loan in response to the perceived "retrade." POB 21. This contention is contradicted by the record. A2220-22.

[77] Op. 21.

Stifel sent the Special Committee a letter saying that it wanted more diligence and suddenly suggesting that the "blocking rights [*i.e.*, the merger covenant] present[ed] a problem."[78] This unexplained change of position reinforced the Special Committee's skepticism of Stifel's intentions:

> We felt like this was not a genuine acquirer . . . . [W]e went back to, okay, our suspicions about these people proved out to be right. They're throwing sand in our gears. They're trying to mess up our ability to deal with other suitors. This was just kind of a spoiler.[79]

On March 31, the Special Committee met to discuss the only offer available, from Hilltop.[80] Sandler O'Neill presented its financial analysis of the merger consideration and delivered its opinion that the proposed consideration was fair to SWS's stockholders from a financial point of view.[81] The Special Committee unanimously recommended that SWS's board adopt and approve the proposed transaction.[82] The board approved the merger later that day.[83]

---

[78] B1374; *see also* Op. 22.

[79] A81 at 138:12-18 (Miller); *see* A2258 (noting the Special Committee's concern that Stifel would lower its bid after delaying the process); A48 at 49:15-21 (Sterling) (expressing the view that Stifel had no interest in buying SWS).

[80] Op. 23 (citing A2258).

[81] Op. 23 (citing B1318 (fairness opinion); A2258 (March 31 Special Committee meeting minutes)).

[82] Op. 24.

[83] *Id.*

G. Petitioners accumulate shares for appraisal

Petitioner Lone Star had held a significant position in SWS early in 2014. As the trial court found, Jeff Eberwein, Lone Star's CEO, urged Esposito to make an offer for SWS.[84] When SWS's share price jumped on Esposito's announcement, Eberwein immediately sold Lone Star's entire position, booking a substantial profit.[85]

In August 2014, Lone Star launched a "co-invest fund" to re-accumulate SWS shares for the purpose of seeking appraisal.[86] Confirming Lone Star's negative view of SWS's stand-alone prospects, the marketing materials for this appraisal fund warned of the risks that (1) "[t]oo many 'no' votes from arbitrageurs seeking appraisal may stop the deal" and "SWS shares would lose value from [Lone Star's] cost basis on a deal break"; and that (2) if "[Hilltop] walks away from the deal [then] we lose money."[87] Petitioners Merlin Partners, L.P. and AAMAF, L.P (collectively "Ancora," as both are controlled by Ancora Advisors) pursued a similar investment strategy and their internal documents similarly note SWS's poor stand-alone operating performance.[88] The downside risks that Petitioners identi-

[84] Op. 19 n.107; A185 at 445-447 (Eberwein); A2077.

[85] B1375; B1381 (Eberwein sells 157,000 shares of SWS on the same day that Esposito's offer was announced); A188 at 458:17-19 (Eberwein).

[86] B382 at 23:21-25 (Eberwein Dep.); B334 at 33:22-24 (Bannerot Dep.) (deposition testimony of Lone Star employee Frederick Bannerot); B1388.

[87] B1395, B1399; *see also* Op. 24.

[88] B1408; B83 at 46:16-18, 104-105 (Hummer Dep.) (deposition testimony of Ancora employee Ryan Hummer).

fied all reflected the view that SWS would perform poorly if it continued as a stand-alone entity.[89]

H. Oak Hill and Hilltop exercise warrants

On September 26, 2014, shortly before the record date for the stockholder vote on the merger, Oak Hill partially exercised its warrants, acquiring a total of 6.5 million shares of SWS and eliminating $37.5 million in debt.[90] On October 2, 2014, Hilltop exercised its warrants in full, acquiring 8.7 million shares of SWS.[91] Both Oak Hill and Hilltop exercised these warrants to vote for the merger, and it is undisputed that neither would have exercised the warrants absent the proposed

---

[89] Op. 24 (noting the "irony" of Petitioners' position that, although they claim SWS was worth far more than the merger price, "a prime investment risk" to the dissenting stockholders was that "the deal would not close and they would remain investors in SWS as a going concern"); *see* B1410 (warning Lone Star's investors that "[t]he main risk to this strategy is [Hilltop] gets frustrated and walks away from the contemplated acquisition of SWS").

[90] Op. 24 (citing A2682). Petitioners insist that the Special Committee moved the record date in order to permit Oak Hill and Hilltop to exercise their warrants. POB 24, 50. In fact, the record date was moved because of a delay in the SEC review-and-comment process. SWS's board initially estimated that an October 15, 2014 stockholder meeting date with a September 5, 2014 record date would leave enough time for the SEC's review and approval. *See* A2308. After learning on September 3, 2014 that the SEC's review would not be completed in time, *see* B1411, the Special Committee delayed the meeting and record date by roughly a month. A2362. *See also* A3587 (Respondents' Post-Trial Answering Brief).

[91] Op. 24 (citing A2720).

merger.[92] When Hilltop exercised its warrants, it lost any right to block any acquisition of SWS.

I. Fiduciary duty actions are filed and dropped

Two SWS stockholders filed putative class action complaints challenging the transaction after it was announced, which were subsequently consolidated under the caption *In re SWS Group, Inc. Stockholder Litig*., C.A. No. 9516-VCG. The parties agreed upon a non-monetary settlement in advance of the SWS stockholder vote, but the plaintiffs subsequently voluntarily dismissed their claims with prejudice before the settlement hearing.[93] There has been no fiduciary challenge to the transaction.

J. SWS records weak 2014 performance

On September 26, 2014, SWS announced its financial results for the fiscal year ended June 30, 2014: another net loss of $7 million and another decline in net revenue, from $271.6 million to $266.4 million.[94] After closing, SWS tabulated its 2014 calendar year financial results, which again lagged behind the Management

---

[92] Op. 38; *see* A160 at 346:13-347:4 (Ford) (exercising the warrants absent the merger "made no financial sense" because it would mean forfeiting interest and its protections under the Credit Agreement only to acquire a larger equity position in a "bad company that [was] losing money."); B533-34 at 152-155 (Kauffman Dep.) (Oak Hill representative: same).

[93] *See* B1604 (Stipulation of Dismissal, *In re SWS Group, Inc. Stockholder Litig*., C.A. No. 9516-VCG (Del. Ch. Feb. 25, 2016)); B1610 (SWS Group, Inc., Report on Form 8-K, Nov. 13, 2014).

[94] Op. 25 (citing A2550).

Projections in every metric.[95] SWS recorded a net loss of $15.6 million in 2014 — $20.8 million short of the projections.[96]

K. Stockholders approve the merger

On November 21, 2014, SWS's stockholders approved the merger, with 75.7% of voting shares and 68.8% of outstanding shares voting in favor.[97] Excluding the shares held by appraisal dissenters, virtually all voting shares approved the transaction.[98] In the eight months between the announcement of the merger agreement and the stockholder vote, no other bidder came forward to express an interest in a potential transaction, notwithstanding a 3% breakup fee and typical deal-protection measures[99] — even after Hilltop exercised its warrants and the merger covenant fell away on October 2.[100] The transaction closed on January 1, 2015. Due to a decline in Hilltop's share price between March 2014 and the closing date, the fixed stock component of the merger consideration fell in value. The merger consideration was worth $6.92 per share of SWS at closing.[101]

---

[95] *Compare* A2283 (Management Projections) *with* B1415-16 (CY2014 results).

[96] *Id*.

[97] B1459.

[98] *See* A3435 (Respondents' Opening Post-Trial Brief)

[99] A2832.

[100] Op. 25.

[101] Op. 25.

L. The parties' widely divergent estimates of SWS's value at trial

Professor Richard Ruback presented expert valuation testimony for Respondents.[102] Ruback relied on a conventional DCF analysis. To derive SWS's future cash flows, Ruback looked to the Management Projections. Averaging the expected long-term growth rate of the economy and the expected long-term inflation rate, Ruback applied a generous perpetuity growth rate of 3.35%. He then discounted cash flows to the closing date at a rate of 14.95%, reflecting the risk-free rate, SWS's equity beta, a historical equity risk premium, and a size premium calculated using SWS's pre-offer market capitalization. Ruback's DCF yielded a valuation of $5.17 per share as of the Valuation Date. Ruback reconciled his DCF analysis with the merger price by noting the substantial expected synergies and cross-checked it against SWS's pre-offer share price.

Petitioners relied upon David Clarke, who opined that the fair value of SWS was $9.61 per share.[103] Clarke's valuation included a DCF analysis (to which he assigned 80% weight) and a comparable-companies analysis (to which he assigned 20% weight). Instead of looking to the Management Projections for SWS's expected future cash flows, Clarke created new projections that included two years of increasing growth and removed the interest payments SWS would have made had Oak Hill and Hilltop not exercised their warrants in connection with the merger. Clarke's DCF analysis assumed that SWS could distribute to stockholders $117.5 million in 2014 and 2017 with no effect on SWS's operations and results.

---

[102] A421-92 (Ruback Opening Report); A581-A635 (Ruback Rebuttal Report).

[103] A330-A420 (Clarke Opening Report); A525-80 (Clarke Rebuttal Report).

M. The Court of Chancery determines that SWS's fair value was $6.38 per share

The Court of Chancery adopted the DCF valuation proposed by Ruback, with four adjustments. *First*, the court adopted a size-premium at the midpoint between Ruback and Clarke's estimations.[104] *Second*, the court rejected Ruback's use of the historical equity risk premium, instead applying the supply-side equity risk premium proposed by Clarke.[105] *Third*, the court applied Clarke's beta of 1.10 rather than Ruback's 1.18.[106] These three adjustments reduced the discount rate from 14.95% to 12.76%. *Fourth*, the court subtracted certain warrant-related interest expenses from SWS's projected cash-flows for fiscal years 2015 and 2016.[107] Collectively, these adjustments yielded a fair valuation of $6.38 per share.

In reaching this valuation, the court rejected (1) Clarke's comparable-companies analysis because his comparables "diverge in significant ways from SWS in terms of size, business lines, and performance";[108] (2) Clarke's extended projections because, given SWS's "structural issues and performance problems," the court found "inadequate evidence to support the extension of straight-line unprecedented growth";[109] and (3) Clarke's proposed distributions of SWS's

---

[104] Op. 48-49.

[105] Op. 45-46.

[106] Op. 46-47.

[107] Op. 43.

[108] Op. 31.

[109] Op. 31-35.

capital.[110] The court noted that it was unsurprising that its DCF analysis yielded a value below the merger price, because the evidence indicated that "this was a synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."[111]

[110] Op. 41-42.

[111] Op. 49-50.

ARGUMENT

I. THE TRIAL COURT ERRED BY ASSIGNING WEIGHT TO PETITIONERS' "CIRCULAR" CALCULATION OF SWS'S SIZE PREMIUM

A. Question Presented

Whether the trial court erred in its DCF by rejecting the size premium determined by SWS's market capitalization. This issue was raised below and was considered by the trial court. A3266-67, A3286-87.

B. Scope of Review

In reviewing a statutory appraisal, the Court applies "an abuse of discretion standard and grant[s] significant deference to the factual findings of the trial court." *DFC Glob. Corp.* v. *Muirfield Value Partners, L.P.*, 2017 WL 3261190, at *12 (Del. Aug. 1, 2017). The trial court abuses its discretion "when either its factual findings do not have record support or its valuation is clearly wrong." *Golden Telecom, Inc.* v. *Glob. GT L.P.*, 11 A.3d 214, 219 (Del. 2010).

C. Merits of Argument

"[A]n equity size premium generally is added to [a] company's cost of equity in the valuation of smaller companies to account for the higher rate of return demanded by investors to compensate for the greater risk associated with small company equity." *Gearreald* v. *Just Care, Inc.*, 2012 WL 1569818, *10 (Del. Ch. Apr. 30, 2012). Annual databases published by Duff & Phelps report the observed size premiums for public companies, divided into "deciles" based on market capitalization. These size premium groups are based on the market value of outstanding equity of the companies in the data set, excluding convertible debt, convertible preferred shares, and unexercised options. *See Merion Capital, L.P.* v. *3M Cogent*, 2013 WL 3793896, at *19-20 (Del. Ch. July 8, 2013) (the size premium databases track "an empirical relationship between the market value of stocks and higher rates of return").

The calculation of the size premium of a public company is thus a simple exercise: the appraiser establishes the market capitalization of the company and looks up the associated size premium in the current Duff & Phelps database.[112] This is exactly what Respondents' expert Ruback did here. He multiplied SWS's stock price just before Hilltop's offer was announced ($6.06) by the number outstanding shares (32,747,990) to calculate a market capitalization of $198.5 million.[113] This market capitalization put SWS at the low end of a decile that included companies with market capitalizations between $190.9 million and $300.7. The reported size premium associated with companies in that range is 4.22%.[114]

---

[112] *See, e.g.*, *Merlin Partners LP* v. *AutoInfo, Inc.*, 2015 WL 2069417, at *15 (Del. Ch. Apr. 30, 2015); *3M Cogent*, 2013 WL 3793896, at *20; *Gearreald*, 2012 WL 1569818, at *12; *Cede & Co.* v. *JRC Acquisition Corp.*, 2004 WL 286963, at *8-9 (Del. Ch. Feb. 10, 2004).

[113] A439 ¶ 35 (Ruback Opening Report). This was a conservative approach, given that SWS's market capitalization had increased by 20% based on market speculation of an acquisition. Op. 15.

[114] Op. 47-48; B1466.

By contrast, Petitioners' expert Clarke instead used a methodology that he conceded was "circular" to yield a size premium of 2.69%.[115] Clarke first decided a DCF of SWS should yield a value of $464 million. He then consulted the Duff & Phelps database to find the reported size premium for companies with an observed market capitalization of $464 million.[116] In other words, Clarke used his DCF model to determine one of the inputs to that model. Asked at trial why he did not rely on SWS's observed market capitalization to derive the size premium, Clarke testified that his circular approach is what is "typically done in valuing companies" and declared that he could not think of "any logical explanation" for using a public company's market capitalization to determine its size premium.[117] Clarke further testified that the Duff & Phelps database included warrants.[118]

Every part of this testimony was in error. As Ruback established at trial — and as the size-premium databases unambiguously declare — the Duff & Phelps dataset excludes warrants and instead reports the observed size premium basis associated with equity value.[119] For this reason, courts appraising public

[115] A270 at 678:5-6 (Clarke).

[116] A366 (Clarke Report) ("Using the D&P CRSP size data, my concluded value for SWS of $464 million would place [SWS] in the ninth decile, indicating that a size premium of 2.69% would be appropriate.").

[117] A211 at 550:14-551:5 (Clarke); A270 at 678:9-10 (Clarke) ("I think I would use a circular approach no matter what.").

[118] A210 at 545:21-546:2 (asserting that the warrants rendered SWS "really sort of unique among public companies") (Clarke); A270 at 679:14-15 (Clarke).

[119] A283 at 729:23-730:16 (Ruback); B1472 (noting that Duff & Phelps relies on the CRSP database); B1476 (noting that the CRSP database excludes warrants); A271 at 682:6-10 (Clarke).

companies routinely look to Duff & Phelps data to calculate size premiums without regard to the capital structure of the subject company. *See supra,* n.112. And contrary to Clarke's testimony, there is an eminently "logical" explanation for this approach: it tethers a company's size premium to its actual size and cabins the discretion of litigation-driven appraisers to value companies free from the discipline of market evidence. For these reasons, Delaware courts have repeatedly rejected Clarke's "circular" approach in cases where a company's observable equity value is available.[120]

On appeal, Petitioners contend first that SWS's "operative reality" at the time of the merger included 15,217,319 shares issued to Hilltop and Oak Hill upon exercise of their warrants, and that those shares push SWS into a higher size-premium decile.[121] For the reasons set out in Part IV, *infra*, Petitioners are incorrect that these shares were part of SWS's operative reality under Section 262. In any event, the inclusion of those shares would not affect the proper size premium of 4.22%. Multiplying the 48,115,828 shares Petitioners say were part of SWS's operative reality by the unaffected stock price of $6.06 yields an adjusted market capitalization of $291 million — still well within the $190.9 to $300.7 million decile associated with the 4.22% size premium.[122]

---

[120] *See In re Appraisal of DFC Glob. Corp.*, 2016 WL 3753123, at *14 (Del. Ch. July 8, 2016), *rev'd on other grounds sub nom. DFC Glob. Corp.* v. *Muirfield Value Partners, L.P.*, 2017 WL 3261190, at *12 (Del. Aug. 1, 2017); *3M Cogent*, 2013 WL 3793896, at *19; *JRC Acquisition*, 2004 WL 286963, at *8-9.

[121] POB 27-28.

[122] *See* A3623 at n.173 (Respondents' Answering Post-Trial Brief).

Notwithstanding this arithmetic, Petitioners falsely claim that "Ruback conceded that if he included the warrants, he would be pushing himself into the wrong decile."[123] In the cited testimony, Ruback only stated that he did not include the value of warrants in SWS's market capitalization because the database groupings were based on market capitalizations that specifically excluded warrants. For that reason, he explained, including warrants when calculating a company's market capitalization would not be "apples to apples" and would risk "pushing [the analysis] into the wrong portfolio." Ruback never testified that including the warrants in SWS's size premium calculation would change the decile, which is inaccurate as a matter of simple math.[124] No matter how Petitioners seek to distort the record, the size premium remains the same whether or not the shares issued in connection with the warrant exercise were part of SWS's operative reality.

The trial court nevertheless adopted a size premium of 3.46%, the midpoint between the 4.22% premium applicable to companies with SWS's market capitalization and the 2.69% premium applicable to larger companies. The court concluded that averaging the premiums was appropriate because, while SWS was a public company and thus "generally susceptible to Ruback's market capitalization approach," it also "had a substantial amount of in-the-money warrants and

[123] POB 28.

[124] A283 at 729:23-730:16 (Ruback).

significant influence by certain major creditors — making it in some ways more analogous to a private company."[125]

The court departed from well-founded precedent in failing to base SWS's size premium on its market capitalization. "The Court of Chancery consistently has used market capitalization as the benchmark for selecting the equity size premium." *3M Cogent*, 2013 WL 3793896, at *19. "[T]he size premium itself is calculated using market value, when available, as it is here." *DFC Glob. Corp.*, 2016 WL 3753123, at *14. Where, as here, there is an observable market capitalization, Delaware courts have rejected size premiums derived from the "somewhat circular" approach Petitioners sponsor here. *JRC Acquisition*, 2004 WL 286963, at *8.

Petitioners provided the trial court with no basis to depart from these precedents. The Duff & Phelps database reflects an empirical analysis of size premiums based on equity values that takes into account the variability of corporate capital structures. Petitioners supplied no evidence to support their claim that the reported size premiums are inapplicable to public companies with "in-the-money warrants" or "significant influence by major creditors"; there is no such evidence and the evidence presented at trial was to the contrary.[126] Nor is there

---

[125] Op. 49.

[126] A283 at 729:23-730:16 (Ruback); B1476. *See also 3M Cogent*, 2013 WL 3793896, at *19-20 (declining to adjust the market capitalization to find size premium to avoid risk of valuation distortion).

any evidence showing that SWS's capital structure was unusual in the context of the companies in its size-premium group.

Permitting litigation-driven experts to depart from objective, verifiable market evidence in the calculation of size premiums lacks any basis in the economic evidence or Delaware precedent and unjustifiably increases the unpredictability of appraisal outcomes. Second-best solutions may be necessary where no market evidence exists (for example, in the valuation of private companies). But there is no reason to credit expert valuation as a proxy for market capitalization when the actual market data is available.

II. THE COURT OF CHANCERY ERRED BY PRESUMING THE ACCURACY OF THE SUPPLY-SIDE EQUITY RISK PREMIUM

A. Question Presented

Whether the trial court erred in adopting the supply-side equity risk premium against the weight of the evidence.[127] This issue was raised below and was considered by the trial court. A3264-65, A3285-86.

B. Scope of Review

The Court reviews the statutory appraisal decisions of the Court of Chancery for abuse of discretion, with errors of law reviewed de novo. *See supra*, p.27.

C. Merits of Argument

The equity risk premium ("ERP") is the premium required by investors to invest in a firm or project with the same level of systematic risk as the stock market. At trial, Respondents' expert Ruback prepared a DCF valuation using the "historical ERP," which is based on the historical return that equity investors have received for bearing market risk, calculated as the difference between historical returns on U.S. stocks and risk-free U.S. government bonds.[128] Ruback offered detailed testimony in support of the historical ERP, buttressed by a survey of recent valuation textbooks showing that most valuation practitioners rely on that measure.[129]

---

[127] Op. 45-46 & n.236.

[128] A435-36 at ¶ 29 (Ruback Opening Report).

[129] A282 at 725:17-726:7 (Ruback); A437-38 at ¶ 32 (Ruback Opening Report).

Petitioners' expert Clarke favored the "supply-side" ERP, which seeks to divide equity returns into inflation, income return, growth in real earnings per share, and growth in the price-to-earnings ratio — with growth in the price-to-earnings ratio being excluded from the supply-side ERP.[130]

The Court of Chancery applied the supply-side ERP. While the court acknowledged that the appropriate ERP must be determined on a "case-by-case" basis,[131] it selected the supply-side ERP because it found "there [wa]s no basis in the factual record to deviate from what th[e] Court has recently recognized as essentially the default method in these actions."[132]

But "[i]n a statutory appraisal proceeding, both sides have the burden of proving their respective valuation positions by a preponderance of evidence."[133] The Court of Chancery in this case excused Petitioners of their burden to demonstrate that the supply-side approach continued to reflect the current weight of academic and professional judgment — a burden that Petitioners abdicated.

1. ERP is a factual matter to be determined on the basis of the evidence presented

"[A]ny estimate of ERP is just that, an estimate of something that is highly uncertain," such that "the relevant academic and professional community — and

[130] A209 at 544 (Clarke).

[131] Op. 45-46.

[132] Op. 46.

[133] *M.G. Bancorporation, Inc.* v. *Le Beau*, 737 A.2d 513, 520 (Del. 1999).

not [the Court of Chancery] — should develop the accepted approach."[134] Reflecting this principle, the Court of Chancery has adopted supply-side, historical, and mixed risk premiums depending on the record presented.[135]

2. Only the historical ERP is supported by the trial record

Only the Respondents carried the burden of proof with respect to ERP. At trial, Ruback demonstrated that a recent survey of finance and valuation textbooks showed that historical ERP is now the preferred approach.[136] In addition, Ruback explained that his research supports the conclusion that participants in the M&A markets rely upon historical ERP in their decision-making.[137]

Ruback also offered extensive testimony explaining that the supply-side ERP has not sustained support in the academic community as an alternative to the historical ERP. As Ruback explained at trial, the supply-side measure grew out of the view, prevalent before the Great Recession but increasingly suspect as academics study market disruptions after 2007, that cyclical risk had been removed

---

[134] *Glob. GT L.P.* v. *Golden Telecom, Inc.*, 993 A.2d 497, 517 (Del. Ch. 2010) (favoring a supply-side measure of ERP).

[135] *See, e.g.*, *BMC Software*, 2015 WL 6164771, at *18 & n.168 (flagging the "meaningful debate on the issue" and noting the implications of using an average of historical and supply-side ERPs); *In re Rural/Metro Corp. Stockholders Litig.*, 102 A.3d 205, 226 (Del. Ch. 2014) (averaging historical and supply-side ERP where "neither expert argued definitively for the superiority of one estimate over the other").

[136] A282 at 725:22-726:10 (Ruback); A437-38 at ¶ 32 (Ruback Opening Report).

[137] *Id*.

from the economy. For that reason, he testified, supply-side ERP has fallen farther from favor in recent years. Ruback also testified that there is little justification for excluding the systemic risk of changes in P/E multiples from the equity risk premium, as the supply-side ERP seeks to do. Furthermore, because the supply-side ERP is developed by dividing observed equity returns into a number of internal components, it relies on a series of subjective assumptions concerning the composition of equity returns. Historical ERP, as Ruback emphasized, relies entirely on observable market data.[138]

On the other side of the scale, Petitioners' expert Clarke testified only that "experts in the area of cost of capital have all said to use a forward-looking [ERP] and . . . recommend using a supply-side [ERP]."[139] Clarke's conclusory utterance of blanket consensus is inaccurate, as Ruback's testimony and recent scholarship demonstrate. It constitutes neither evidence of academic acceptance of the supply-side ERP nor a rationale as to why the supply-side ERP is more reliable, nor a basis to reject Ruback's testimony that the current weight of academic authority

---

[138] A281-82 at 722-27 (Ruback); A435-38 (Ruback Opening Report).

[139] A209 at 544:10-16 (Clarke) (emphasis added).

favors the historical approach.[140] Moreover, Clarke's characterization of supply-side ERP as "forward looking" is inaccurate. The supply-side ERP begins with the same historical data as the historical ERP.[141] The difference is that the supply-side approach then adjusts the data in an attempt to account for long-term trends in price-to-earnings ratios, on the assumption, which is the subject of ongoing scholarly debate and which the evidence in this case indicated is not generally endorsed in current practice, that volatility has been squeezed out of the marketplace. Clarke attacked the historical approach, but he did not present evidence showing that the supply-side measure represents current best practices of valuation practitioners.

The evidence presented at trial thus provided no basis to conclude that the supply-side methodology is now more accurate than the historical methodology. Only Respondents carried their "burden of proving their respective valuation position[] by a preponderance of evidence."[142]

---

[140] In his rebuttal report, Clarke quoted a passage from a treatise supporting the use of "forward ERP" over the historical measure. A535-36 (Clarke Rebuttal Report). He failed to mention that on the next page of the same treatise, the authors wrote that "[a]ll of the[] methods [for estimating ERP] can be informative [and] each model has weaknesses that may disqualify it from being used as 'the' single model." Shannon P. Pratt & Roger J. Grabowski, Cost of Capital: Applications and Examples 139 (5th ed. 2013). This reflects a consistent theme in the literature: "The entire valuation process is based on applying reasoned judgment to the evidence derived from economic, financial, and other information" and "[e]stimating the ERP is no different." *Id.* at 139.

[141] A3616-17 (Respondents' Post-Trial Answering Brief).

[142] *M.G. Bancorporation*, 737 A.2d at 520.

III. THE COURT OF CHANCERY DID NOT ABUSE ITS DISCRETION WITH RESPECT TO ITS TREATMENT OF EXCESS REGULATORY CAPITAL

A. Question Presented

Whether the trial court acted within its discretion in concluding that SWS could not have distributed $117.5 million in capital without impairing its projected performance. This issue was raised below and was considered by the trial court. A3282-84.

B. Scope of Review

The standard of review of this issue is abuse of discretion. *Golden Telecom*, 11 A.3d at 217-18. *See supra*, p.27.

C. Merits of Argument

In the face of the trial court's factual findings based on uniform evidence, Petitioners ask this Court to determine that $117.5 million of SWS's excess regulatory capital constituted non-operating assets or excess cash distributable to SWS stockholders.[143] This contention is based on errors of fact, logic, and law. Excess regulatory capital is not, as Petitioners claim, "excess to [a bank's] operations" and does not imply that a "bank is underutilizing its assets by holding cash or low-risk investments."[144] Rather, excess capital is capital beyond the minimums that financial institutions are required to maintain under federal regulations.[145] Both banks

---

[143] POB 9-13, 32-37.

[144] POB 9, 33.

[145] Op. 39-40.

and broker-dealers must maintain substantial excess capital to remain in business.[146] Such excess capital is "distributable" only if it is not deployed as part of the business plan to support cash flow generation and can be distributed to stockholders without impairing future earnings. Conclusive evidence, credited by the Court of Chancery at trial, established that SWS did not have such "distributable" excess capital.

1. The Court of Chancery's treatment of regulatory capital does not depend on "erroneous assumptions" but instead reflects the court's well-supported factual finding that SWS had no distributable capital

In the trial court, Petitioners argued that SWS's excess capital should be treated as "'distributable cash flow' not captured in the projected operations of the business" and thus available to stockholders.[147] Petitioners argued that $87.5 million of cash was "immediately distributable" as of the valuation date, because Hilltop and Oak Hill exercised warrants converting $87.5 million of debt into equi-

---

[146] *See* B1624-25 (Federal Reserve SR 09-4 (Feb. 24, 2009)) ("banking organizations are generally expected to operate with capital positions well above the minimum ratios"); A110 at 253:5-15 (Edge) (SWS's broker-dealer required a $100 million capital buffer). Federal regulators may require riskier banks to maintain greater amounts of excess capital than required of others. B1625 (Federal Reserve SR 09-4 (Feb. 24, 2009)) ("supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization's risk-based capital ratio"). That was so for SWS — regulators issued a Cease and Desist Order against the Bank in 2011 even though the Bank had maintained substantial excess capital and met the regulatory criteria to be considered "well capitalized." A1541.

[147] A3362 (Petitioners' Opening Post-Trial Brief).

ty, and that an additional "$30 million in capital could be distributed to shareholders" in 2017.[148]

After weighing the evidence regarding SWS's business plan and capital position, the Court of Chancery rejected these claims. The court credited managements' evaluation of SWS's capital needs, found no "persuasive reason to second-guess managements' implied judgment" as to its deployment of capital, and rejected as "facially unreasonable" Petitioners' view that SWS had an excess $117.5 million in distributable capital.[149]

Petitioners contend that 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."[150] But this is manifestly not what the trial court assumed. The court instead, and just as Petitioners urged, considered whether SWS had excess capital that was "distributable." Addressing that question, the court concluded that Petitioners' assumption that a large distribution "could be made" without any impact on operations was "facially unreasonable"; and rejected Petitioners' claim that "such a massive distribution would be possible."[151] No part of the court's holding turned on whether SWS would actually make the "massive distribution" Clarke imagined. The holding instead reflected the court's factual finding that SWS could not make such a distribution "without

[148] A360-61 (Clarke Opening Report).

[149] Op. 41-42.

[150] POB 32.

[151] Op. 41.

effect on the Company's ability to generate cash flow consistent with the projections."[152]

The evidence uniformly supported the finding that management expected all of SWS's excess capital would be deployed to generate projected cash flows. Although SWS maintained adequate capital ratios at its bank, its business plan called for "the continued diversification of the balance sheet and conservative growth strategies," and the continued management of "a tiered investment portfolio designed to provide cash flows for loan originations."[153] The CEO of SWS's bank thus testified that management's projections assumed that the Bank's capital would remain invested in revenue-generating assets and available to support projected growth.[154] This business plan, including the capital plan underlying it, was the subject of extensive negotiation with federal regulators, who capped how aggressive SWS's projected growth could be, given its capital levels.[155] Similarly, the evidence showed that SWS had to maintain at least $100 million of excess net capital at its broker-dealer unit to remain in business and that management counted on a cushion beyond that as "growth capital" that would support projected earnings growth.[156]

---

[152] Op. 42.

[153] A2554-55.

[154] Op. 40 (citing A98 at 205:17-206:19 (Chereck)).

[155] A97 at 200:18-201:10 (Chereck); A98 at 204:15-205:8 (Chereck); A112 at 262:12-21 (Edge).

[156] A110 at 251:13-253:15 (Edge).

The evidence also established that SWS did not have excess cash or other non-operating assets that could be distributed without undermining operations. In late 2013, at the behest of federal regulators, SWS began considering how it could pay off the loans from Hilltop and Oak Hill when they came due in 2016.[157] Federal regulators cautioned SWS not to assume that it could extract capital from the Bank to fund repayment.[158] At the same time, SWS's auditors informed the board that it might be necessary to flag the next audit with a "going-concern qualification" due to the repayment obligation.[159] By the end of 2013, SWS did "not have a plan" to pull $100 million out of the company and pay off the loans, and there is no evidence it could ever execute such a plan and remain a viable stand-alone business.[160]

Petitioners offered no contrary evidence suggesting that any portion of SWS's excess regulatory capital could actually be distributed without impairing projected cash flows. The warrant exercise — which Clarke used to justify his addition of $87.5 million to SWS's fair value — only increased capital by cancelling debt; it did nothing to increase "'excess cash' or marketable securities beyond what

---

[157] Op. 14; A109 at 247:23-248:15 (Edge).

[158] Op. 14; A110-11 at 254:10-255:11 (Edge); B703 at 103:4-104:9 (Edge Dep.).

[159] Op. 14; A74 at 108:2-8 (Miller).

[160] Op. 14-15; A74 at 108:9-12 (Miller); B176 at 185:21-186:1 (Ross Dep.). Petitioners note (POB 34) that future cash flows, as well as excess cash or other non-operating assets, have the same present value regardless of whether they are assumed to be distributed to stockholders or reinvested in the company at its cost-of-capital. That is true, but irrelevant, as the principle does not apply to capital that is already invested in the company and supporting the business.

was needed to run the business to meet management projections."[161] Petitioners pointed to SWS's projected capital ratios and substantial investment portfolio and asked the trial court to make the speculative leap that some of the excess regulatory capital must have been improperly deployed and could have either been distributed or reinvested at the cost of capital. But these arguments, repeated on appeal[162] — that SWS's capital ratios were too high, that SWS's investment portfolio was too conservative, that SWS should have deployed capital to generate greater returns — amount to second-guessing the Management Projections and contending that SWS should have made a greater return on its capital.[163] Petitioners' claim that SWS could have generated its projected results with far less capital amounts to a renewal of their unsuccessful request to replace management's ordinary-course projections with Clarke's made-for-litigation projections. But Delaware courts are properly skeptical of an "expert's *post hoc*, litigation-driven forecasts," especially when "contemporaneous, reliable projections prepared by management" are available.[164]

---

[161] Op. 40.

[162] POB 11-12, 35-37.

[163] Petitioners quote a *Hilltop* document indicating that "excess capital" was one of the things it was "buying," to support the idea that excess capital had independent value apart from future cash flows. POB 36. While Hilltop hoped to make use of the excess capital through its substantially larger and better performing banking operations, the relevant question is whether *SWS* could translate the capital into greater cash flows on a stand-alone basis, and the evidence on that question, as the trial court found, was uniformly negative. A176 at 411:1-3 (Ford).

[164] *Owen* v. *Cannon*, 2015 WL 3819204, at *22 (Del. Ch. June 17, 2015). As this Court recently observed in *DFC*, the "loan growth had to come from somewhere and the petitioners never put their finger on where that would be." *DFC Glob. Corp.*, 2017 WL 3261190, at *26.

That skepticism should be at a highpoint here, where Petitioners are second-guessing Management Projections for SWS's bank that were the subject of binding negotiations with federal regulators. As the court below found, it is "doubtful, in light of SWS's recent emergence from major regulatory intervention, and its continuing business line in a highly regulated industry, that . . . a massive distribution would be possible from a regulatory perspective."[165] Nor is there any evidence in the record that regulators would have allowed SWS to alter its capital plan even if (contrary to fact) management believed it could.

2. The Court of Chancery's analysis did not impose a minority discount

Petitioners now assert that Respondents' expert's approach to excess capital, as adopted by the Court of Chancery, applied a "dividend valuation model" to excess capital that purportedly imposed a minority discount on the appraised shares. The argument should not be considered on appeal, as it was never raised below.[166]

[165] Op. 42.

[166] In the trial court, Respondents argued extensively that SWS's excess regulatory capital was not distributable, *see* A3457-59 (Respondents' Opening Post-Trial Brief); A3606-11 (Respondents' Answering Post-Trial Brief). Petitioners never suggested that Respondents' position would impose a minority discount and the Vice Chancellor was thus deprived any opportunity to pass upon Petitioners' claim. Under Supreme Court Rule 8, "[o]nly questions fairly presented to the trial court may be presented for review" on appeal unless the interests of justice require consideration of the question. *See also Russell* v. *State*, 5 A.3d 622, 627 (Del. 2010) ("[T]his Court may not consider questions on appeal unless they were first fairly presented to the trial court for consideration. This prohibition applies to both specific objections as well as the arguments that support those objections.").

At any rate, Petitioners' new argument fails on the merits. They fault the trial court for "effectively appl[ying] a dividend valuation model to the excess capital."[167] But no one did any such thing. Both Respondents' expert Ruback and the Court of Chancery applied a standard discounted cash flow analysis. Ruback based his valuation on "cash flows available to the firm" which would be either "paid out or reinvested."[168] The court likewise followed a DCF methodology that calculated the "sum of [SWS's] future cash flows discounted back to present value."[169] The court declined to assign additional value independent of cash flows for SWS's excess capital because it found that such excess capital could not have been extracted without adversely affecting SWS's ability to run its business. Put otherwise, the Court of Chancery held that SWS did not have the capacity to dividend its excess capital. The court's holding had nothing to do with "the lack of a projected dividend" or SWS's "dividend policy." The court's holding was based on its factual finding that SWS could not distribute any additional cash without impairing its ability to generate cash flows anticipated by its already-optimistic projections.

Contrary to Petitioners' suggestion,[170] that analysis is thus nothing like the valuation method found objectionable in *PNB*. The court there rejected "a minority share valuation using PNB's expected dividends," rather than valuing "the

---

[167] POB 38.

[168] A295 at 778:12-21 (Ruback).

[169] Op. 31.

[170] POB 40-42.

available cash flow that constituted PNB's dividend-paying capacity." *PNB*, 2006 WL 2403999, at *24, 26. Here, the trial court asked exactly the question required under *PNB*: How much capital did SWS have the "capacity" to dividend without impairing its business and operations? The answer, on the facts, was zero. Petitioners' contention that the Court of Chancery applied a minority discount to SWS's excess capital is without merit.[171]

3. Petitioners' claim that the Court of Chancery ignored elements of present value is meritless

In further support of their claim that excess regulatory capital should be accounted for separately on top of cash flows, Petitioners insist that "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."[172]

This proposition is wrong, as *PNB* itself confirms. In *PNB*, Petitioners' expert here — Mr. Clarke — testified for petitioners and, after observing that PNB had regulatory capital beyond its regulatory requirements, "recommend[ed]" that the court value the target bank company as though it "w[ould] reduce its starting Tier-1 Ratio at the outset." *PNB*, 2006 WL 2403999, at *27. The court refused, specifically rejecting Clarke's proposal to "build a one-time payout of $7.1 million

---

[171] Petitioners cite various cases for the proposition that a minority discount should not be applied in determining fair value in an appraisal. POB 39. These cases are irrelevant here, because the trial court did not apply any such discount.

[172] POB 40-41.

into [the] discounted cash flow analysis" to lower PNB's equity-to-asset ratio. *Id.* The court held:

> Despite its high Tier-1 Ratio as of the Merger date, though, there is no basis in equity to assume that PNB was required to premise the Merger price on a reduction of its starting Tier-1 Ratio.

Id. The court instead looked at PNB's net income projections and adjusted them lower when arriving at free cash flow for use in the DCF analysis, to account for retained earnings that would be necessary to keep PNB at a Tier-1 capital ratio of 8.5%. *Id.* at *27, *31. While the court thus declined to assume that *new* cash flow would be retained so that the bank would remain as well capitalized as it was on the valuation date, it also refused to assume that *existing* capital was unnecessary for operations and distributable.[173]

Clarke urges here exactly what *PNB* rejected as having "no basis in equity" — adding value to a DCF analysis for excess regulatory capital as if there were a one-time dividend of what Clarke terms "immediately distributable" capital. Worse yet, Clarke assumes — contrary to all the evidence — that extracting over a hundred million dollars of SWS's capital would have no impact on its future performance. The court in *PNB* noted that "there was testimony of inconclusive

[173] The other case on which Petitioners rely, *Dunmire* v. *Farmers & Merchants, Bancorp of W. Pa., Inc.*, 2016 WL 6651411 (Del. Ch. Nov. 10, 2016), is inapposite, as both parties agreed that some of the bank's excess capital was distributable. *Id.* at *16. The court thus applied adjustments to "account for excess cash on [the bank's] balance sheet." *Id.* at *11. The court did not address the treatment of excess regulatory capital that was deployed and not excess to operations.

nature regarding whether a one-time payout of $7.1 million, as advocated by Clarke, would reduce PNB's profit margin."[174] By contrast, the testimony here conclusively established that management had considered SWS's capital levels in developing its business plan and long-term projections and did not think those projections were achievable without maintaining those capital levels.[175] Even SWS's *regulators* set the growth rate for the Bank based on its capital plan. Because the value of the capital, including excess regulatory capital, is reflected in the cash flows the capital is projected to generate, a DCF analysis that values those cash flows does not, as Petitioners contend, "effectively zero[] out the present value of SWS's excess capital,"[176] but rather properly values all of SWS's capital.

[174] 2006 WL 2403999, at *27 n.136.

[175] *See supra*, p.42.

[176] POB 41.

IV. THE TRIAL COURT ERRED BY INCLUDING THE EXERCISE OF THE WARRANTS

A. Question Presented

Whether the trial court erred in concluding that the calculation of SWS's fair valuation should take into account the exercise of warrants made in expectation of the Hilltop merger. This issue was raised below and was considered by the trial court. A3276-77.

B. Scope of Review

The Court reviews statutory appraisal decisions of the Court of Chancery for abuse of discretion, with errors of law reviewed de novo. *See supra*, p.27.

C. Merits of Argument

Section 262(h) requires that, in determining fair value, the appraisal court must exclude "any element of value arising from the accomplishment or expectation of the merger."[177] The Court of Chancery found that Hilltop and Oak Hill exercised their warrants in expectation of the merger and that neither would have exercised them absent the merger.[178] The court nevertheless included the warrant exercise as an element of value in the appraisal. Because it contravenes the statute, this ruling was error.

In resolving this issue, the court below relied on this Court's decision in *Cede & Co.* v. *Technicolor, Inc.*, 684 A.2d 289 (Del. 1996). *Technicolor* involved

---

[177] 8 *Del. C.* § 262(h).

[178] Op. 37-38.

a two-step merger. In between the first and second steps, the buyer, Ronald Perelman, developed a plan to sell off some of Technicolor's assets. The question was whether the Perelman Plan should be included in determining fair value under Section 262(h). Chancellor Allen, with his customary knack for seeing the point and saying it right, wrote: "Future value that would not exist but for the merger cannot, I believe, accurately be said to have been taken from a dissenting shareholder in the merger, even if it is capable of being proven on the date of the merger."[179] So, to give effect to the statutory exclusion of "elements of value arising from the accomplishment or expectation of the merger," the trial court determined not to compensate the petitioner for value that "but for the merger . . . would not exist."[180]

This Court reversed. Its decision did not identify any infirmity in the trial court's statutory interpretation. Instead, rooting the holding in the facts of the two-step merger at issue, the Court decided that value "created by substituting new management or redeploying assets during the transient period between the first and second steps of this two-step merger" should have been included in the valuation determination.[181]

In the two decades since, the Delaware courts have never interpreted *Technicolor* to require that the fair value of an appraised firm include changes in

---

[179] *Cede & Co.* v. *Technicolor, Inc.*, 1990 WL 161084, *19 (Del. Ch. Oct. 19, 1990).

[180] *Id.* at *18-19.

[181] *Technicolor*, 684 A.2d at 298.

capital structure caused by the pending merger. *See BMC Software*, 2015 WL 6164771, at *13 & n.151; *JRC Acquisition*, 2004 WL 286963, at *7; and *Gearreald*, 2012 WL 1569818, at *8.

In *Gearreald*, for example, the acquired entity had operated with a capital structure consisting of a mix of debt, preferred stock, and common equity. The company paid off its debt before the merger closed and converted its preferred stock to common equity in connection with the transaction. The Court determined that these changes to the company's capital structure occurred in anticipation of the merger and thus could not be considered in the fair value determination; instead, it was necessary to evaluate the company using the "theoretical capital structure it would have maintained as a going concern." *Id*. at *8.

Likewise, in *JRC Acquisition*, the acquired entity took on additional debt to finance its acquisition. The court held that this merger-related change in capital structure could not be incorporated into the fair valuation inquiry, because it was an "element of value arising from the accomplishment or expectation of the merger." *See* 2004 WL 286963, at *7. The court concluded that nothing in *Technicolor* "supports the position [that] the merger itself, in this case the debt incurred because of the merger, can be included as an element of value." *Id*. And most recently, in *BMC Software*, the Court of Chancery held that where a company was preserving excess cash in contemplation of a pending merger, that excess cash should be excluded from the fair value analysis. *See* 2015 WL 6164771, at *13 & n.151 (citing *Gearreald*).

The trial court distinguished *Gearreald*, *JRC Acquisition*, and *BMC Software* on the ground that the change in capital structure in those cases was undertaken by the subject company rather than by certain stockholders.[182] But the distinction should not make an interpretive difference. These decisions reflect the principle, grounded in the statute, that dissenting stockholders are not entitled to value arising from modifications to capital structure undertaken in expectation of the merger. *See, e.g.*, *Gearreald*, 2012 WL 1569818, at *8. Neither the words of the statute, nor any policy behind it, suggest that dissenting stockholders are entitled to merger-specific value just because it was created by stockholder rather than company action. Just as in those cases, the change to SWS's capital structure — the exercise of the Hilltop and Oakhill warrants — would not have occurred but-for the merger. Just as in those cases, then, the "capital structure [SWS] would have maintained as a going concern" would not have included the warrant exercises, and so the warrant exercise cannot be a basis for valuation of SWS as a going concern.

Nor can it be said, consistent with the statute, that the Section 262(h) exclusion cannot apply to elements of value "which exist on the date of the merger."[183] Elements of value created in "expectation of the merger" are excluded under the plain words of Section 262(h). It is inherent in the idea of "expectation" that it relates to an anticipated future event. To rule the exclusion inapplicable to

---

[182] Op. 38.

[183] Op. 37 (quoting *Technicolor*).

elements of value existing on or before the date of the merger would render meaningless the statutory "expectation" exclusion. *Technicolor* does not require a different result. That decision turned on an "element of value" — an asset divestiture plan — that could have and rationally would have been achieved by the stand-alone company, even if the second step of the merger was not completed.

Not so here. It is undisputed that the warrants were exercised in "expectation of the merger"; indeed the evidence was clear that exercise of the warrants without the merger would have been economically irrational.[184] *Gearreald*, *JRC Acquisition*, and *BMC Software* all say that this warrant exercise should be excluded from SWS's appraised fair value. More important, Section 262(h) requires the same result.

[184] *See* B533-34 at 152-155 (Kauffman Dep.); A160 at 346:13-347:4 (Ford); A40 at 17:10-18 (Sterling).

V. THE COURT OF CHANCERY PROPERLY DECLINED TO TREAT THE MERGER PRICE AS A FLOOR FOR FAIR VALUE

A. Question Presented

Whether the Court of Chancery acted within its discretion by calculating a fair value for SWS below the merger price despite alleged infirmities in the sales process. Petitioners did not raise this question below.

B. Scope of Review

Petitioners raise this issue for the first time on appeal and it is therefore not properly before this Court. *See* Supreme Court Rule 8. Should the Court nevertheless consider the issue, the standard of review is abuse of discretion. *Golden Telecom*, 11 A.3d at 217-18.

C. Merits of Argument

In the trial court, neither side advocated the merger price as determinative evidence of fair value, although for different reasons.[185] Respondents argued that, because the merger price reflected Hilltop's anticipation of substantial synergies, the merger price could not represent the fair value of SWS on a stand-alone basis.[186] Respondents also established that their proffered valuation was consistent with the merger price less estimated synergies attributable to SWS.[187]

---

[185] Op. 2.

[186] *Id*.

[187] Op. 49-50; A3448-56; A3624-41.

Petitioners, on the other hand, argued that, because of defects in the SWS sale process, the deal price was unreliable and the court should disregard it entirely.[188] Petitioners never showed how the alleged flaws in the sale process could account for the disparity between the deal price (which they acknowledge includes synergies) and their proffered DCF.

Given the parties' positions and the trial record, the trial court did not rely on the merger price to calculate the fair value of SWS.[189] But the court did reconcile the merger price with its valuation, noting that "the fact that [its] DCF analysis resulted in a value below the merger price is not surprising: the record suggests that this was a synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."[190]

For the first time on appeal, Petitioners contend that the trial court should not have entirely disregarded the merger price but instead should have treated it as a floor for statutory fair value.[191] This argument should be rejected. Not only did Petitioners fail to raise it below,[192] it has no support in the record or the law. Petitioners' unsupported attack on the sale process only highlights the fact that all the observable market evidence — including deal price — supports Respondents' valuation, not Petitioners'.

---

[188] Op. 2.

[189] Op. 30.

[190] Op. 49-50.

[191] POB 43-54.

[192] Supreme Court Rule 8.

1. Petitioners' description of the SWS sales process has no basis in the trial court's findings of fact

Petitioners renew their complaints about the sale process without ever indicating how the supposed process flaws make the deal price unreliable or affected any element of the trial court's valuation. Petitioners instead seem to assume that alleging process flaws is enough to show that transaction price is the floor in any proper valuation.[193]

It is unsurprising that Petitioners cannot show how the supposed process problems depressed deal value, because Petitioners' complaints are supported neither by the Court of Chancery's findings of fact nor the trial record. Petitioners carry on as though Hilltop were SWS's controlling stockholder and used its control to force a lowball squeeze-out on SWS.[194] That is all unfounded. Hilltop owned only 4% of SWS's stock and had one designee on SWS's 10-person board,[195] which was otherwise composed of independent directors; Hilltop's bid was at a substantial premium and included substantial synergy sharing with SWS; Hilltop's was the only offer SWS ever received at any price and it was overwhelmingly approved by SWS's stockholders.[196]

Nor did the Court of Chancery remotely determine that Hilltop engaged in "unfair dealing."[197] The Court of Chancery determined that the transaction price

---

[193] POB 45.

[194] *See, e.g.*, POB 1, 46-49.

[195] A2743; Op. 4.

[196] *See supra*, pp.17-19, 23.

[197] POB 43-44.

was not a reliable indicator of value, principally because Hilltop had, during some of the relevant period, a contractual right to veto a competing bid below $8.625 and because the transaction was synergies-driven but the precise value of synergies was not readily calculable.[198]

The trial court did not credit the various claims of unfair dealing that Petitioners now advance. To the contrary: Petitioners claim of unfair "timing" allegations hinge on the claim that SWS was poised for a turnaround, but the trial court specifically rejected that claim and instead held that SWS was struggling and had little prospect for growth.[199] SWS could have declined Hilltop's offer, but given its poor prospects its board was pleased to field a synergies-driven proposal.[200] And Petitioners' accusations that Jeremy Ford misused SWS information, deceived SWS, or improperly contacted SWS employees, were given no credit by the court below and are not supported by the evidence.[201]

Equally empty is Petitioners' charge that Hilltop somehow "structured" the merger consideration to SWS's detriment.[202] The Special Committee pushed Hilltop for a larger stock component in Hilltop's offer, because it wanted SWS's stockholders to share in Hilltop's upside and avoid a tax hit.[203]

---

198 Op. 30, 49-50.

199 Op. 11-14.

200 A76 at 115:2-6 (Miller).

201 *See supra*, n.42, n.46.

202 POB 47.

203 A82 at 139:21-24 (Miller).

Petitioners invest substantial effort in attempting to show that the Special Committee limited Stifel's ability to bid for SWS. Petitioners never explain *why* the Special Committee would have mistreated Stifel. There is no reason. The evidence at trial shows that the Special Committee directed Sandler to solicit a Stifel bid, that Stifel received substantial diligence, including extensive in-person meetings with SWS's top management, and that Stifel's CEO concluded Stifel was "having a hard time getting comfortable with the stock loan business," that he "didn't like the clearing business," that SWS was "very small relative to the size of his firm," and that "he just felt that there was too much to [SWS] that he didn't want."[204] Stifel could have made any offer at any time but it never did, not even in the weeks before the merger closed, when its purported concern about the Hilltop merger covenant had fallen away.

The same goes for the allegation that Hilltop "[d]ominated and [c]ontrolled the [n]egotiations," by refusing to waive its rights under the Credit Agreement and by placing a deadline on its offer.[205] Hilltop, with its tiny equity stake and one director, had no ability to control SWS, its board or its stockholder vote. And Hilltop's decision not to waive its bargained-for contractual rights could not coerce SWS into accepting Hilltop's offer — and there is no evidence that it did. Indeed, the Special Committee successfully pressed Hilltop to raise its offer twice.[206]

---

[204] B175 at 181:11-19 (Ross Dep.); *see also* A80-81 at 134:11-135:22 (Miller).

[205] POB 48-49.

[206] *See supra*, pp.17-18.

What the record does show is that SWS was publicly in play for a year, was shopped to 17 bidders, and that no one was willing to bid but Hilltop, let alone offer more. This evidence indicates that the deal price was a ceiling rather than a floor for SWS's statutory fair value.

2. All market indicators confirm that the transaction price exceeded SWS's fair value

Petitioners ask this Court to overturn the trial court's exercise of discretion and remand with instructions to value SWS far above both the premium deal price and SWS's historical trading range. In making that request, Petitioners fail here (as they failed below) to account for substantial market failures suggested by their valuation. Thus, while Petitioners complain loudly about Hilltop's merger covenant, it was undisputed that the merger covenant would not impede any offer over $8.625 per share. Petitioners valued SWS at $9.61 per share. If that valuation were correct, potential buyers left tens of millions of dollars on the table by failing to bid at (say) $8.65. Strategic buyers (like Stifel) who stood to capture synergies, left far more.

Likewise undisputed is that the merger covenant fell away as an obstacle to a bid at any price on October 2 — seven weeks before the stockholder vote. If Petitioners' valuation was correct, then any buyer could have topped Hilltop by a nickel and captured many tens of millions more in value, even accounting for the small termination fee. But no one even expressed interest in exploring a topping bid — not even Stifel, which had already conducted substantial due diligence and stood to capture synergies in a potential deal.

Petitioners failed to account for these massive market failures below and they cannot account for them now. The reason is that their expert's valuation cannot be squared with the actions of real people with real money at stake.[207] Petitioners claim SWS was worth $9.61 per share but SWS traded at $6.06 per share in the days before Hilltop's offer — a price that the lower court found had run up on market anticipation of a merger, and which did not reflect SWS's dismal 2014 operating performance.[208]

Instead of taking account of the market evidence, Petitioners focus on two factors that are entirely divorced from market valuation. They fault the court for rejecting SWS's tangible book value as a reliable indicator of value.[209] But the trial record demonstrated that SWS's tangible book value had no correlation with its fair value, as evidenced by the fact that SWS's shares had long traded at a steep discount to tangible book.[210] The record is likewise clear that SWS tried to sell itself for its tangible book value, but no acquirer was willing to pay anywhere near that price. SWS's tangible book value thus shed no light on the price anyone would actually pay for SWS or its shares.

---

[207] In their solicitation materials, even Petitioners cautioned that SWS was a losing investment as a stand-alone entity. *See supra*, p.20.

[208] Op. 15, 25.

[209] POB 52.

[210] A628 (Ruback Rebuttal Report Exhibit 12). *See* A3638-40 (Respondents' Post-Trial Answering Brief).

Petitioners also assert that the court should have assigned weight to the Special Committee's initial rejection of Hilltop's $7.00 per share offer. The claim makes no sense. That $7.00 figure already baked in synergies (as the record makes clear).[211] More important, the Special Committee's rejection of Hilltop's initial offer was a negotiation tactic to extract a greater share of those synergies and a higher price for SWS stockholders.[212] The Special Committee's bargaining position sheds no light on SWS's fair value, except to emphasize that the Special Committee and Hilltop bargained to the level where a willing seller met a willing strategic buyer.

---

[211] *See supra*, pp.11-13.

[212] A76 at 115:2-6 (Miller).

CONCLUSION

The Court should remand with instructions that the Court of Chancery modify its DCF analysis to remove the impact of the merger-related exercise of the warrants, apply the historical equity risk premium, and eliminate any weight accorded to Petitioners' circular calculation of size premium. The decision below should otherwise be affirmed.

ROSS ARONSTAM & MORITZ LLP

By: /s/ Garrett B. Moritz
Garrett B. Moritz (Bar No. 5646)
Eric D. Selden (Bar No. 4911)
Nicholas D. Mozal (Bar No. 5838)
100 S. West Street, Suite 400
Wilmington, Delaware 19801
(302) 576-1600

Attorneys for Respondents-Below, Appellees/Cross-Appellants SWS Group, Inc. and Hilltop Securities Holdings LLC

OF COUNSEL:

William Savitt
Andrew J.H. Cheung
Noah B. Yavitz
WACHTELL, LIPTON, ROSEN & KATZ
51 West 52nd Street
New York, New York 10019

October 5, 2017