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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' REPLY BRIEF ON CROSS-APPEAL

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

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

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PRELIMINARY STATEMENT

Respondents' opening brief in support of their cross-appeal identified three errors in the decision below. Neither caselaw nor the facts found at trial sustain Petitioners' opposition:

(1) **Size premium**. Because SWS was a widely traded public company, its size, for purposes of determining a size premium, was readily calculated by multiplying its share price by shares outstanding, yielding its market capitalization. This approach to calculating size premium has the virtues of being objective (and thus not amenable to expert interpretation) and of reflecting the wisdom of the market. For those reasons, it is the conventional approach to size premium for public companies. Respondents' expert employed this conventional approach. Petitioners' expert employed a "circular" calculation of SWS's size premium that is reserved for private companies, for which observable market data is unavailable. The trial court averaged the two figures on the ground that SWS had "a substantial amount of in-the-money warrants and significant influence by certain major creditors" and was therefore "in some ways more analogous to a private company."

This was error. SWS's capital structure was fully known to the public that valued it in a liquid trading market. No facts were found to undermine the reliability of the public's valuation of SWS. Nor were any facts found to suggest that the size-premium decile applicable to SWS was inappropriate. In their response, Petitioners argue that SWS's capital structure was so "unusual" that the normal size-premium rules do not apply. No evidence supports this claim. And Petitioners have no answer to the fact that tables reflecting size-premium data

expressly exclude warrants from their determination. To nevertheless include warrants in deriving a size premium would constitute plain analytical error. Petitioners have supplied no support for their approach and no reason to displace market evidence of firm size with expert discretion.

(2) **ERP**. The trial court erred by relieving Petitioners of their burden to support their "supply-side" estimate of equity risk premium. Petitioners' response does not address this argument. Petitioners only reiterate their flawed criticisms of the "historical" estimate of equity risk premium advanced by Respondents at trial.

(3) **Warrant exercise**. At trial, Respondents established that Hilltop and Oak Hill exercised their warrants solely in expectation of the SWS merger. Accordingly, consistent with every Court of Chancery decision to address a pre-merger change in capital structure, and as required by the plain words of Section 262(h), the exercise must be excluded from SWS's appraisal valuation as an "element of value arising from . . . expectation of the merger." Petitioners make no effort to reconcile their contrary position with the words of the statute. They instead ask the Court to extend *Cede & Co.* v. *Technicolor* to require the valuation of "elements of value" in a manner that collides with both the statute's text and numerous decisions of the Court of Chancery. Petitioners have supplied no explanation how *Technicolor* could or should be so interpreted.

ARGUMENT

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

To determine the size premium input for their DCF valuations of SWS, both parties' experts relied on published tables reporting the observed rates of return for a sample set of exchange-traded public companies. Dr. Richard Ruback, Respondents' expert, identified the size premium input for his valuation — 4.22% — by finding the tabulated rate of return associated with the companies whose observed market capitalizations were in the same range as SWS's. By contrast, Petitioners' expert David Clarke ignored SWS's observed market capitalization. Clarke instead determined the size premium input for his valuation — 2.69% — by first using a DCF analysis to generate his own estimate of SWS's total equity value and then selecting the tabulated rate of return associated with companies whose observed market capitalization was in the same range as that estimate. Clarke characterized his approach as "circular."[1] The trial court averaged the two proffered inputs to yield a size premium of 3.46%.[2]

This was error, as Respondents explained in their opening brief. Until the decision below, the Court of Chancery had uniformly held that where a public company's market capitalization is observable, as SWS's was here, that market

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

[2] Op. 49.

capitalization supplies the basis for determining the company's size premium.[3] The Court of Chancery has approved some measure other than observed market capitalization to compute the size premium only for private companies.[4] The trial court's resort to the "circular" approach in this case thus marked a departure from settled practice.

Petitioners defend the trial court's reliance on Clarke's estimate of SWS's total equity value by citing the factual finding that SWS, though listed on the New York Stock Exchange, was "in some ways more analogous to a private company" because "it had a substantial amount of in-the-money warrants" whose holders had "significant influence" over SWS.[5] According to Petitioners, this finding established that SWS was enough like private companies whose market capitalizations are "not easily derived or reliable" as to justify use of some measure other than observed market capitalization to determine its size premium.[6]

This argument rests on the unstated assumption that the market capitalization of an exchange-traded public company is "not easily derived or

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[3] *See, e.g.*, *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 *11 (Del. Aug. 1, 2017); *Merion Capital, L.P.* v. *3M Cogent, Inc.*, 2013 WL 3793896, at *19 (Del. Ch. July 8, 2013); *Cede & Co.* v. *JRC Acquisition Corp.*, 2004 WL 286963, at *8-9 (Del. Ch. Feb. 10, 2004).

[4] *See* Op. 48 & n.251 (citing Respondents' Post-Trial Answering Brief 47-48).

[5] Appellants'/Cross-Appellees' Reply Brief on Appeal and Answering Brief on Cross-Appeal ("PAB") 35 (quoting Op. 49).

[6] PAB 37-38.

reliable" if the company possesses some attribute common among private companies. That assumption lacks foundation. The market capitalizations of private companies are often "not easily derived" because their shares do not trade; or because information about the prices at which their shares trade is not collected or publicly available. And, even when such information is publicly available, a private company's observable market capitalization may be not "reliable" because the market for the company's shares is thin, or because the company is not required to disclose information necessary for market participants to assess its value.

By contrast, the market capitalization of a public company, especially one listed on a major exchange, is generally "easily derived" because share price information is both publicly available and readily accessible. It is also generally "reliable" because it reflects the prices at which shares trade in a large and active market, informed (as in the case of U.S.-listed firms like SWS) by mandatory disclosure rules.[7] Whether a public company's market capitalization is "easily derived or reliable" thus turns on the nature of the market for its shares, not on whether it does or does not have some characteristic supposedly unusual among public companies.

Petitioners do not dispute that the shares of SWS traded in a large, active, and public market (in which Petitioners themselves were active participants). Nor have they offered any other reason to think that SWS's share price did not reflect the market's informed view of its value. Petitioners have thus supplied no basis to

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[7] *Cf. DFC*, 2017 WL 3261190, at *17-18.

conclude that SWS's observed market capitalization was "not easily derived or reliable." No Delaware court has approved determining size premium using some measure other than observed market capitalization in like circumstances.

Petitioners nevertheless insist that Clarke's substitution of his own estimate of total equity value for SWS's observed market capitalization is a method "generally accepted in the financial community."[8] All Petitioners point to as evidence for that proposition, however, is Clarke's conclusory testimony that his approach "is typical[]" in "valuing companies."[9] Clarke's testimony is so unmoored from accepted practice that he said he could not think of "any logical explanation" for using a public company's market capitalization to determine its size premium — as though one wouldn't logically consider how big something is in evaluating its size.[10] This view collides not only with valuation practice, but also with the uniform decisions of Delaware courts recognizing observed market capitalization as the proper and commonsense measure of firm size. Indeed, neither Petitioners nor Clarke identify any instance in which another member of

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[8] PAB 38.

[9] PAB 38 & n.128. Petitioners assert that Clarke's "iterative" approach is "described by" an old edition of the valuation handbook published by Duff & Phelps, the publisher of the size premium tables on which both parties' experts relied. PAB 38. But the quotation from the handbook they cite does not address the "iterative" approach and in any event has been deleted from subsequent editions. *Id.* (citing A366).

[10] A211 at 550:21-551:5 (Clarke).

the financial community has ever applied his "iterative" approach to determine the size premium of a public company.[11]

Petitioners invoke *In re Appraisal of DFC Global Corp.*[12] and *In re Appraisal of the Orchard Enterprises, Inc*.[13] as support for the trial court's reliance on Clarke's circular approach. Neither case endorses the use of that approach with respect to a public company. To the contrary, *DFC rejected* an expert's use of the "iterative" approach as "a practice suited for companies that are not publicly traded" and affirmed that "the size premium itself is calculated using market value,

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[11] Petitioners assert that Respondents "have never suggested" that Clarke's approach to determining SWS's size premium is not generally accepted in the financial community. PAB 38. That is wrong, as the trial court's opinion shows. *See* Op. 48 ("The Respondents point out that Clarke's approach is 'circular,' and that his approach is only 'occasionally used' for computing size premiums for private companies where market capitalization is not easily derived or reliable."). Petitioners have repeatedly claimed that Respondents "conceded" matters that Respondents actually dispute and disprove. *E.g.*, *compare* PAB 3 n.3, *with* ROB 27; *compare* PAB 9, *with* A3607; *compare* PAB 20, *with* PAB 20 n.74; *compare* PAB 15, *with* ROB at 48 n.173.

[12] 2016 WL 3753123.

[13] 2012 WL 2923305 (Del. Ch. July 18, 2012).

when available, as it is here."[14] *Orchard* did not address the "iterative" approach at all because it was not used by either of the parties' experts — who in any event agreed on the need for an adjusted size premium.[15]

A further trouble with Petitioners' argument is that, even indulging the assumption that a finding that SWS's capital structure was unusual for a public company suffices to establish that SWS's observed market capitalization was unreliable, the evidence does not support any such finding. The sole testimony that Petitioners identify as supporting such a finding is Clarke's statement that SWS had a "very unusual capital structure" and so was "really sort of unique among public companies, at least that [he had] ever looked at."[16] But Clarke never claimed to have done any analysis to justify his characterization of SWS's capital structure as "very unusual" for a public company. Rather than substantiating this testimony, Petitioners assert that Respondents' expert conceded that SWS's capital

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[14] 2016 WL 3753123, at *13-14. The court in *DFC* found that the target's observed market capitalization on the last unaffected trading date before the acquisition did not reflect negative earnings news that was announced the next day and that would have caused a drop in the stock price. Since the target's observed market capitalization was at the bottom of a market capitalization decile range for determining the associated size premium — "on a knife's edge" in the court's words — the court determined that the size premium should be selected using the next smallest decile range. *Id.* That adjustment does not justify the trial court's use of Clarke's DCF estimate of SWS's total equity value here because the inclusion of "a substantial amount of in-the-money warrants" in SWS's capital structure and the identities of the warrant holders were publicly disclosed before the last unaffected trading date. Op. 49.

[15] 2012 WL 2923305, at *21-22.

[16] PAB 36 & n.124 (citing A210 at 545:16-546:2 (Clarke)).

structure was unusual for a public company, but they mischaracterize his testimony.[17] Ruback clearly testified that he did not know whether SWS's capital structure was unusual for a public company, and that it was irrelevant in any event — because the published tables for determining size premiums recognize the existence of, but expressly exclude, warrants and other convertible instruments when calculating the market capitalization of the companies in their dataset.[18] Petitioners have thus failed entirely to show that SWS's capital structure was unusual for a public company.[19]

Petitioners' remaining argument — that the trial court was required to rely on Clarke's size premium because Ruback's size premium was based on an incorrect calculation of market capitalization — also lacks merit. To calculate SWS's market capitalization, Ruback multiplied the number of SWS shares outstanding on its last trading day unaffected by the merger (32,747,990) by the closing share price on that day ($6.06), yielding $198.5 million. The Duff &

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[17] PAB 36 & n.124.

[18] A3146 at 182:12-18 (Ruback Dep.) ("A. I don't know how frequently you find warrants for 34 percent of the company outstanding; just don't know. Q. Do you have any sense in public markets how often that occurs? A. I just don't know."); A283 at 730:11-16 (Ruback).

[19] Any such finding would collide with the prevalence of private investment in public company (or "PIPE") transactions such as the Hilltop and Oak Hill investments in SWS. *See, e.g.*, "Recent Trends in the PIPE Market," Law360, Feb. 28, 2017 (nearly 1000 PIPE transactions worth over $44 billion completed annually, most often featuring convertible equity securities), available at https://www.law360.com/articles/896516/recent-trends-in-the-pipe-market.

Phelps treatise assigns a size premium of 4.22% for firms of this size.[20] Petitioners contend that this size premium should be disregarded because Ruback did not include the 15,217,391 shares issued in the pre-merger warrant exercise that the trial court found to be part of SWS's "operative reality as of the merger date."[21]

But even assuming that the trial court's finding was correct and those shares should have been included in the calculation, the appropriate size premium remains the same because the tabulated size premium for companies with a market capitalization of $291 million (48,115,828 times $6.06) is still 4.22%.[22] Confronted with this inconvenient arithmetic, Petitioners assert that $291 million is a "lawyer-calculation[]" on which Respondents may not rely because they did not proffer expert testimony that 48,115,828 times $6.06 equals $291 million.[23] But Petitioners have never objected, in this Court or below, to the correctness of Ruback's formula for market capitalization, which is standard. Expert testimony is not required to establish that plugging Petitioners' preferred share count into that uncontested formula yields $291 million.[24]

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[20] A439 ¶ 35 & n.45 (Ruback Opening Report).

[21] Op. 36. The trial court's finding was not correct, for the reasons explained below, *see infra* Point III, and in Respondents' prior brief, *see* Appellees/Cross-Appellants' Answering Brief on Appeal and Opening Brief on Cross-Appeal ("ROB") Point IV.

[22] ROB 30; A3623 at n.173 (Respondents' Answering Post-Trial Brief).

[23] PAB 3-4.

[24] Simple multiplication is not a matter on which "scientific, technical or other specialized knowledge will assist the trier of fact." Delaware Rule of Evidence 702.

Petitioners also suggest, in the alternative in a footnote, that the appropriate share count figure is not 48,115,828 (the sum of the share count Ruback used and the 15,217,391 shares issued in the pre-merger warrant exercise) but rather 50,139,294 (the sum of the share count Ruback used and the 17,391,304 shares represented by all of the warrants, whether exercised or not).[25] Using a share count of 50,139,294, Petitioners say, increases the market capitalization just enough to decrease the size premium in their favor. But in the court below and in their opening brief in this Court, Petitioners argued that only an additional 15,217,291 shares were part of SWS's "operative reality" as of the merger date because only 15,217,291 shares were issued as a result of the pre-merger warrant exercise — and that is what the Court of Chancery found.[26] Petitioners offer no reason to count shares represented by unexercised warrants in calculating market capitalization — especially because unexercised warrants are expressly excluded in the calculation of observed market capitalizations reported in the Duff & Phelps size premium tables on which both parties rely.[27]

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[25] PAB 5 n.14.

[26] A3370 (Petitioners' Post-Trial Opening Brief); A3533 (Petitioners' Post-Trial Answering Brief); Appellants' Opening Brief 28; Op. 39.

[27] Petitioners vaguely suggest that the $6.06 unaffected share price used to calculate SWS's market capitalization is too low because the warrant exercise would have been "favorable news." PAB 4. That assertion is refuted by the trial court's findings that SWS performed dismally in 2014, substantially missing management's projections, and that its pre-announcement price was artificially inflated by merger speculation. Op. 15. These findings of fact suggest that $6.06 was, if anything, too high.

Petitioners' position on size premium echoes the broader theme of their appeal: Instead of looking to observable, objective market evidence, Petitioners would have this Court, and the Court of Chancery, enhance expert discretion to sponsor appraisal valuations untethered to values derived from market transactions between buyers and sellers spending real money. Consistent with this approach, Petitioners' position — that the expert-driven "circular" approach should be credited even when the public markets have already determined a company's size — introduces uncertainty and multiplies litigation, with no basis in evidence or economic theory. On the other hand, by linking a company's size premium to actual market evidence, the traditional calculation of size premium eliminates an opportunity for valuation experts to "second-guess[] the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter."[28]

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[28] *DFC*, 2017 WL 3261190, at *15.

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

At trial, Respondents presented expert evidence to support a valuation using the historical equity risk premium ("ERP") to determine SWS's cost of capital. Petitioners' expert proposed a valuation using the supply-side ERP. The trial court applied the supply-side ERP, yielding a lower ERP for SWS and a correspondingly lower cost of capital and higher valuation. This decision was not supported by the evidence.

Respondents presented the following evidence in support of the historical methodology:

- A 2015 survey of valuation professionals showing a continuing preference among experts for the historical approach.[29]
- Expert testimony that market shocks since the Great Recession have undermined the assumption, fundamental to the supply-side approach, that some risk has been squeezed out of the equity markets.[30]
- Expert testimony that the historical approach relies on verifiable market data while the supply-side approach introduces subjective assumptions into the valuation.[31]

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[29] *See, e.g.*, A282 at 725:22-726:10 (Ruback); A437-38 at ¶ 32 (Ruback Opening Report).

[30] A282 at 724:11-23 (Ruback).

[31] A282 at 726:20-727:11 (Ruback); A436-37 at ¶ 31 (Ruback Opening Report).

At trial, and again in their answering brief in this Court, Petitioners sought to attack some (though not all) of this evidence. They point out that the 2015 survey showing academic preference for the historical ERP methodology includes older as well as more recent authorities; that some of the authorities cited in that survey do not express a preference for either approach; and that Respondents' expert has not himself published on the subject since 1996.[32] But Petitioners cite no survey or other evidence suggesting that valuation experts prefer supply-side ERP to historical or do not generally accept the historical approach to ERP. Nor do Petitioners cite any evidence to rebut Ruback's testimony that the market volatility attendant to the Great Recession undermined earlier support for the supply-side methodology.

Nor, moreover, do Petitioners' critiques of Ruback's opinion hit their mark. Petitioners reproduce in their brief a passage from their expert's rebuttal report nitpicking certain of the 150 textbooks canvassed in the 2015 survey of professional opinion.[33] But Ruback did not rely on the survey to suggest unanimity of opinion behind a historical risk premium. Rather, he cited it as evidence that the weight of academic opinion supports historical ERP as the best estimate of expected future equity returns, and as evidence of an absence of broad support for supply-side ERP. What the survey showed (and Petitioners do not contest the

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[32] PAB 40-43.

[33] PAB 41.

point) was that Clarke's supply-side approach was not endorsed by even one of the textbooks canvassed in the survey.[34]

That is Respondents' evidence, much of it uncontroverted, as to historical ERP. On the other side of the scale — Petitioners' evidence in favor of the supply-side approach — the entirety of Clarke's trial testimony was that "all" experts "recommend using a supply-side [ERP]."[35] This testimony makes no sense, insofar as it blinks the robust debate on the issue and is disproven not only by Ruback's testimony in this case but by the expert survey Ruback introduced in his report and described at trial.

In their answering brief in this Court, Petitioners describe their evidentiary showing like this: "Petitioners proffered extensive expert evidence supporting the use of the supply-side equity risk premium."[36] They do not set out that evidence but instead cite without elaboration four pages from Clarke's rebuttal report. All those pages do, however, is challenge Ruback's evidence in support of the historical methodology. While Petitioners claim that some experts do "not look[]" to historical ERP,[37] they do not identify even one other expert who relies on the

[34] A282 at 725:22-726:10 (Ruback); A437-38 at ¶ 32 (Ruback Opening Report). Petitioners also question the relevance of Ruback's testimony that market participants rely upon historical ERP in their decision making on mergers and acquisitions. PAB 41-42. They forget that ERP is tied directly to the expectations of market participants, including those very same M&A market actors.

[35] A209 at 544:10-16 (Clarke).

[36] PAB 42.

[37] PAB 41.

supply-side approach.[38] Petitioners point to nothing in the record in favor of continued use of the supply-side ERP, aside from Clarke's unsupported assertion, and thus have failed to carry their "burden of proving their respective valuation position[] by a preponderance of evidence."[39]

Petitioners cannot excuse their evidentiary failure by pointing to case law. *Golden Telecom* applied the supply-side method but made clear that the appropriate ERP is not a matter of law but a question of fact — in inquiry as to a best estimate — that must be determined by "the relevant academic and professional community."[40] The evidence of the preferences of that community in this case supports only the historical methodology.

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[38] Clarke's report cites Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital: Applications and Examples* (5th ed. 2013). But that treatise concludes that "[a]ll of the[] methods [for estimating ERP] can be informative [and] *each* model has weaknesses that may disqualify it from being utilized as 'the' single model." *Id.* at 139. And Pratt & Grabowski ultimately endorse a *higher* cost of equity capital than the one advanced by Petitioners and applied by the trial court based on the supply-side ERP. *Id.* (adding a risk-free rate of 4% to the supply-side ERP for a base cost of equity capital of 9% to 10%). As explained in the 2015 Valuation Handbook, a source relied upon by both experts with respect to ERP, the 2.47% 20-year U.S. government bond yield used as the risk-free rate in this action was "artificially repressed" and "abnormally low," and use of such a non-normalized risk-free rate requires application of a higher ERP, because "using a non-normalized risk-free rate (with no corresponding adjustments to the ERP) would likely lead to an *underestimated* cost of equity capital." BR3-37.

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

[40] *Global GT L.P.* v. *Golden Telecom, Inc.*, 993 A.2d 497, 517 (Del. Ch. 2010). The proof of the point is that recent Chancery decisions continue to recognize "meaningful debate on th[is] issue," *Merion Capital* v. *BMC Software*, 2015 WL 6164771, at *18 & n.168 (Del. Ch. Oct. 21, 2015), and continue to include

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

Section 262(h) of the Delaware General Corporation Law directs the Court of Chancery to exclude "any element of value arising from the accomplishment or expectation of the merger" in determining fair value in an appraisal proceeding.[41] In this case, the Court of Chancery found that Hilltop and Oak Hill exercised their warrants only in expectation of the merger and would not have exercised any warrants absent the merger.[42] This finding of fact was well supported by the evidence of record and Petitioners do not challenge the finding on appeal. But even though the exercise of the Hilltop and Oak Hill warrants was thus concededly an "element of value arising from the . . . expectation of the merger," the Court of Chancery declined to exclude the warrant exercise from its fair value determination.

Petitioners defend the ruling below on the ground that the warrant exercise was a "known element of value not conditioned or contingent on the [m]erger,"[43] and was therefore properly included in the trial court's fair value determination. Respondents do not dispute Petitioners' contention that the warrant exercise was a known element of value not conditioned or contingent on the merger.

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historical ERP in their valuations, *In re Rural/Metro Corp. Stockholders Litig.*, 102 A.3d 205, 226 (Del. Ch. 2014) (averaging historical and supply-side ERP).

[41] 8 *Del. C.* § 262(h).

[42] Op. 37-38; ROB 21-22.

[43] PAB 48-49.

Because the relevant facts are not disputed, the legal question is presented clearly: Should a known "element of value" that concededly "ar[ose] from the . . . expectation of the merger," but was not conditioned or contingent on the merger, be excluded from the Court of Chancery's fair value determination?

Section 262(h) supplies the answer: Yes. The statute instructs that "*any* element of value arising from the . . . expectation of the merger" should be excluded from the calculation of fair value. It contains no exception for known elements of value not conditioned or contingent on the merger.

Petitioners make no effort to reconcile their interpretation with the words of the statute. Instead they rely entirely on this Court's decision in *Cede & Co.* v. *Technicolor*.[44] But unlike this case, that decision did not involve an element of value arising only from the expectation of a merger. As Respondents set out in their moving brief — and as Petitioners do not dispute — *Technicolor* turned on the unusual facts of the two-step merger at issue in that case. On those facts, the Court held that statutory fair value included value arising from an asset divestiture plan that could and rationally would have been achieved absent the merger.[45]

Indeed, Petitioners have not identified even one case in which an appraisal court included in its valuation an element of value that arose from the expectation of a merger. This is no surprise, as any such decision would collide with the clear command of the statute. On the other hand, as demonstrated in Respondents'

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[44] 684 A.2d 289 (Del. 1996).

[45] *Id*. at 298-99.

opening brief,[46] the Court of Chancery has repeatedly, consistent with the statute, excluded elements of value in circumstances much like this. Petitioners' attempts to distinguish these cases all miss the mark. In *JRC Acquisition*, the acquired entity assumed additional debt to finance its acquisition. The court held that no caselaw "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," and accordingly held that Section 262(h) required the exclusion of the merger-related change in capital structure.[47] Petitioners say this case is different because the debt at issue was assumed by the acquirer, not the appraised entity.[48] But Petitioners have misread the opinion. *JRC Acquisition* involved the appraisal of shares in JR Cigar;[49] the relevant section of the opinion analyzes debt that "JR Cigar incurred . . . to finance the merger."[50] Read correctly, *JRC Acquisition* is directly contrary to the result Petitioners now defend.

In *Gearreald*, the appraised entity had paid off its debt before its acquisition closed. The court excluded this repayment from its valuation, reasoning that "the correct capital structure for an appraisal of [the company was] the theoretical

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[46] ROB 51-52.

[47] *JRC Acquisition*, 2004 WL 286963, at *7.

[48] PAB 47.

[49] *See JRC Acquisition*, 2004 WL 286963, at *1 ("This action . . . seeks an appraisal of 652,400 shares of 800-JR Cigar Inc. ('Respondent,' '<u>JR Cigar</u>' or the 'Company')").

[50] *Id*. at *7.

capital structure it would have maintained as a going concern."[51] Petitioners observe that the company appraised in *Gearreald* had repaid its debt as a condition of its merger agreement.[52] True enough — but nothing in the opinion suggests that this fact was relevant to the court's decision. The court instead focused on the statutory language, holding that the debt repayment must be excluded as an "element of value" because it "arose directly out of the expectation of the merger."[53] As relevant precedent, *Gearreald* looked to *JRC Acquisition*, which "rejected the proposition" — precisely the same proposition Petitioners advance here — "that changes to a company's capital structure in relation to a merger should be included in an appraisal."[54]

Lastly, in *BMC Software*, the court held that where a company was preserving excess cash in contemplation of a pending merger, it was necessary to exclude that excess cash from the fair value analysis.[55] To reconcile *BMC* with

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[51] *Gearreald* v. *Just Care, Inc.*, 2012 WL 1569818, at *8 (Del. Ch. Apr. 30, 2012).

[52] PAB 46.

[53] *Gearreald*, 2012 WL 1569818, at *8.

[54] *Id*. (citing *JRC Acquisition*, 2004 WL 286963, at *7). Petitioners labor over the *Gearreald* court's treatment of preferred stock as common equity. The appraised company had converted preferred shares to common equity in connection with the merger. Under Petitioners' reading of *Technicolor*, that pre-merger conversion should have been issue-dispositive. In *Gearreald*, however, the court evaluated the preferred stock as common equity not because of its conversion, but because the appraised company had historically failed to pay dividends to the preferred stockholders. *Gearreald*, 2012 WL 1569818, at *9 ("[T]he preferred stock should be treated as common equity because that was the true economic nature of the [c]ompany's preferred stock financing.").

[55] *See* 2015 WL 6164771, at *13 & n.151 (citing *Gearreald*).

their position, Petitioners assert the Court of Chancery in that case did not "exclude[] 'known elements of value' not conditioned or contingent on the completion of the merger from the appraisal."[56] That is false. The excess cash in that case was a "known element of value" — it was a sum certain and there was no claim that it was speculative or difficult to calculate — and it was concededly not "conditioned or contingent on the completion of the merger." But the *BMC* court excluded it nevertheless.[57]

That's because Section 262(h) required its exclusion. No case before this one has included as an element of statutory fair value a change in capital structure found to have arisen from the expectation of the merger. Petitioners thus seek to extend *Technicolor* to require a result that is not only inconsistent with the words of the statute but would also undermine a series of Chancery cases that faithfully apply them. Petitioners have supplied no basis to extend that vexed decision so as to create an unnecessary conflict with plain statutory text.

Before concluding, Petitioners serve up an argument that "[e]quity" or "economic fairness" required the trial court to include the warrant exercises in SWS's fair value.[58] Appraisal is an exercise in statutory valuation, not an

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[56] PAB 50.

[57] The decision below distinguished these cases on the ground that they involved changes in capital structure undertaken by the subject company rather than by third-party stockholders, Op. 38, although it did not explain why that distinction should make a difference. Notably, Petitioners do not defend the trial court's reasoning, but rather expressly disavow it as "dictum . . . unsupported by Delaware law." PAB 50-51.

[58] PAB 51-52.

undefined search for "economic fairness." Nor have (or can) Petitioners show that equity favors their position. They do not even suggest an equitable basis why they should benefit from Oak Hill's decision, based entirely on the impending merger, to convert its warrants to shares. As to Hilltop, it converted its warrants and voted its shares, but Petitioners have offered nothing to suggest that Hilltop's exercise of its contractual rights injured SWS stockholders. And in converting its shares, Hilltop sacrificed its contractual protections as a creditor of SWS. This included the elimination of the merger covenant, which further cleared the way for a topping bid for SWS — a bid that never came, because no one but Hilltop was ever serious about buying it.

CONCLUSION

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

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