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Using Company-Specific Risk in the Delaware Chancery Court

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For Delaware courts, discounted cash flow analysis has become the principal valuation methodology for determining going concern value of an entity. In *Cede & Co. v. JRC Acquisition Corp.*, Civil Action No. 18658-NC, 2004 WL 286963, at 2 (Del. Ch. Feb. 10, 2004), the court observed:

> In recent years, the DCF valuation methodology has featured prominently in this Court because it is the approach that merits the greatest confidence within the financial community.

Our analysis of Delaware case law shows that although company-specific risk premium as a concept has sometimes survived challenges in the Delaware Court of Chancery, that court freely rejects or modifies the premium values used by an expert. The court may question whether the risk factors considered by the expert for a proposed company-specific risk premium are really company-specific, and whether the risk factors are already (or should have been) reflected in the subject company's projected future cash flows. In addition, some opinions criticize a lack of methodological rigor in the use of company-specific risk premium and raise concerns about the expert's subjectivity and potential bias in justifying and quantifying the company-specific risk premium used.

In this article, we review recent Delaware court opinions on the inclusion of a company-specific risk premium in cost of equity for valuation analysis using the discounted cash flow methodology. The focus is on the Delaware Court of Chancery, as that is the Delaware trial court regularly called upon to decide on a company-specific risk premium.

Recent Delaware court opinions question the use of company-specific risk premiums. Given the importance of cost of equity in DCF analysis, and since experts tend to differ in their estimates of cost of equity, a controversy exists concerning whether it is appropriate to add a separate company-specific risk premium in calculating cost of equity. Recent Delaware opinions show that the court has often questioned whether proposed company-specific risk factors are already captured by either beta or other factors such as industry and size, and whether the inclusion of company-specific risk factors via a cost of equity addition is necessary if the same risk factors could instead be captured through downward adjustments to the company's cash flow projections. Ted Israel suggests in his article "The Generous Helping of Company-Specific Risk That May Already Be Included in Your Size Premium" (*Business Valuation Update*, June 2011) that adding a company-specific risk premium may double-count the effect of company-specific risk factors, first in the numerator of the discounted cash flow calculation (cash flows) and second in the denominator of the calculation (cost of capital). The court has also questioned the reliability of company-specific risk adjustments given the judgment calls required in the course of the analysis of company-specific risk premium, and its potential for misuse by experts in adversary proceedings are also argued.

Chancellor (then Vice Chancellor) Strine addressed the debate about the need for company-specific risk premium in 2003 in *Union*

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Illinois 1995 Investment Limited Partnership v. Union Financial Group, Ltd., 847 A.2d 340 (Del. Ch. 2003), an appraisal proceeding in which the court based its valuation of the subject company on the price obtained in the very merger at issue. In dictum, Chancellor Strine remarked on the company expert's use of a company-specific risk premium in calculating the company's cost of equity, and took note of "the debate about whether company-specific risk premiums can be added to arrive at an accurate cost of capital for use in a discounted cash flow analysis." Having stated that the case gave him no occasion to accept or reject the use of a company-specific risk premium, Chancellor Strine nonetheless continued:

> I understand that investors do consider company-specific risks in calculating the cost of capital they will use in investing money and that investment banks use company-specific risk premiums in advising clients. They particularly do so when a company's shares do not actively trade on a daily basis in a public market. Pure proponents of the [capital asset pricing model] argue [however,] that only systemic risk as measured by beta is relevant to the cost of capital and that company-specific risks should be addressed by appropriate revisions in cash-flow estimates.

The debate about adding a company-specific risk premium to the cost of equity based on beta is observable in other Delaware court opinions dating back to the 1990s. In *Onti, Inc. v. Integra Bank*, 751 A.2d 904, 920 (Del. Ch. 1999), the court accepted the application of a company-specific risk premium, but observed that in two prior cases the court had adjusted for company-specific risks, not by attempting to calculate a company-specific risk premium, but rather by adjusting the beta, on the theory that "the beta perhaps [acted] as a surrogate company specific risk premium."

In *Union Illinois v. Korte*, No. Civ. A. 17392, 2001 WL 1526303, at 9 (Del. Ch. Nov. 28, 2001), a Special Master's Report (subsequently endorsed

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by the court) rejected a proposed company-specific risk premium and noted that even the expert who proposed its use "conceded . . . that firm-specific risk would normally be included as part of a standard projection of earnings" rather than as a separate premium added to the cost of equity. In *Gotham Partners v. Hallwood Realty Partners, L.P.*, 855 A.2d 1059, 1077 (Del. Ch. 2003), a breach-of-fiduciary-duty action, the court adopted nearly all of the defendants' expert's valuation of the business, with the exception of the expert's use of company-specific risk premium. The court's reason for rejecting the proposed company-specific risk premium was that risks that were specific to the business had *already* been accounted for in the estimation of its beta.

In *Solar Cells, Inc. v. True North Partners, LLC*, No. Civ. A. 19477, 2002 WL 749163, at 6 n.11 (Del. Ch. Apr. 25, 2002), Chancellor Chandler articulated the following concern over the susceptibility of company-specific risk estimations to misuse in the adversarial context—an articulation that has subsequently appeared in a number of Chancery decisions:

> This Court has been, understandably in my view, suspicious of expert valuations offered at trial that incorporate subjective measures of company specific risk premia, as subjective measures may easily be employed as a means to smuggle improper risk assumptions into the discount rate so as to affect dramatically the expert's ultimate opinion of value.

Similarly, Chancellor Strine remarked in *Delaware Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290, 339 (Del. Ch. 2006), "To judges, the company specific risk premium often seems like the device experts employ to bring their final results into line with their clients' objectives, when other valuation inputs fail to do the trick."

The concern about a possible built-in bias in the analysis of company-specific risk factors has caused the Court of Chancery to exercise caution and demand fact-based evidence to support a company-specific risk premium. In *Gessoff v. IIC Industries Inc.*, 902 A.2d 1130, 1158 (Del. Ch. 2006), the court cited Chancellor Chandler's comment in *Solar Cells* and continued: "In accordance with that sentiment, our courts have not applied company-specific risk premia without fact-based evidence produced at trial on which to base that discount." The court in *Gessoff* then rejected defendants' expert's proposed company-specific risk premium on the ground that it was "unmoored to any objective financial analysis the court can reasonably evaluate."

Fact-based evidence was also the issue in a 2010 case, *In re Sunbelt Beverage Corp.,* C.A. No. 16089-CC, 2010 WL 26539 (Del. Ch. Jan. 5, 2010, revised Feb. 15, 2010), a breach of fiduciary duty case in which the court held that defendants had failed to establish the appropriateness of their expert's use of a company-specific risk premium in valuing the company. The court concluded: "It is important for any proposed company-specific risk premium to be based on a specific financial analysis, so that the Court can verify both the propriety of including the risk premium and the appropriate level of the premium."

In *Le Beau v. M.G. Bancorporation, Inc.,* No. Civ. A. 13414, 1998 WL 44993, at 10 (Del. Ch. Jan. 29, 1998), an appraisal proceeding in which the valuation of the subject company hinged on valuations of its subsidiaries, the company's financial expert applied a company-specific risk premium to determine the discount rate for the valuation of one of the subsidiaries, citing risks arising from a lawsuit and from the subsidiary's dependence on a key supplier. Without rejecting the concept of company-specific risk premium, the court simply found the concept inapplicable to the facts that the court inferred from the evidence presented. The court reasoned: "The underlying evidence that these 'risks' were material is unpersuasive."

In *Hintmann v. Fred Weber, Inc.*, No. 12839, 1998 WL 83052, at 5 (Del. Ch. Feb. 17, 1998), another appraisal proceeding, the court made clear that it did not reject the concept of company-specific risk premium and noted that it "may be appropriate to account for risks not captured in the equity risk premium and the small size

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premium," but also added that the company-specific risk premium cannot be "determined by reference to the published results of empirical research" and (quoting a valuation text) "'remains largely a matter of the analyst's judgment.'" The court then rejected the company's expert's company-specific risk premium, because the expert had failed to provide the necessary factual support for it and noted that the expert did not explain "how either of his proposed reasons for adding the extra premium translated into greater risk."

A concern that the expert might try to use company-specific risk premium in a biased fashion was articulated in *In re Loral Space and Communications Inc. Consolidated Litigation*, C.A. Nos. 2808-VCS, 3022-VCS, 2008 WL 4293781, at 30 n.151 (Del. Ch. Sept. 19, 2008), in which the court stated that "flaws in the work of" an expert's valuation "leave [the court] unable to draw any confidence from [the expert's] work," and added: "In that regard, the [expert's] use of a 5% company specific risk premium . . . is but one notable example" of the expert's "too easy willingness . . . to come up with a way to justify the fairness of [the] deal . . . rather than a willingness to perform real valuation work."

When choosing between company-specific risk premium values proposed by opposing experts, Chancery has similarly looked for company-specific evidence or examined the experts' potential biases or their lack of precision. *Delaware Open MRI Radiology Associates v. Kessler*, 898 A.2d 290 (Del. Ch. Apr. 26, 2006) was a combined shareholder breach-of-fiduciary-duty action and appraisal proceeding in which the plaintiffs/petitioners' expert had applied a company-specific risk premium smaller than that applied by the opposing expert. According to the court, "neither [of the two competing experts] explained their estimates [of the company-specific risk] with any confidence-inspiring precision." The court adopted the lower estimate proposed by the plaintiffs/petitioners' expert, and stated it was doing so "in view of the unavoidable imprecision of the exercise."

Similarly, in *Onti, Inc. v. Integra Bank*, the court held that while the facts provided a basis for applying a company-specific discount premium, the reasons given by the company's expert did

Cases in which the court questioned the very possibility of applying a company-specific risk premium	**Cases in which the court accepted the possibility of a company-specific risk premium but rejected its use in the case at hand**	**Cases in which the court commented on the susceptibility of company-specific risk premiums to subjective bias**	**Cases in which the court employed a company-specific risk premium**
Union Illinois v. Korte, No. Civ. A. 17392, 2001 WL 1526303 (Del. Ch. Nov. 28, 2001 *Union Ill. 1995 Inv. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340 (Del. Ch. 2003) *Gotham Partners v. Hallwood Realty Partners, L.P.*, 855 A.2d 1059 (Del. Ch. 2003)	*Le Beau v. M.G. Bancorporation, Inc.*, 1998 WL 44993 (Del. Ch. Jan. 29, 1998) *Hintmann v. Fred Weber, Inc.*, 1998 WL 83052 (Del. Ch. Feb. 17, 1998) *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130 (Del. Ch. 2006) *In re Sunbelt Beverage Corp.*, C.A. No. 16089-CC, 2010 WL 26539 (Del. Ch. Jan. 5, 2010)	*Solar Cells, Inc. v. True North Partners, LLC*, No. Civ. A. 19477, 2002 WL 749163 (Del. Ch. Apr. 25, 2002) *In re Loral Space and Commc'ns Inc. Consolidated Litig.*, C.A. Nos. 2808-VCS, 3022-VCS, 2008 WL 4293781 (Del. Ch. Sept. 19, 2008)	*Wacht v. Continental Hosts, Ltd.*, Civ. A. No. 7954, 1994 WL 52522 (Del. Ch. Sept. 16, 1994) *Onti, Inc. v. Integra Bank*, 751 A.2d 904 (Del. Ch. 1999) *Delaware Open MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006) *Reis v. Hazelett Strip-Casting Corp.*, C.A. No. 3552-VCL, 2011 WL 4346913 (Del. Ch. Jan. 21, 2011, corrected Feb. 1, 2011)

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not justify a premium as high as the one he had used. The court explained: "I do not believe all of these items [considered by the expert] are particularly specific to the [company], especially the ones relating to competition, dependence on a single location, and risk of obsolescence. Such 'company specific' risks apply to nearly all companies in the entire United States economy." Accordingly, in its own judgment call, the court chose to halve the company-specific risk premium applied by the company's expert. Likewise, in *Wacht v. Continental Hosts, Ltd.*, Civ. A. No. 7954, 1994 WL 525222, at 6 (Del. Ch. Sept. 16, 1994), the court rejected *in toto* plaintiff's expert's valuation of defendant company and accepted defendant's expert's valuation, including a "premium . . . based, in part, on [specific risks such as] the uncertainty of passage of new tax laws [and] litigation pending with the City of New York," but applied a 3% specific risk premium rather than the 5% applied by defendant's expert. And similarly, in *Reis v. Hazelett Strip-Casting Corp.* C.A. No. 3552-VCL, 2011 WL 4346913, at 23 (Del. Ch. Jan. 21, 2011, corrected Feb. 1, 2011), the court, adopting a capitalized earnings approach to a valuation, used a company-specific risk premium to calculate the cost of equity of the company, but used plaintiff's proposed 2% factor rather than defendants' proposed 6% factor "because of the dangers inherent in overestimating the company-specific risk premium, and because [the court] believe[d] the earnings figures [for the valuation] underestimate the real economic returns that [the company] generates for its owners."

The Delaware decisions relevant to the use of a company-specific risk premium can be summarized in the following table:

Supporting the use of company-specific risk premium in expert reports. The judicial opinions we have reviewed demonstrate that while Chancery has not rejected the application of company-specific risk premium outright, it has sometimes rejected the premium in favor of an adjustment to the subject company's beta or other variables such as cash flows. In other recent cases, Chancery has accepted the expert's use of the company-specific risk premium (sometimes implicitly) but replaced the premium applied by the expert with a smaller premium calculated by the court. Overall, the opinions we have reviewed show that the Chancery has been willing to accept the use of company-specific risk premium when it is supported by fact-based evidence and empirically based methodological arguments.

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