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Expert Analysis

Analysis of Delaware Chancery Court Opinions on the Use of Company-Specific Risk Premiums in Valuation

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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.[1] 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 method.[2] We also provide an overview of some of the common approaches used by valuation professionals to estimate company-specific risk premium.

UNDERSTANDING DCF

Under the discounted cash flow methodology, the value of a subject company is the present value of its future cash flows discounted at its cost of capital, which is a weighted sum of the cost of debt and cost of equity. The cost of equity for the subject company is generally calculated starting from a traditional finance model such as the capital asset pricing model.

This model measures the company's risk through the parameter beta, which analyzes a stock's covariance (a statistical term for the correlation between two variables) versus the variance of a diversified market portfolio, such as the S&P 500 index.[3] The cost of equity is derived by determining an appropriate risk-free rate plus a risk premium for the stock measured by beta times the market's equity risk premium.

Beta, however, only measures the additional risk added by a company to the diversified market portfolio. This is known as systematic risk. In traditional corporate finance models, the remaining company-specific risk, known as unsystematic risk, can be eliminated if an investor holds a diversified portfolio and is therefore not relevant to computing the cost of equity for a company. The equity premium for unsystematic risk is known as company-specific risk premium.

In valuing small companies, the question arises of whether estimating the cost of equity using beta adequately captures the risk factors associated with such investments. The theory behind the systematic risk concept assumes all investments being valued are also included in the market portfolio. In practice, however, the market portfolio used to measure beta may exclude an array of investments, such as closely held companies and small, publicly held companies with infrequently traded stocks. Investor-managers holding these types of companies as an investment may not be in a position to diversify away the investment's unsystematic risk.

For these reasons, many financial professionals contend that in valuing closely held firms or small public firms, the cost of equity should be increased to reflect additional risk factors specific to a particular company. Several company-specific risk factors, such as management quality, management depth, customer concentration, product concentration, risk of entry of new competitors and limited access to capital have been cited in support of a company-specific risk premium in addition to the cost of equity.[4]

Our analysis of Delaware case law shows that although the company-specific risk premium concept has survived some challenges, the Delaware Chancery 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, or whether the risk factors are already, or should have been, reflected in the subject company's projected 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 quantifying and justifying the company-specific risk premium used.

RECENT DELAWARE COURT OPINIONS ON COMPANY-SPECIFIC RISK PREMIUMS

The Chancery Court is required to make a finding of fact on the value of a going concern in two common contexts. The first is that of a shareholder action against corporate fiduciaries for breach of a duty in connection with a sale of the company. The most onerous of Delaware's three tiers of judicial review for a corporate fiduciary's conduct is triggered once the shareholder plaintiff establishes self-interest, gross negligence or bad faith on the part of the fiduciary.[5]

The "entire fairness" standard that then governs has two prongs — "fair dealing" and "fair price" — which require findings on whether the sale process was fair and whether the price was fair.[6] The "fair price" prong of this analysis presupposes a valuation of the subject company.

The second context requiring a judicial finding on the value of a going concern is an appraisal proceeding under Delaware General Corporation Law Section 262. If a merger or consolidation qualifies and a dissenting shareholder perfects its appraisal rights and petitions for an appraisal, then the court "shall determine the fair value of the [dissenters'] shares" as of the date of the merger, "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."[7]

While there are important differences between an appraisal proceeding and a shareholder action against fiduciaries,[8] the court will often consolidate the evidentiary hearing of an appraisal proceeding with the trial of a breach-of-fiduciary-duty shareholder action arising from the same transaction. Typically, the court's finding on the fair value of the company's shares will be used for meeting the fair price prong of the entire-fairness standard and remedying a breach of fiduciary duty.[9]

VALUATION FACTORS

During the valuation of a company, evidence may comprise "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court, subject only to" any strictures imposed by Section 262, such as that stating the valuation must be exclusive of value arising from the merger.[10] The Chancery Court regularly considers valuations undertaken by "comparable companies" or "comparable transaction" analyses, and the court sometimes rejects conclusions resulting from classic valuation approaches in favor of the actual price at which the subject merger was effected.[11] Most commonly, however, the court favors a discounted cash flow valuation methodology.[12]

To support the valuation presented to the court, petitioners and respondents in an appraisal proceeding — or plaintiffs and defendants in a breach-of-fiduciary-duty action — each submit valuation reports from their respective financial experts.[13] The Chancery Court, however, understands the inherent subjectivity of the discounted cash flow valuation exercise. In the seminal decision in *Cede & Co. v. Technicolor*, then-Chancellor William B. Chandler III shared his observations:

> Experience in the adversarial, battle of the experts' appraisal process under Delaware law teaches one lesson very clearly: valuation decisions are impossible to make with anything approaching complete confidence. Valuing an entity is a difficult intellectual exercise, especially when business and financial experts are able to organize data in support of wildly divergent valuations for the same entity. For a judge who is not an expert in corporate finance, one can do little more than try to detect gross distortions in the experts' opinions. This effort should, therefore, not be understood, as a matter of intellectual honesty, as resulting in the fair value of a corporation on a given date. The value of a corporation is not a point on a line, but a range of reasonable values, and the judge's task is to assign one particular value within this range as the most reasonable value in light of all the relevant evidence and based on considerations of fairness.[14]

Many financial professionals contend that in valuing closely held firms or small public firms, the cost of equity should be increased to reflect additional risk factors specific to a particular company.

CONSIDERING COMPANY-SPECIFIC RISKS

Given the importance of cost of equity in discounted cash flow analysis, and the tendency of experts to differ in their estimates for cost of equity, a controversy has arisen concerning whether it is appropriate to add a separate company-specific risk premium in calculating cost of equity.

The court has questioned whether proposed company-specific risk factors are already captured by beta or other aspects, such as industry and size. The court has also discussed whether company-specific risk factors could be captured through downward adjustments to the company's cash flow projections instead of being added to the cost of equity.

Adding a company-specific risk premium could account for the effect of risk factors twice — first in the numerator of the discounted cash flow calculation (cash flows) and second in the denominator of the calculation (cost of capital).[15] The reliability of company-specific risk adjustments is also in question, given the judgment calls required during the analysis of a company-specific risk premium and the potential for experts to misuse the premium in adversary proceedings.

Although the company-specific risk premium concept has survived some challenges, the Delaware Chancery Court freely rejects or modifies the premium values used by an expert.

The debate about the need for a company-specific risk premium was addressed in 2003 in *Union Illinois 1995 Investment LP v. Union Financial Group*,[16] an appraisal proceeding in which the court based its valuation of the subject company on the price obtained in the merger at issue. Though each expert proposed a valuation of the company based on discounted cash flow analysis, no part of either expert's valuation was adopted by the court.

In dictum, then-Vice Chancellor Leo E. Strine Jr. remarked on the company's expert's use of a company-specific risk premium in calculating the company's cost of equity: "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."[17]

Having said that the case gave him no occasion to accept or reject the use of a company-specific risk premium, the vice chancellor nonetheless shared his opinion:

> 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.[18]

Court decisions on company-specific risk premiums

Questioned the concept	*Union Illinois v. Korte,* 2001 WL 1526303 (Del. Ch. 2001) *Union Illinois 1995 Investment LP v. Union Financial Group Ltd.,* 847 A.2d 340 (Del. Ch. 2003) *Gotham Partners v. Hallwood Realty Partners LP,* 855 A.2d 1059 (Del. Ch. 2003)
Accepted the concept, but rejected its use in the case	*Le Beau v. M.G. Bancorporation,* 1998 WL 44993 (Del. Ch. 1998) *Hintmann v. Fred Weber Inc.,* 1998 WL 83052 (Del. Ch. 1998) *Gesoff v. IIC Industries,* 902 A.2d 1130 (Del. Ch. 2006) *In re Sunbelt Beverage Corp.,* 2010 WL 26539 (Del. Ch. 2010)
Questioned possible bias in determining discount	*Solar Cells v. True North Partners LLC,* 2002 WL 749163 (Del. Ch. 2002) *In re Loral Space & Communications Consolidated Litigation,* 2008 WL 4293781 (Del. Ch. 2008)
Employed a company-specific risk premium	*Wacht v. Continental Hosts Ltd.,* 1994 WL 52522 (Del. Ch. 1994) *Onti Inc. v. Integra Bank,* 751 A.2d 904 (Del. Ch. 1999) *Delaware Open MRI Radiology Associates v. Kessler,* 898 A.2d 290 (Del. Ch. 2006) *Reis v. Hazelett Strip-Casting Corp.,* 2011 WL 4346913 (Del. Ch. 2011)

The debate about adding a company-specific risk premium to the cost of equity based on beta is observable in Delaware court opinions dating back to the 1990s. In a 1999 case, *Onti Inc. v. Integra Bank*,[19] the court accepted the application of a company-specific risk premium but observed in two prior cases the court had accounted for company-specific risks by instead adjusting the beta, based on the theory that "beta perhaps act[ed] as a surrogate company-specific risk premium."[20]

In a 2001 case, *Union Illinois v. Korte*,[21] a special master's report, subsequently endorsed by the court, rejected a proposed company-specific risk premium, noting 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."[22]

In a 2003 breach-of-fiduciary-duty action, *Gotham Partners v. Hallwood Realty Partners LP*,[23] the court adopted nearly all the defense expert's valuation of the business, with the exception of his use of a company-specific risk premium. The court's reason for rejecting the proposed premium was that risks specific to the business had already been accounted for in the estimation of its beta.[24]

While factor scoring methods result in a quantified company-specific risk premium, the selection of risk factors and the assignment of values are necessarily subjective.

Concern over the susceptibility of company-specific risk estimations to misuse in the adversarial context has appeared in a number of Chancery Court decisions. Then-Chancellor Chandler said, "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."[25]

Similarly, then-Vice Chancellor Strine said, "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."[26]

MAKING THE NUMBERS COME OUT

Concern about bias in the analysis of company-specific risk factors has caused the Chancery Court to demand fact-based evidence to support a company-specific risk premium. In a 2006 case, *Gessoff v. IIC Industries*, the court cited then-Chancellor Chandler's comment in *Solar Cells v. True North Partners LLC* that challenged an expert's judgment-call estimation of a company-specific risk factor: "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."[27]

Fact-based evidence was also the issue in a 2010 case, *In re Sunbelt Beverage Corp.*,[28] a breach-of-fiduciary-duty action in which the court held that the defendants failed to establish the appropriateness of their expert's use of a company-specific risk premium in valuing the company. The court said in conclusion, "[I]t 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."[29]

In *Le Beau v. M.G. Bancorporation*,[30] 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. The expert cited risks arising from a lawsuit and from the subsidiary's dependence on a key supplier. Without rejecting the concept of a company-specific risk premium, the court found that "[t]he underlying evidence that these 'risks' were material [was] unpersuasive."[31]

In *Hintmann v. Fred Weber Inc.*,[32] another appraisal proceeding, the court made clear that it did not reject the concept of a company-specific risk premium, saying it "may be appropriate to account for risks not captured in the equity risk premium and the small size premium." The court added, though, that the company-specific risk premium cannot be "determined by reference to the published results of empirical research" and "remains largely a matter of the analyst's judgment," citing a valuation text for support of that proposition.[33] The court then rejected the company's risk premium, because the expert failed to explain "how either of his proposed reasons for adding the extra premium translated into greater risk."[34]

In *In re Loral Space & Communications Consolidated Litigation*, the court expressed concern for the biased use of a company-specific risk premium, saying "flaws in the work of" the expert's valuation "leave [the court] unable to draw any confidence from [the expert's] work."

The court added, "In that regard, the [expert's] use of a 5 percent 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."[35]

Concern about bias in the analysis of company-specific risk factors has caused the Chancery Court to demand fact-based evidence to support a company-specific risk premium.

DUELING COMPANY-SPECIFIC RISK VALUES

When choosing between company-specific risk premium values proposed by opposing experts, the Chancery Court has looked for company-specific evidence and examined the experts' potential biases or lack of precision. *Delaware Open MRI Radiology Associates v. Kessler*[36] was a combined shareholder breach-of-fiduciary-duty action and appraisal proceeding in which the plaintiffs' expert 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 … with any confidence-inspiring precision."[37] The court adopted the plaintiffs' lower estimate because of "the unavoidable imprecision of the exercise."[38]

Similarly, in *Onti v. Integra Bank*, cited earlier,[39] then-Chancellor Chandler held that while the facts provided a basis for applying a company-specific discount premium, the company's expert did not justify a premium as high as the one he had used in calculating the cost of equity.

"I do not believe all of these [risks] … are particularly specific to the [company], especially the ones relating to competition, dependence on a single location, and risk of obsolescence," he wrote. "Such 'company-specific' risks apply to nearly all companies in the entire United States economy."[40]

Accordingly, the court made its own judgment call to halve the company-specific risk premium applied by the company's expert.

In *Wacht v. Continental Hosts Ltd.*, the court rejected *in toto* the plaintiff's expert's valuation of the defendant company. The court instead accepted the defense expert's valuation, which included a premium "based, in part, on … the uncertainty of passage of new tax laws [and] litigation pending with the city of New York." The court, however, applied a 3 percent specific risk premium rather than the 5 percent the expert suggested.[41]

Similarly, in *Reis v. Hazelett Strip-Casting Corp.*, the court accepted the use of a company-specific risk premium, but used the plaintiff's proposed 2 percent factor rather than the defendant's 6 percent factor.

The court said it did this "[b]ecause 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."[42]

SUPPORTING THE USE OF COMPANY-SPECIFIC RISK PREMIUMS IN EXPERT REPORTS

The judicial opinions reviewed here demonstrate that while the Chancery Court has not rejected the application of company-specific risk premiums, 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, the Chancery Court has replaced the expert's premium with a smaller premium. Overall, the opinions show that the court has been willing to accept the use of a company-specific risk premium when it is supported by fact-based evidence. Several empirical approaches have been advanced to quantify company-specific risk premiums.

If a risk factor is deemed company-specific, the courts would likely look for factual evidence to support the score the expert assigned to the factor.

Academic papers tend to address the topic indirectly, through related topics such as "idiosyncratic risk" or the stock market's use of firm-specific information in portfolios of securities. These are not relevant, though, to our focus on the valuation of closely held or thinly traded individual companies.

A common approach to determine company-specific risk premiums is to analyze the subject company with a checklist of various risk factors in order to subjectively form a premium value. The court is likely to doubt such an approach, unsupported by empirical analysis. Mindful of this problem, some practitioners have supplemented the judgment-call analysis with a scoring approach. By assigning a score for each factor analyzed and computing a total score for the subject company, a quantitative measure of company-specific risk is achieved. These methods are generally known as "factor scoring" or "risk scoring."

An example of a factor scoring approach is described in an article distributed by Highland Global.[43] Seven company-specific risk factors are analyzed and scored on a scale of zero to 10, with zero being the lowest level of risk and 10 being the highest. The average of the scores gives the company-specific risk premium value.

The model includes revenue growth as a risk factor, with a score of 10 for declining growth and a score of zero for revenue growth in excess of eight percent. Financial risk is measured by a total debt-to-equity ratio, with a ratio higher than 90 percent resulting in a score of 10. Operational risk is measured by the ratio of fixed costs to sales, with a ratio higher than 90 percent resulting in a score of 10. A company assigned the highest value of 10 for each factor would receive a company-specific risk premium of 10 percent.

As one might suspect from the Delaware case law, this scoring method has also been criticized. It is questionable whether the risk factors commonly considered in determining company-specific risk premiums are already reflected in other risk premium values added to cost of equity, such as the equity risk premium multiplied by beta, a size premium or an industry risk premium. For example, operating margin, which may be included as part of a scoring approach and is enunciated in a popular valuation book as one of the "three fundamental risk measures" of a company,[44] is not necessarily limited to small, private companies. Therefore, its effect on risk could arguably be captured with beta or through industry risk premium instead.

THE DOWNSIDE OF 'SCORING'

While factor scoring methods result in a quantified company-specific risk premium, the selection of risk factors and the assignment of values are necessarily subjective. As such, Delaware courts may question the selection of risk factors, the way the scores are assigned for each factor and the method for converting the final score to a premium value. In particular, courts may question whether the risk factors truly measure company-specific risk as opposed to diversifiable systematic risk. For example, revenue growth, debt-to-equity ratio and the ratio of fixed cost to sales may be similar within an industry. If a risk factor is deemed company-specific, the courts would likely look for factual evidence to support the score the expert assigned to the factor.

Another method of quantifying company-specific risk premiums is observed in the work of Peter Butler and Keith Pinkerton. Through a series of articles, they advocate an approach based on corporate finance theory.[45] A concept called "total beta," which has been used in finance literature for decades, is "the catalyst" for their approach.[46]

They say the total beta of a company can be interpreted as the sum of the company's diversifiable systematic risk (beta) and the unsystematic risk. They believe the unsystematic risk is a relevant risk factor for computing the cost of equity for private companies and small public companies whose owners are unable to diversify away company-specific risks. They thus advocate incorporating a risk premium for the unsystematic risk. Under this interpretation, the company-specific risk premium equals the equity risk premium times the sum of total beta minus beta. Any size premium or other premiums already added by the expert are then subtracted.

This calculation measures the risk of diversification, or what an investor can avoid in risk by holding a diversified portfolio of investments as assumed by the capital asset pricing model.

There is an ongoing discussion among leading financial practitioners about whether Butler and Pinkerton's interpretation of this risk premium as company-specific risk premium is applicable to all potential buyers or only to potential buyers who will not be holding the subject company in a diversified portfolio.

POPULARIZING TOTAL BETA

Aswath Damodaran, whose writings popularized the concept of total beta, discussed on his website the applicability of the total beta concept to private firm valuation:

> If the private firm is being valued for sale, whether and how much the market beta should be adjusted will depend upon the potential buyer or buyers. If the valuation is for an initial public offering, there should be no adjustment for non-diversification, since the potential buyers are stock market investors. If the valuation is for sale to another individual or private business, the extent of the adjustment will depend upon the degree to which the buyer's portfolio is diversified; the more diversified the buyer, the higher the correlation with the market and the smaller the total beta adjustment.[47]

Damodaran's comments beg the question of whether a financial professional should consider the pool of potential buyers when valuing a thinly traded public company or a privately held firm. In Damodaran's framework, if the pool of potential buyers includes both diversified and nondiversified investors, the diversified investors can expect to offer higher bids since their cost of capital would be lower[48] than that of the non-diversified investors. Then the fair value, or the price at which a company is sold, would be based on the bids of diversified investors and the cost of capital would exclude a company-specific risk premium. If, on the other hand, the pool of potential buyers is limited to non-diversified investors, the company-specific risk premium could rise.

Consistent with Damodaran's comment, some valuation professionals, such as Larry Kasper,[49] question whether the Butler-Pinkerton approach really proposes different costs of equity for diversified and non-diversified buyers. A business valuation conference in 2009, convened by the American Society of Appraisers, hosted a session on the topic of total beta that included discussions by Butler, Kasper and Damodaran.

Roger Grabowski, the panel's moderator, summarized the discussions and presentations in an editor's column in Business Valuation Review.[50] On the issue of the risk faced by a nondiversified investor, Grabowski said the total beta concept "leads to the position that there are at least two costs of capital for a business — the cost of equity capital for investors that comprise the pool of likely buyers (diversified to varying degrees) and the cost of equity capital to the current, undiversified owner."[51] He adds, "the cost of capital should reflect the risk of the investment, not the cost of funds to the investor."[52]

In conclusion, Grabowski says "using the total beta to estimate the cost of equity capital may confuse investment value (the value to a particular investor) with fair market value (or fair value for financial reporting) of an investment and deriving an estimate for company-specific risk based on … [total beta] may quantify two risks simultaneously — company-specific risk and lack of diversification risk of the venturer."[53]

A DCF 'THRILLA IN MANILA'

Unsurprisingly, Butler disagrees.[54] One commentator described the arguments among Butler, Kasper and others as the business valuation field's equivalent of "Thrilla in Manila."[55] These comments demonstrate the ongoing debate about the probative force of the Butler-Pinkerton approach.[56]

The Butler-Pinkerton methodology, along with other empirical approaches that capture company-specific risk, have yet to be tested in the Delaware courts and elsewhere. In the meantime, financial professionals need to be conscious of the concerns raised in Delaware regarding the use of company-specific risk premiums. They should prepare to address concerns in court with facts specific to the subject company, buttressed to the utmost with empirical analysis.

NOTES

1 *Cede & Co. v. JRC Acquisition Corp.,* No. 18658-NC, 2004 WL 286963, at 2 (Del. Ch. Feb. 10, 2004) ("In recent years, the DCF valuation methodology has featured prominently in this court because it … merits the greatest confidence within the financial community" (internal quotation marks omitted).).

2 The cases discussed in this article are primarily decisions of the Delaware Chancery Court. The Delaware Supreme Court has not directly addres-sed the topic of company-specific risk premium. *Cf. M.G. Bancorporation v. Le Beau,* 737 A.2d 513, 523-24 (Del. 1999) (rejecting an attack on the Chancery Court's decision to reject both opposing experts' discounted cash flow valuations).

[3] By definition, beta is 1 for the market index.

[4] For additional examples of company-specific risk factors, see Shannon Pratt, Valuing a Business: The Analysis and Appraisal of Closely Held Companies (5th ed. 2008), Chapter 9; Peter J. Butler & Keith A. Pinkerton, *Quantifying Company Specific Risk: A New Empirical Framework with Practical Applications,* Bus. Valuation Update (February 2007); and Roger Grabowski & Bernard Pump, Company-Specific Risk Premiums: Applications and Models, presentation at the American Bankruptcy Institute Valuation Conference (Feb. 24, 2010).

[5] *See In re Walt Disney Co. Derivative Litig.,* 906 A.2d 27, 52 (Del. 2006); *Brehm v. Eisner,* 746 A.2d 244, 264 n.66 (Del. 2000).

[6] *Weinberger v. UOP Inc.,* 457 A.2d 701, 711 (Del. 1983).

[7] Del. Gen. Corp. Law § 262(h).

[8] The burden of proof is of particular significance: "Unlike in an action where wrongdoing has been alleged, '[i]n a statutory appraisal proceeding, both sides have the burden of proving their respective valuation positions by a preponderance of evidence.'" *Reis v. Hazelett Strip-Casting Corp.,* No. 3552-VCL, 2011 WL 4346913, at 7 (Del. Ch. Jan. 21, 2011, corrected Feb. 1, 2011) (quoting *M.G. Bancorporation Inc. v. Le Beau,* 737 A.2d at 520).

[9] *See Reis,* 2011 WL 4346913, at 11 ("[T]he 'fair price' aspect of the unitary entire fairness standard is widely regarded as requiring a valuation analysis equivalent to the 'fair value' inquiry in an appraisal."); *In re Emerging Commc'ns S'holders Litig.,* No. 16415, 2004 WL 1305745, at 10 (Del. Ch. May 3, 2004, revised June 4, 2004) ("[T]he fiduciary 'fair price,' and statutory 'fair value' contentions converge.").

[10] *Weinberger*, 457 A.2d at 713.

[11] *See Union Ill. 1995 Inv. LP v. Union Fin. Group Ltd.,* 847 A.2d 340, 357 (Del. Ch. 2003) (In an appraisal proceeding, evidence of the company's value "may include facts bearing on the market value of the subject company," and "[t]his includes the transaction that gives rise to the right of appraisal, so long as the process leading to the transaction is a reliable indicator of value and merger-specific value is excluded.").

[12] *See JRC Acquisition,* 2004 WL 286963, at 2; *see also In re Emerging Commc'ns,* 2004 WL 1305745, at 12 n.36 (rejecting comparable companies approach on the ground that the company "had no true comparables" and endorsing "[t]he DCF methodology … because [the company] had available contemporaneous management forecasts, predictable earnings and cash flow"); *cf. S. Muoio & Co. LLC v. Hallmark Entm't Invs. Co.,* No. 4729-CC, 2011 WL 863007, at 20 (Del. Ch. Mar. 9, 2011) (noting that "the court also gives more credit and weight to experts who apply multiple valuation techniques that support one another's conclusions and that serve to cross-check one another's results" (internal quotation marks omitted)); *Reis*, 2011 WL 4346914, at 25-26 (adjusting upward the value determined by a capitalized earnings analysis, based on the higher value determined by a "book value" analysis).

[13] *In re Emerging Commc'ns,* 2004 WL 1305745, at 11.

[14] *Cede & Co. v. Technicolor Inc.,* No. 7129, 2003 WL 23700218, at 2 (Del. Ch. Dec. 31, 2003, revised July 9, 2004). The chancellor went on to say the Delaware Supreme Court appears less conscious of the imprecision of the valuation process: "The same institutional pressures that result in this disinclination [to conduct valuations] at the Chancery Court level, of course, do not apply at the appellate level and may explain why the Supreme Court exhibits more confidence in the ability to ascertain *the* fair value of an enterprise." *Id.* at 2 n.5.

[15] For related arguments, see for example, Ted Israel, *The Generous Helping of Company-Specific Risk That May Already Be Included in Your Size Premium,* Bus. Valuation Update, Vol. 17, No. 6 (June 2011).

[16] *Union Illinois,* 847 A.2d 340.

[17] *Id.* at 355 n.28.

[18] *Id.*

[19] *Onti Inc. v. Integra Bank,* 751 A.2d 904 (Del. Ch. 1999).

[20] *Id.* at 920.

[21] *Union Ill. v. Korte,* No. 17392, 2001 WL 1526303 (Del. Ch. Nov. 28, 2001).

[22] *Id.* at 9.

[23] *Gotham Partners v. Hallwood Realty Partners LP,* 855 A.2d 1059 (Del. Ch. 2003).

[24] *Id.* at 1077.

[25] *Solar Cells Inc. v. True North Partners LLC,* No. 19477, 2002 WL 749163, at 6 n.11 (Del. Ch. Apr. 25, 2002).

[26] Del. Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 339 (Del. Ch. 2006).

[27] *Gessoff v. IIC Indus.,* 902 A.2d 1130, 1158 (Del. Ch. 2006). The court in *Gessoff* then rejected the defense expert's proposed company-specific risk premium, saying it was "unmoored to any objective financial analysis the court can reasonably evaluate." *Id.* at 1159.

[28] *In re Sunbelt Beverage Corp.,* No. 16089-CC, 2010 WL 26539 (Del. Ch. Jan. 5, 2010, revised Feb. 15, 2010).

[29] *Id.* at 13.

[30] *Le Beau v. M.G. Bancorporation,* 1998 WL 44993 (Del. Ch. Jan. 29, 1998).

[31] *Id.* at 10.

[32] *Hintmann v. Fred Weber Inc.,* 1998 WL 83052 (Del. Ch. Feb. 17, 1998).

[33] *Id.* at 5.

[34] *Id.*

[35] *In re Loral Space & Commc'ns Consol. Litig.,* Nos. 2808-VCS and 3022-VCS, 2008 WL 4293781, at 30 n.151 (Del. Ch. Sept. 19, 2008).

[36] *Delaware Open MRI,* 898 A.2d 290.

[37] *Id.* at 339-40.

[38] *Id.* at 340.

[39] *Onti,* 751 A.2d 904.

[40] *Id.*

[41] *Wacht v. Continental Hosts Ltd.,* No. 7954, 1994 WL 525222, at 6 (Del. Ch. Sept. 16, 1994).

[42] *Reis*, 2011 WL 4346913, at 23. *Reis* was neither an appraisal proceeding nor a straightforward shareholder action for breach of fiduciary duties. The shareholder plaintiff had been cashed out of shares by a reverse stock split that left the plaintiff only holding a fraction of a share when there was a charter amendment prohibiting fractional shares. The shareholder sued for the "fair value" of the shares under Section 155(2) of the Delaware General Corporation Law. The court held that the determination of the fair value of the plaintiff's stock should proceed as it would in a breach-of-fiduciary-duty action. *Id.,* at 8.

[43] The undated article is titled "The Specific Company Risk Premium – A New Approach." The article may be obtained from http://www.highlandglobal.com after free registration.

[44] *See* Pratt, *supra* note 4, at 203.

[45] Peter J. Butler, & Keith A. Pinkerton, *Company Specific Risk — A Different Paradigm: A New Benchmark,* Bus. Valuation Review (Spring 2006); Butler & Pinkerton, *supra* note 4; Peter J. Butler & Keith A. Pinkerton, *Company-Specific Risk: The Dow 30 v. Private Company USA,* The Value Examiner (September/October 2007); Peter J. Butler & Keith A. Pinkerton, *Comparing the Butler-Pinkerton Model to Traditional Methods Under Four Daubert Criteria,* Deluxe BV Update (November 2007).

[46] Butler & Pinkerton, *A Different Paradigm,* at fn. 7.

[47] Aswath Damodaran, *Estimating the cost of equity for a private company, available at* http://pages.stern.nyu.edu/~adamodar/New_Home_Page/valquestions/totalbeta.htm.

[48] In the discounted cash flow analysis, a lower cost of capital translates to a higher value, all other things being equal.

[49] *See* Larry J. Kasper, The Butler Pinkerton Model for Company-Specific Risk Premium — A Critique, Bus. Valuation Review (Winter 2008); Larry J. Kasper, Anomalous Findings from the Butler Pinkerton Model for Company-Specific Risk Premiums, Presentation at ASA Advanced Business Valuation Conference (October 2009). For Butler's response to Kasper's comments, see Peter J. Butler, A Total Repudiation of Mr. Kasper's Critique of the Butler Pinkerton Model, *available at* http://www.bvmarketdata.com/pdf/BPMRebuttal.pdf.

[50] Roger J. Grabowski, *Editor's Column,* Bus. Valuation Review (Fall 2009).

[51] *Id.* at 126.

[52] *Id.*

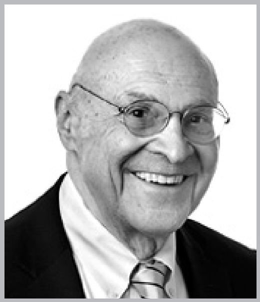
[53] *Id.*

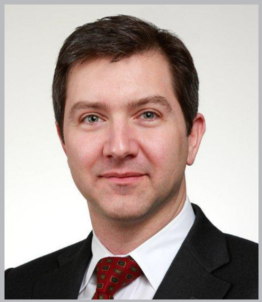
[54] For Butler's response, *see* Peter J. Butler, Letter to the Editor, Bus. Valuation Review (Spring 2010).

[55] Posting of Raymond J. Dragon to AccountingWeb US blog, http://www.accountingweb.com/blogs/dragon4/rj-bv/bvs-thrilla-manila (Mar. 29, 2010). "Thrilla in Manila" refers to the Muhammad

Ali–Joe Frazier world heavyweight boxing championship match which took place in Manila, Philippines, Oct. 1, 1975.

56 The use of the Butler-Pinkerton approach in an expert report by Butler for the defendants in an Idaho case in 2010 was challenged by the plaintiffs. Butler's approach survived the motion *in limine*. In his expert report, however, Butler did not offer his own company-specific risk premium value based on the Butler-Pinkerton model. He instead offered a qualitative conclusion that the defense expert's cost-of-equity estimate was too low. As such, the court did not have to decide whether the Butler-Pinkerton approach to quantifying company-specific risk premium was admissible testimony. *Alamar Ranch v. County of Boise,* No. 1:09-cv-00004-BLW (D. Idaho Nov. 7, 2010), Document 103, Motion in Limine to Exclude, or in the Alternative Strike, Portions of the Expert Opinions of Peter J. Butler.





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