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April 2, 2001

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Re: Stephen A. Cole v. Kenneth A. Kershaw, et. al., C.A. No. 13904
Date Submitted: November 2, 2000
Date Decided: March 30.2000

Dear Counsel:

In its post-trial Opinion dated August 15, 2000, this Court determined that the defendants had breached their fiduciary duty to the plaintiff, Stephen Cole ("Cole"), by eliminating his partnership interest in Churchtown Partners ("Churchtown"or "the Partnership") without notice and at an unfair price. The defendants accomplished that by merging Churchtown into an entity, BARKE, LLC, that was owned by all the (former) partners of Churchtown except Cole.

The merger took place on October 1, 1993.

In its Opinion the Court held that Cole would be entitled to his proportionate share (12.5%) of the Partnership's net worth on the date of the merger, "adjusted downwards to account for the incremental risk Cole inflicted upon the remaining partners by his refusal to pay the cash calls and to execute the loan refinancing documents."[1] Specifically, the Court detenmined that:

> Two further deductions [from the value of the Partnership's assets] are needed before Cole's damages can be determined: (1) the Partnership's debts and expenses as of October [1] 1993, and (2) an amount attributable to Cole's failure to meet cash calls and to' sign the loan refinancing documents. Because the record is not sufficiently developed or clear as to what the Partnership's debts and expenses were [as] of October 1993, I request that the parties submit to the Court supplemental memoranda addressing this point. The memoranda shall also address the appropriate rate of interest that should be added to the amount of Cole's unpaid cash calls.
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> Moreover, a further separate adjustment must be made to the damages award to account for Cole's failure to meet the cash calls between 199 1 and October 1993, and for the risks and expenses of

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[1] *Cole v. Kershaw*, Del. Ch., C.A. 13904, Jacobs, V.C., Mem. Op. at 25 (Aug. 15, 2000) ("Opinion").

> the Partnership being borne entirely by the other partners. Without an adjustment to reflect that fact, Cole would receive a larger *pro rata* share of the value of Churchtown's assets than what (in my view) would be fair.[2]

Finally, the Court determined that:

> [T]he most appropriate way to adjust for the risk and expense Cole should have (but did not) assume between 1991 and October 1993 is to require him to pay the principal amount he owes--approximately $62,370--plus interest at a rate that would reflect the rate of return an investor willing to buy into Cole's highly speculative position in the Partnership in 1991 would likely have demanded. This approach has the virtue of requiring Cole to account for both his fair share of the Partnership expenses, and for the risks he shirked. The parties' supplemental submissions should include argument as to what interest rate is most appropriate to accomplish this purpose.[3]

Thereafter, the parties submitted supplemental memoranda, in which both sides agreed that the value of Cole's 12.5% interest in the Partnership as of the October 1, 1993 merger date was $118,666.50, before any adjustments. The dispute concerned the amount of the adjustments. Specifically, the parties dispute

[2]Opinion, at 31-32.

[3]*Id.* at 34.

(1) the appropriate interest rate that should be applied to the $62,370 of unpaid cash calls, and (2) the amount of the interest rate adjustment to reflect the incremental risk that Cole, by not paying the cash calls or signing the loan refinancing documents, inflicted upon his (now former) partners (the defendants). This Opinion resolves those two remaining disputes.

I. COLE'S DAMAGE AWARD

In its August, 15, 2000 Opinion, the Court intended that the (now undisputed) $188,666.50 value of Cole's partnership interest would be adjusted to reflect two separate items: (a) interest to compensate the rernaining partners of the loss of the $62,370 of cash calls that Cole failed to contribute, and (2) a separate discount (calculated as an additional interest rate) to reflect the incremental risk inflicted upon the defendants by Cole's failure to abide by his partnership obligations. The net figure would be the amount of Cole's damage award, to which prejudgment interest would then be added.

A. Compensation for Lost Use of $62,370

The first issue is what interest rate would appropriately compensate the Partnership (and the remaining partners) for their lost use of the $62,370 of cash

calls that Cole: failed to make. The answer to that question is relatively straightforward. Section 13 of the Churchtown Partnership Agreement provided that if any partner loans money to the Partnership, the Partnership shall pay interest not exceeding one percent (1%) over the prime rate charged by Wilmington Trust Company. All parties agree that (i) the relevant Wilmington Trust prime rate was 6%, (ii) the appropriate maximum rate under Section 13 would be 7%, and (iii) 7% would be an acceptable interest rate for that purpose. The defendants also urge that 8% is an appropriate interest rate. Because Cole's default amounted *de facto* to a $62,370 loan by the remaining partners to the Partnership, I conclude that the appropriate interest rate chargeable to Cole on that amount is 7%.

B. Discount For The Incremental Risk Imposed Upon Remaining Partners

The remaining dispute concerns the appropriate amount of the second adjustment to Cole's damage award (a discount, expressed as an interest rate) to reflect the "risks that Cole shirked."[4] That issue is hotly contested. The plaintiffs

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[4]Opinion, at 34. The interest rate (discount) for this purpose was to "reflect the rate of return an investor willing to buy into Cole's highly speculative position in the Partnership in 199 1 would likely have demanded." *Id.*

contend that the amount of that discount should be 20%; the defendants argue that the discount should be no less than 40%, and that a more realistic discount should be somewhere between 70% to 90%, given the highly risky circumstances the Partnership was facing in 199 1.

Initially I reject the defendants' 70 % to 90% discount levels as unreliable and far too high. They are unfairly high because they would result in Cole receiving no ($0) damage award. There is no basis in the record to suppose that a 12.5% interest in the Partnership was worth nothing, or that the Churchtown partners would. permit an outside investor to purchase a 12.5% partnership interest for free. Cole's initial investment in 199 1 was approximately $84,500, and by October 1993 his Partnership share was worth about $119,000.

Moreover, the defendants' discount levels are unreliable, because they were derived from market data based on relatively few active buyers, and because the discounts were based on liquidation values, not going concern values. I also reject the defendants' proposed 40% discount rate. The defendants, who have the burden, have not attempted to show in any persuasive way that an investor willing to buy into Cole's Partnership position would demand a 40% discount to reflect

the risks that Cole shirked. On this record, both discounts are equally plausible, Because the purpose of this exercise is to require Cole "to account for the risks . . . he shirked," and because the defendants have not shown that their 40% discount rate is more compelled by the evidence than Cole's proposed 20% rate, I adopt Cole's 20% discount rate as the measure of the second adjustment to his damage award.

These two adjustments are to be made as follows: The amount of unpaid cash calls ($62,370) shall be increased by 7%, and the increased amount ($66,736)' shall be deducted from $118,667 (the value of Cole's Partnership interest as of October 1, 1993), to arrive at an adjusted value of Cole's Partnership interest, of $5 1,93 1. That adjusted figure shall then be reduced by the second (20%) downward adjustment, which brings the amount of Cole's damage award to $41,545, net of prejudgment interest.[6] The $41,545 represents the amount that for remedial purposes Cole should have received on the merger date. Because no amount was ever paid to Cole for the expropriation of his 12.5% interest in the

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'$62,370 x 1.0'7 = $66,736. Both sides agree that interesi will accrue on the $62,370 amount for a period of only one year.

[6]$51,931 x .8 = $41,545.

Partnership, he is entitled to pre-judgment interest in addition to the $41,545 net damage award. What follows is the Court's determination of pre-judgment interest.

II. PRE-JUDGMENT INTEREST

While the legal rate of interest has historically been the benchmark for pre-judgment interest, the legal rate is a mere guide, not an inflexible rule. A court of equity "has broad discretion, subject to principles of fairness, in fixing the rate to be applied.[7] The problem here is what pre-judgment interest rate is appropriate, given the relative equities presented by the case and the seven years and four month[8] time period during which pre-judgment interest is payable. During that time, the Federal Discount Rates have of course fluctuated.

As a starting point, I have averaged the sum of the Discount Rates for each year of this period, and where the record discloses that the Discount Rate varied within a given year, I selected the highest rate reached during that year. In this manner I arrived at an average legal rate for the period of 10.1%, as follows:

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[7]*Summa Corp. v. Trans World Airlines, Inc.,* Del. Supr., 540 A.2d 403, 409 (1988); by statute, the legal rate is five percent over the Federal Discount Rate. 6 Del. C. § 2301.

'That period begins on October 1, 1993 (the date of the merger) and ends on February 29, 2001 (the approximate date of this Opinion), representing a time span of '7 1/3 years.

Year	Federal Discount Rate[9]	Legal Interest Rate
1993 (2 mo)	3.0 %	8.0%
1994	4.75%	9.75%
1995	5.25%	10.25%
1996	5.0%	10%
1997	5.0%	10%
1998	5.0%	10%
1999	5.0%	10%
2000	6.0%	11%
2001 (2 mo)[10]	5.5%	10.5%
Average:	5.1%	10.1%

If pre-judgment interest were calculated at the 10.1% average legal rate, Cole's damage award would be $72,316.[11] In my view and in these circumstances, that result is inequitable to Cole. The $72,316 amount is $12,184 less than Cole's initial investment in the Partnership. No basis in equity or fairness has been shown for allowing Cole's former partners, who captured for themselves <u>all</u> the post-October 1993 appreciation in the Partnership's assets, to

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[9]The Federal Discount Rates are found at Exhibit B to Plaintiffs Supplemental Opening Post-trial Memorandum dated October 3, 2000.

[10]Although the record does not disclose the Federal Discount Rate for the first two months of 2001, updates are disclosed by the plaintiffs data source, H.15 Release of the Federal Reserve Board of Governors, available online at www.federalreserve.gov/releases/H15/data.htm.

[11]$41,545 x 10.1% x 7.33 = $30,771 (prejudgment interest)
+ 41,545 (principal amount of damages)
Total $ 72,316.

appropriate a significant portion of Cole's initial capital investment as well. In this case, Cole's former partners will already have been compensated (as a result of the two adjustments) for their loss of use of Cole's cash calls and for the additional risk inflicted by Cole's derelictions of duty. Moreover, there is no showing that Cole's former partners lost any of their principal investment. On the contrary, as a result of the merger they received assets representing in value (i) their original -investment, plus (ii) Cole's original investment,[12] plus all of the potential post-October 1993 appreciation on the entire original investment (including Cole's). Why, then, should Cole be required to forfeit a portion of his original investment?

In these circumstances, minimal fairness requires that Cole recover at least his original investment, even if he (unlike his partners) will enjoy no return on that investment. That result is achieved by awarding pre-judgment interest at a rate higher than the average legal rate for the period in question. The interest rate that best approximates that result is 14.5%, which yields a damage award to Cole of

‘*Except for $2,000 which Cole was never paid.

$85,721.[13]

III. CONCLIJSION

For the foregoing reasons, Cole is entitled to a money judgment in the amount of $85,721, with costs of this action to be borne by the defendants. Counsel shall submit an appropriate form of Final Order and Judgment implementing the determinations in this Opinion and the Opinion dated August 15, 2000.

Very truly yours,

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cc: Register in Chancery

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[13]$41,545 x .145 x 7.33 = $44,176 (pre-judgment interest)
+ 4 1.545 (principal amount of damages)
Total $85,721.