COURT OF CHANCERY
OF THE
STATE OF DELAWARE

J. TRAVIS LASTER
VICE CHANCELLOR

New Castle County Courthouse
500 N. King Street, Suite 11400
Wilmington, Delaware 19801-3734

Date Submitted: August 27, 2012
Date Decided: August 30, 2012

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RE: *IQ Holdings, Inc. v. Am. Commercial Lines Inc.*, Case No. 6369-VCL

Dear Counsel:

On April 12, 2011, IQ Holdings, Inc. ("IQ Holdings") filed a petition seeking appraisal of its shares in American Commercial Lines Inc. ("American"). The parties have engaged financial experts. IQ Holdings retained David N. Fuller, and American retained Melissa Kibler Knoll. Believing that IQ Holdings improperly revised and supplemented its expert report after the discovery cutoff, American has moved to strike the revised portions and to preclude Fuller from testifying about them.

FACTUAL BACKGROUND

Pursuant to a stipulated scheduling order, expert reports were to be exchanged by February 17, 2012 and rebuttal reports by March 30. On January 27, the parties agreed to revise the schedule so that expert reports would be exchanged on March 2 and rebuttal reports on April 13, which they were.

Pursuant to a revised stipulated scheduling order dated May 3, 2012 (the "Revised Scheduling Order"), all expert discovery was to be completed by May 18. The Revised Scheduling Order stated that the "appraisal action shall proceed on the following schedule, unless modified by agreement of the parties or further Court order[.]"

On May 15, 2012, less than two days before Fuller's deposition, IQ Holdings provided American's counsel with a revised copy of Fuller's report. American's counsel objected but went forward with Fuller's deposition as scheduled.

To resolve American's objection, the parties agreed in a series of emails to modify the schedule for expert discovery. American made the following proposal:

> (1) Ms. Knoll will update her rebuttal report by July 6th.
> (2) You represent that Mr. Fuller is currently unaware of any changes to his opinions, calculations, and methodologies disclosed in his reports, rebuttal report or deposition testimony and plans to stand on the substance of his current reports and testimony, which he believes are accurate based on facts known to him at this time.
> (3) You represent that Mr. Fuller does not intend to further update his reports and/or testimony based on facts known to him at this time.
> (4) Both sides agree to supplement their reports if required by the Court of Chancery Rules.

Mot. Strike Ex. D at 1. IQ Holdings accepted with the following caveat:

> As a reminder, David Fuller noted two items in his deposition that he might adjust, although neither would be a material change. They are (a) fine tuning on the debt adjustment and (b) taking ACLI out of the data set for the control premium.

Id.

On August 3, 2012, IQ Holdings provided American's counsel with an updated version of Fuller's report containing revisions that American believes went beyond what the parties contemplated. In arguing its motion, American also has cited changes that IQ Holdings made in the May 15 revision. Because the parties agreed to permit that revision, I do not address those changes.

LEGAL ANALYSIS

The Delaware Supreme Court "has long recognized that the purpose[s] of discovery [are] to advance issue formulation, to assist in fact revelation, and to reduce the element of surprise at trial." *Levy v. Stern*, 687 A.2d 573, 1996 WL 742818, at *2 (Del. Dec. 20, 1996) (ORDER). These purposes serve the "well established policy of pretrial disclosure which is based on a rationale that a trial decision should result from a disinterested search for truth from all the available evidence rather than tactical maneuvers based on the calculated manipulation of evidence and its production." *Hoey v. Hawkins*, 332 A.2d 403, 405 (Del. 1975) (internal quotation marks omitted). "The underlying purpose of discovery in general is to reduce the element of surprise at trial by

advancing the time at which disclosure can be ordered from the trial date to a date preceding that date." *Empire Box Corp. v. Ill. Cereal Mills*, 90 A.2d 672, 678 (Del. Super. 1952).

Scheduling orders and discovery cutoffs further these important purposes and policies by ensuring that parties provide discovery in a timely fashion, thereby avoiding trial by surprise and the prejudice that results from belated disclosure. "[P]arties must be mindful that scheduling orders are not merely guidelines but have the same full force and effect as any other court order." *Ams. Mining Corp. v. Theriault*, — A.3d —, —, 2012 WL 3642345, at *21 (Del. Aug. 27, 2012) (internal quotation marks omitted); *accord Sammons v. Doctors for Emergency Servs.*, 913 A.2d 519, 528 (Del. 2006). "Generally speaking, Delaware courts strictly adhere to discovery cut-off dates." *Orloff v. Shulman*, C.A. No. 852, at 1 (Del. Ch. Apr. 10, 2007) (citing *E.I. du Pont de Nemours & Co. v. Admiral Ins. Co.*, 1994 WL 682420, at *3 (Del Super. Nov. 17, 1994)). Late production provides grounds for excluding the evidence. *Concord Towers, Inc. v. Long*, 348 A.2d 325, 326 (Del. 1975) (finding it was error not to exclude a late-produced document). In deciding whether to exclude evidence, "the Trial Court must balance its duty to admit all relevant and material evidence with its duty to enforce standards of fairness and the Rules of Court." *Id.* at 326. These principles apply fully to expert reports. *See Coleman v. PriceWaterhouseCoopers LLC*, 902 A.2d 1102, 1106 (Del. 2006) (affirming exclusion of late-produced supplemental expert report under the *Concord Towers* test).

For an expert to create a new analysis or materially change his opinions after the expert discovery cutoff risks trial by surprise and deprives the opposing party of an orderly process in which to confront and respond to the expert's views. Equally important, a new or materially changed analysis imposes burdens on the Court, which must attempt to evaluate the expert's opinions without the full benefits of adversarial testing. In contrast to new analyses and material changes, concessions and efforts to eliminate disagreement are helpful and encouraged, and providing an updated report reflecting the concessions or agreements assists the Court in understanding the changes. Because an expert always could concede a point on the witness stand, it should rarely be prejudicial for an expert to provide a revised report before trial showing the implications of a concession.

The benefits of concessions and agreements have particular salience in an appraisal, where the sole issue in dispute is the fair value of the petitioner's shares. *See Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1186 (Del. 1988). Fair value typically turns on expert testimony, but relying "on the 'expert input' of finance professionals paid to achieve diametrically opposite objectives tends, regrettably, to surface minor, granular issues." *Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at *2 (Del. Ch. Aug. 19, 2005). "[Disagreement] about virtually everything . . . [is] a circumstance that

complicates" the effort to compare the results of the competing expert opinions. *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 907 (Del. Ch. 1999).

When experts can agree on a valuation methodology or its parameters, it eases the burden on the Court, and it often enhances the witnesses' credibility. *See Finkelstein v. Liberty Digital, Inc.*, 2005 WL 1074364, at *1 (Del. Ch. Apr. 25, 2005) (finding the parties' agreement on the valuation of all but one of the assets "refreshing"). The Court frequently will adopt the methodologies or inputs on which the parties agree. *See Andaloro*, 2005 WL 2045640, at *10 (agreeing with the parties that "the DCF method should be given heavy weight" and using that approach); *Lane v. Cancer Treatment Ctrs. of Am., Inc.*, 2004 WL 1752847, at *36 (Del. Ch. July 30, 2004) (noting the parties' general agreement "on the appropriate borrowing rate" and choosing the slightly more specific one); *Grimes v. Vitalink Commc'ns Corp.*, 1997 WL 538676, at *1 (Del. Ch. Aug. 28, 1997) (finding "no reason to conclude" that many of the valuation assumptions were not accurate given the parties' agreement).

Under these principles, absent good cause, IQ Holdings could not supplement Fuller's analysis to introduce new analyses or make material changes after the discovery cutoff of May 18, 2012, except to the extent the parties agreed. *See Coleman*, 902 A.2d at 1107. In their email exchange, the parties confirmed that Fuller would not further update his report in their July 6 email agreement. The only caveats were "(a) fine tuning on the debt adjustment and (b) taking ACLI out of the data set for the control premium." IQ Holdings could, however, update Fuller's analysis to show the effects of concessions or agreements.

In his updated report, Fuller excluded ACLI from his control premium data set. This change was permissible, both because IQ Holdings flagged it, and because it conceded a point made by American. *See* Fuller Dep. at 202-04. Fuller appropriately updated his control premium calculation to show the effect of the concession.

Fuller also changed his debt calculation. One debate in valuing the subject corporation is how to calculate its debt given the outstanding accrued interest and make-whole premium. During his deposition, Fuller suggested that it might be appropriate to change his accrued interest calculation in light of points made by Knoll, American's expert. Fuller Dep. at 71-73. Construed in Fuller's favor, his testimony also implied a desire to clarify his treatment of the make-whole premium. *Id.* at 130-32. Fuller's updated report revised both the accrued interest calculation and his treatment of the make-whole premium. Like the exclusion of ACLI from the control premium set, these changes were permissible because IQ Holdings flagged them and because they conceded points to American. Fuller appropriately revised his report to show their effects.

But Fuller went further and changed the discount rate that he used in his debt calculation by substituting the subject company's weighted average cost of capital. *See* Reply Ex. G at A.7. This change increased the discount rate, lowered the present value of the debt, and increased the indicated value of the subject company. It was not a concession, a change discussed in deposition, or an update flagged by counsel. The discount rate was an input that Fuller necessarily considered and formed a view about when preparing his original report. He then changed his view after the expert discovery cutoff to adopt a materially different figure. To allow this change would necessitate further rounds of expert discovery, including additional depositions, so that American could explore the reasons for and respond to the change. IQ Holdings has not meaningfully suggested why Fuller had good cause to make the change, or why American should be forced to incur the time and expense of a discovery redo. Fuller therefore will not be permitted to rely on the weighted average cost of capital to discount the company's debt; he must stand on his earlier and lower figure.

Most significantly, Fuller decided in his updated report to give weight to a discounted cash flow analysis when calculating fair value in which he normalized the cash flows for his terminal value calculation. In his earlier report, Fuller presented this analysis as an alternative calculation, did not rely on it, and provided the normalized approach only for "illustrative purposes." Fuller Dep. at 80. By changing tack and giving weight to the normalized analysis, Fuller adopted a new valuation methodology after the discovery cutoff. IQ Holdings is not entitled to make such a change absent good cause. *See Coleman*, 902 A.2d at 1107.

In an effort to establish good cause for this change, IQ Holdings points to *In re Orchard Enterprises, Inc.*, 2012 WL 2923305 (Del. Ch. July 18, 2012). According to IQ Holdings, *Orchard* established a Court of Chancery valuation preference, bordering on a bright-line rule, that terminal value calculations should be premised on normalized cash flows. Because Fuller's earlier analysis did not normalize cash flows, IQ Holdings says *Orchard* obligated Fuller to revise his calculation. *See* Opp'n ¶¶ 8,9.

Orchard did no such thing. Chancellor Strine recognized in *Orchard* that "typically" normalization of capital expenditures and depreciation in the terminal value calculation is appropriate. 2012 WL 2923305 at *15. And it is for many (likely most) mature companies. Early stage ventures and capital-intensive businesses, however, can endure extended periods, longer than the traditional five-year discounted cash flow projection period, during which capital expenditures outpace depreciation. For such a company, rote normalization after five years would be inappropriate, and *Orchard* does not require normalization when the operative reality of the company calls for a different approach.

The concept of normalizing terminal value cash flows is not novel, and Fuller doubtlessly considered it when deciding how best to determine the fair value of the subject company. IQ Holdings cannot rely on *Orchard* to justify a new analysis after the discovery cutoff. It would be unduly prejudicial to require American to confront the new analysis now, after the completion of expert discovery, with trial just over one month away. Fuller's alternative discounted cash flow analysis is therefore excluded, and he is precluded from testifying about it. Fuller instead must rely on the discounted cash flow analysis that he previously prepared.

Within five days, IQ Holdings shall serve a revised expert report showing how returning to the former discount rate and discounted cash flow analysis changes Fuller's valuation. **IT IS SO ORDERED.**

Very truly yours,

/s/ J. Travis Laster

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Vice Chancellor