IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

MICHAEL F. TAYLOR,	)	
	)	
Petitioner,	)	
	)	
v.	)	C.A. No. 19239
	)	
AMERICAN SPECIALTY RETAILING GROUP, INC., a Delaware corporation,	)	
	)	
Respondent.	)	

MEMORANDUM OPINION

Submitted: May 16, 2003
Decided: July 25, 2003

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M. Duncan Grant, Esquire, Joseph S. Naylor, Esquire, PEPPER HAMILTON LLP, Wilmington, Delaware, *Attorneys fur Respondent.*

LAMB, Vice Chancellor.

I.

This is an appraisal action, pursuant to 8 ***Del. C.*** *§ 262, filed as a result of a merger that cashed-out the petitioner's shares and shares of one other stockholder, at a price of $2,200 per share. Both parties presented expert testimony regarding the fair value of the shares held by the petitioner as of the merger date. Neither expert was fully persuasive, and, accordingly, the court must exercise its own independent judgment as to the value of the petitioner's shares. After considering the totality of the evidence presented, the court concludes that the fair value of the petitioner's shares, as of the effective date of the merger, was* $9,079.43 *per share or a total of $181588.60.*

II.

A. *Background*

Respondent American Specialty Retailing Group, Inc. and its subsidiary, Dunham's Athleisure Corporation, both Delaware corporations (collectively "Dunham's"), operate a retail sporting goods chain, with 116 stores in 12 states. Dunham's is in the top ten in sales for sporting goods retailers in the United States. As of October 15, 2001, Dunham's had 3,000 shares of Class A common stock outstanding.

The petitioner, Michael Taylor, is a former employee of Dunham's He purchased 20 shares of Dunham's Class A common stock during his employment. His entitlement to appraisal arises out of an October 15, **2001** *merger (the "Merger Date") that eliminated his interest in Dunham's. The parties stipulated that Taylor timely filed his Petition for Appraisal, and has timely perfected his rights to appraisal. It is also stipulated that Taylor is entitled to the payment of fair value for his shares pursuant to 8* ***Del. C. § 262.***

B. The Experts

Taylor's trial expert was Andrew P. Wilkinson, a principal at the Lefko Group. Wilkinson has worked as a financial analyst, with an emphasis on business valuations, at the Lefko Group since 1988. He earned an M.B.A. in finance from the University of Michigan, and has taught advanced business valuation classes to a master's degree program at Walsh College. in Troy, Michigan. Wilkinson is also a chartered financial analyst and an accredited senior appraiser in business valuation through the American Society of Appraisers. He is a member of various professional societies and organizations, and has testified in approximately 20 to 25 trials as an expert witness.

Wilkinson testified that his company was initially retained by Taylor to do a planning or feasibility analysis involving a rough estimate of Dunham's value as of January 2001. His company was thereafter asked to prepare a complete

valuation of Dunham's as of the Merger Date. Wilkinson testified that, in order to prepare his October 15, 2001 valuation, he reviewed information provided by Dunham's and also conducted independent research.'[1] He concluded that Dunham's had a total equity value of $44 million as of the Merger Date.

Dunham's expert witness was Michael Kern, a managing director at Stout Risius Ross. Stout Risius Ross has employed Kern for the past seven years, and during the course of that period, Kern has been involved with over 550 business valuations. His main area of specialty relates to valuations for companies with annual revenues in the range of $25 million to $1 billion, primarily in the pet supplies industry, clothing industry and the grocery industry. Before he appeared in this action, he has testified only twice, either in court or in arbitration proceedings.

Kern testified that he originally valued Dunham's as of January 3 1, 2001, and at that time he concluded that Dunham's total equity value as of January 31, 2001 was $6.6 million. Kern later updated his valuation as of the Merger Date and testified at trial that Dunham's equity value had not increased since his

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[1] *Wilkinson reviewed, among other things, Dunham's financial statements, tax returns, fixed asset listings, lease summaries, monthly financial income statements, departmental sales data, publicly available documents such as SEC filings, web pages for different companies, industry association data, and general information on the retail sporting goods industry.*

January 31, 2001 valuation, so that, as of the Merger Date, Dunham's total equity value continued to be no greater than $6.6 million.

C. The Valuation Methods Used

The experts for the parties used essentially the same valuation methods to value Dunham's stock. Both experts utilized: (1) the discounted cash flow approach ("DCF"); (2) the comparable/guideline companies approach; and (3) the transaction based approach. Both experts used essentially the same "comparable companies" in their analyses, and both used the same "transaction" in applying the transaction-based approach.[2]

Wilkinson valued Dunham's as of the Merger Date at $44 million or $14,666.67 *per share, and the value of the 20 shares held by Taylor at $293,333. Kern valued Dunham's as of the Merger Date at $6.6 million, or $2,200 per share, and the value of the 20 shares held by Taylor at $44,000.*

III.

Under 8 ***Del. C.*** *§ 262, Taylor is entitled to his* **pro rata** *share of the fair value of Dunham's common stock as of the Merger* Date.[3] *Moreover, Section*

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[2] *Dunham's expert also analyzed a second "transaction" involving its own stock that Taylor's expert did not. For the reasons discussed in Section IV(C)(l)* ***infra*, this** *second "transaction" does little to establish the value of Taylor's shares.*

[3] ***Gray v. Cytokine Pharmasciences, Inc.,*** *2002 WL 853549, at* *6 *(Del. Ch. Apr. 25,* ***2002).***

262(h) requires this court to calculate the going concern value "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."[4] *"In a statutory appraisal proceeding, both sides have the burden of proving their respective valuation positions by a preponderance of the evidence."*[5] *If neither party satisfies its burden, however, the court must then use its own independent judgment to determine fair value?*

IV.

As an initial matter, neither expert has fully satisfied its burden of persuasion regarding its respective valuation of Dunham's, though Wilkinson's valuation is more credible. Both experts make certain meritorious observations and assumptions, while other observations and assumptions lack relevance or credibility. Significantly, Kern's valuation lacks credibility because, although he was retained by Dunham's, he ignored a contemporaneous set of projections prepared by Dunham's management, choosing instead to rely on far more pessimistic assumptions of Dunham's future prospects that he prepared on his

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[4] *8* ***Del. C.*** *§ 262(h).*

[5] ***M. G. Bancorporation, Inc. v. LeBeau,*** *737* A.2d *513, 520 (Del. 1999) (citation omitted).*

[6] **See Gonsalves v. Straight Arrow Publishers,** *701* A.2d *357, 361 (Del. 1997) (noting this court's responsibility to "independently determine the value of the shares that are the subject of the appraisal action");* **Cooper v. Pabst Brewing Co.,** *1993 WL 208763, at* *8 *(Del. Ch. June 8, 1993) (noting that in cases where "none of the parties* establish[] *a value that is persuasive, the Court must make a determination based upon its own analysis").*

own. Moreover, the court is persuaded that Kern's valuation conclusion is strikingly low. For example, Kern's total equity value of $6.6 million is lower than Dunham's trailing 12-month pre-tax income, and only approximately 65 % of its trailing 12-month operating income.[7] *Thus, using Wilkinson's valuation as a baseline, the court will analyze each of the three valuation methods utilized by both experts and come to its own independent judgment for proper valuation of Dunham's.*

A. <u>The Discounted Cash Flow Approach</u>

The court begins its DCF analysis by accepting the basic framework of Wilkinson's model and then considering objections to that analysis that have been lodged by Dunham's. Wilkinson explained that a DCF analysis involves projecting operating cash flows for an extended period, determining a terminal value upon sale at the end of the period, and then discounting those values at a set rate to determine the net present value for 100% of Dunham's common stock. Dunham's does not object to this theoretical framework for valuation.

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[7] *The court understands that these comparisons are, in some sense, "apples to oranges." For example, were Dunham's faced with a mounting debt load (which it was not) or with decreasing growth prospects (which it was not) then such a valuation may in fact be reasonable. Nonetheless in the absence of any convincing explanation (and none was given by Kern), these comparisons are strongly suggestive of a gross undervaluation by Kern. In this connection, the court notes that Marshall Sosne, Dunham's Chief Financial Officer (who is himself a stockholder of the surviving entity) refused to endorse Kern's valuation. Trial Tr. at 167-68.*

1. Projected Revenue Growth

Dunham's first objection to Wilkinson's valuation relates to his projected revenue growth for the company, which Dunham's argues places too much emphasis on its atypical success during the winter of 2000. Kern and Marshal Sosne, Dunham's Chief Financial Officer, testified about the allegedly unusual winter of 2000 and how it led to increased sales that should be treated as a one-time occurrence rather than a sign of increasing long-term sales growth potential. This is so, the argument goes, because of the combination of an extremely cold winter and tremendous sales of scooters, which were peaking in popularity in the Midwest at the time. Those circumstances led directly to abnormally high sales figures for both scooters and all winter-related items, including skis and accessories, boots, and brand name outerwear.

When Wilkinson prepared his projections, he did discount the winter 2000 sales. He just did not discount them as much as Dunham's would have liked. Wilkinson explained that in making the appropriate revenue projections, one examines the company's history, its position within the industry, prospects for the industry and the economy in general, and how the company has grown compared to past expectations. Wilkinson projected results for the four-*month period ended January 3 1, 2002. He also projected revenues through January 3 1, 2005*. *Wilkinson projected revenues for the fiscal year ended*

January 3 1, 2005 to be $249,000,103 *based on an assumed revenue growth rate of 3.5 % for fiscal years 2003, 2004, and 2005 .*[8] *Finally he determined that the terminal value sales growth rate should be 3 % . In contrast, sales for November and December 2000 grew by 15 % compared to the same period in 1999.*

Kern's DCF analysis instead projected 2.5 % revenue growth for fiscal 2002 and 2% growth thereafter. Kern's projections in this regard are highly suspect for a variety of reasons. First, Kern stated that he considered the overall industry growth rate of 1% to 2%, *but conceded this growth rate included not only large chain stores (like Dunham's), but also one-store mom-and-pop sporting good retailers, and that larger retailers like Dunham's were growing at substantially higher rates than smaller* ones.[9]

Second, Kern characterizes sales in November and December 2000 as a one-time event, and argues that it was unreasonable for Wilkinson to make revenue projections based on the assumption that such factors would persist. This is so, the argument goes, because the Midwest experienced an unusually

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[8] *Dunham's fiscal years end on January 3 1. For example, fiscal year 2002 covers the period from February* 1, 2001 *through January 3* 1, 2002.

[9] *Dunham's continually portrays itself as a minor player in the retail sporting goods industry, maintaining that it operates "small sporting goods stores" in "small- to medium-sized markets" to avoid competing with "big box national stores." Resp. Br. at 3.* In *reality, Dunham's is in the top ten in sales for retail sporting goods chains in the United States with 116 stores in 12 states, with many in larger markets. Trial Tr. at 48.*

cold winter, which led to higher than expected sales of skis and related equipment and apparel. To buttress this argument, Dunham's claims that, during the period between the Christmas season of 2000 and the Merger Date, it "returned to its historical pattern of growth, " thereby "undercutting Mr. Wilkinson's theory that fiscal year 2001, [was] a benchmark."[10] This is an incorrect assertion, however. For example, Dunham's average monthly revenues grew at 5% for the eight-month period from February 2001 through September 2001." In addition, there has been no evidence provided, scientific or otherwise, that demonstrates the conditions the Midwest experienced during winter 2000 will not repeat itself. Moreover, all of the other major companies in the retail sporting goods industry, including southern climate-based entities, experienced growth during this period and were experiencing substantial growth into 2002 as well.[12]

Finally, and most significantly, Kern's revenue growth rate analysis is suspect because he neglected to consider Dunham's management's own financial projections, which called for 9.7 % annual revenue growth through 2007.[13] These projections were provided to Fleet Capital, Dunham's lender, for the purpose of

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[10] Resp. Br. at 19.
[11] Pet. Trial Ex. 1, Sch. B-4.
[12] See Pet. Trial Ex. 1, Sch. G-l.
[13] Pet. Trial Ex. 7.

extending a credit facility for an additional five years and increasing the line available from $42 million to $55 million. These projections were, according to Sosne, formulated in October 2001, the very month of the merger. Sosne testified they were prepared with the full authority and approval of management and were submitted in good faith. Considering management's own projections regarding revenue growth, Wilkinson's 3.5% growth'rate for revenue is far more reasonable than Kern's 2 % growth rate.

2. *Estimates Of Operating Income As A Percentage Of Revenue*

Dunham's second objection to Wilkinson's valuation is that Wilkinson allegedly erred in his estimates of Dunham's operating income as a percentage of its revenue ("Operating Margins"). Wilkinson's valuation assumes that Dunham's Operating Margins would likely range from 4.3 % to 5.1% in the years following the Merger Date. This estimate, according to Kern, is erroneously high because it ignores the fact that on a historical basis Dunham's Operating Margins had never been higher than 2.6 % until fiscal year 2001, and that even in that year its Operating Margin was only 3.2%. Although this argument has some merit, Kern's projections in this regard are flawed as well.

Kern would have this court believe that in the face of continuously increasing Operating Margins from 1998 through 2001, Dunham's was somehow headed for a major reversal of fortune and would only experience Operating

Margins of 3.2 % for 2002 and eventually decline to 2.1% in 2006 and beyond. [14] *There is no evidence to indicate that such a decrease in Operating Margins is looming: Rather, the evidence tends to show that Operating Margins were improving with time, albeit at a slower pace than Wilkinson projected. The court* finds *that management's own projections in this regard are the most persuasive. The projections that Dunham's provided to Fleet Capital the same month the merger occurred demonstrate that management believed that Operating Margins were improving over time. Management projected Operating Margins as 3* .4% *for 2002, 3.3% for 2003, 3.4% for 2004, 3.6% for 2005, and 3.8% for 2006 and 2007.* [15] *These projections appear both reasonable and in line with the upward trend for Dunham's Operating Margins, and, as such, the court will rely upon them.*

3. *Adjustments To Account For Working Capital And Impending Capital Expenditures*

Dunham's third objection to Wilkinson's DCF analysis relates to supposedly impending capital expenditures that were necessary and known at the time of his valuation. In particular, Dunham's first complains that Wilkinson failed to reduce his DCF analysis to account for its impending $4 million

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[14] *See Resp. Trial Ex. 21, Ex. E.*
[15] *Pet. Trial Ex. 7.*

purchase of new cash registers for its stores. Dunham's then complains that Wilkinson failed to make an adjustment for increased working capital requirements, which it would need in order to grow revenues in the future. There are easy answers to both these complaints.

First, there was simply no reliable evidence establishing the need for, and imminence of, a $4 million expenditure for new cash registers at Dunham's stores. Kern testified his consideration of this anticipated expenditure was a significant difference between his DCF analysis and Wilkinson's Kern, however, failed to independently verify how much this alleged expenditure would cost or whether it was even necessary. He also testified that he was not provided any written documentation relative to this alleged anticipated expenditure. Instead he simply accepted management's word at face value about such an expenditure. For these reasons, the court is persuaded that Wilkinson's decision not to account for a $4 million capital expenditure for cash register purchases was appropriate.

Second, Wilkinson did account for additional working capital and capital expenditure requirements. This was accomplished by assuming that those needs would be fmanced. Given that Dunham's has plenty of borrowing power, Wilkinson's interest expense provision in his projection included an interest

provision to handle an additional $10 million in capital expenditures and working capital provisions.

4. *Size-Risk Premium*

One of the requirements for a DCF analysis is to select the appropriate discount and capitalization rates based on market risk. The capitalization rate is used to determine the terminal value for a company. The discount rate is used to reduce values from future years to present value. As a practical matter, the lower the capitalization and discount rates, the higher the terminal value and present value will be.

One of the key elements in calculating capitalization and discount rates is a modifier that takes into account the risk associated with the company based on its size. This modifier is typically referred to as a "Size-Risk Premium." At trial, both experts testified that they selected their Size-Risk Premium based on charts from Ibbotson Associates' 2001 yearbook. Ibbotson Associates is a well-*recognized organization that provides, among other things, data for valuation premiums that should be applied to various companies.*

The first part of the chart at issue breaks companies down into sequential deciles *1 through 10, with 1 representing companies with the largest market capitalization and 10 the smallest, and then provides the relevant Size-Risk*

Premium for each size? Ibbotson then divides decile 10 into two halves, with the first half (decile 10a) *applicable to the larger companies within decile* 10 *and the second half (decile* 10b) *the smaller* ones.[17] *The Ibbotson Associates yearbook explains that the largest company within decile* 10b *is Vlasic Foods International, which has a market capitalization of approximately $48.3 million. Unfortunately, the Ibbotson Associates yearbook does not provide what is the market capitalization of the smallest company in decile* 10a.[18] *This first portion of the chart states, in relevant part, that the Size-Risk Premiums for companies in deciles 9,* 10a, *and* 10b *are* 1.74%, 2.78%, *and 8.42% respectively."*

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[16] *See Resp. Trial Ex. 22, Tab 4.*

[17] ***See id.***

[18] *Dunham's asserts that* "[t]he *Ibbotson yearbook clearly states that the capitalization cut-off between deciles* 10a *and* 10b *is* $48,345,000. *That is, all companies with market capitalizations of* $48,345,000 *or less fall within decile* 10b, *while companies with market capitalizations greater than* $48,345,000 *but no greater than* $84,521,000 *fall within decile* 10a" *Resp. Br. at 24. This is not what the Ibbotson Associates yearbook says. Rather, it merely provides that the largest company within decile* 10b *has a market capitalization of* $48,345,000 *and the company with the largest capitalization within decile* 10a *has a market capitalization of* $84,521,000. *There is no indication of whether a company with a market capitalization of less than* $48,345,000 *may nonetheless fall within decile* 10a *or even decile* 9 *given certain characteristics. This is evidenced by Kern's own determination of* Dunham's *Size-Risk Premium of 3.95 % , which was significantly lower than what decile* 10b *suggests it should be.*

[19]***See*** *Resp. Trial* Ex. *22, Tab 4.*

The second portion of the Ibbotson chart consists of three categories that sequentially combine deciles 3 through 10b *into broader groupings, each encompassing a three decile* band.[20] *It calls these bands "Mid-Cap, 3-5," "Low-Cap 6-8," and "Micro-Cap* 9-10." *Just as with the first part of the chart, the second part provides a relevant Size-Risk Premium for each band, essentially averaging the statistics for the three deciles encompassed within that group. For example, the second portion of the chart states in relevant part that the Size-Risk Premium for companies in the Micro-Cap 9-10 is 2.62%. This is the Size-Risk Premium Wilkinson utilized in determining his capitalization and discount rate.*

Dunham's disagrees with Wilkinson's use of the more generalized Micro Cap 9-10 category to determine its Size-Risk Premium. Dunham's instead argues that because its equity value (even assuming Wilkinson's $44 million valuation) is below $48,345,000, *Wilkinson was obligated to use a Size-Risk Premium of 8.62% pursuant to decile* 10b. *This argument, however, is belied by Kern's use of a significantly lower Size-Risk Premium in his own projections. Kern's valuation report specifically discusses his choice of Size-Risk Premium to apply. His report provides:*

> *We estimated the small stock risk premium based on information compiled by Ibbotson as published in its [yearbook]. Based thereon,*

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[20] *See id.*

we estimate a small stock premium of 3.95 % based on the historical returns (in excess of the return on the S&P 500 Index) of companies that are comparable in size to Dunham's.[21]

The court finds this reasoning persuasive and adopts it. Wilkinson inappropriately used a risk size premium of 2.62 % , which was based on essentially an average of deciles 9, 1 Oa, and 10b. *Dunham's does not share similar characteristics with companies in decile 9. A more accurate Size-Risk Premium should fall within the range of deciles* 10a *and* 10b. *A Size-Risk Premium of 3.95 % is closer to decile* 10a *than it is to decile* 10b, *but this is an appropriate weighting because Dunham's shares more risk characteristics with companies in decile* 10a *than it does with companies in decile* 10b. *This is because companies falling within decile* 10b *include many start-up ventures that receive public funding and are inherently riskier.*

5. The Court's DCF Valuation

The court begins by accepting Wilkinson's basic framework, and then adjusts his projections and valuation based on the valid objections advanced by Dunham's. By accepting management's accounts of projected Operating Margins, Wilkinson's projected free cash flow for Dunham's becomes $1,400,900 *for the four months ended January 31, 2002,* $3,768,100 *for fiscal*

[21] **Pet. Trial Ex. 21 at 54.**

year 2003, $4,099,200 *for fiscal year 2004, and* $4,609,100 *for fiscal year* 2005. *Using a Size-Risk Premium of 3.95% increases Wilkinson's terminal value capitalization rate from 15 % to 16.35 % , thus reducing the terminal value of Dunham's to* $29,035,500. *Moreover, a 3.95% Size-Risk Premium increases Wilkinson's discount rate to 19.35* %, *which leads to a present value factor of 97* .09 *% for the four months ended January 31, 2002, 81.35* % *for fiscal year 2003, 68.16 % for fiscal year 2004, 57.11% for fiscal year 2005, and 55.45 % for the terminal value. This all results in a DCF for 100% of Dunham's value of* $25,953,200.

B. *The Comparable/Guideline Companies Approach*

The comparable company approach involves reviewing publicly traded competitors or participants in the same market or industry, generating relevant multiples from public pricing data of the comparable companies and applying those multiples to Dunham's in order to arrive at a value. Wilkinson looked at comparable publicly traded companies in the sporting goods industry with ascertained market values to determine those companies' multiples of market value of invested capital ("MVIC") to EBITDA.[22] *Specifically, Wilkinson*

[22] *EBITDA is a company's earnings before interest, taxes, depreciation and amortization.*

selected Sports Authority, Inc., Gart Sports Company, Sports Chalet, Inc., and Hibbett Sporting Goods, Inc. as publicly traded sporting goods companies that were comparable to Dunham's The four companies selected offer a wide spectrum of store type, geographic location, capital structure, number of stores, financial performance, and other factors. These four companies summarize the risks facing a similar privately held entity very well.

Wilkinson averaged the multiples of MVIC to EBITDA of the comparable companies as of the Merger Date. He then reduced that average, which was 5.77, by 10% to reach his proposed EBITDA multiple of 5.2. Next, Wilkinson multiplied his 5.2 figure by Dunham's unadjusted EBITDA of approximately $10.3 million for the trailing twelve-month period ending September 25, 2001, to obtain a total capital value estimate of approximately $53.8 million. Subtracting from that figure $14.4 million, representing Dunham's interest-bearing debt as of January 3 1, 2001, Wilkinson stated that his MVIC analysis suggested a total equity value of $39.4 million as of the Merger Date? The court starts with this figure and will next address each of Dunham's objections to it.[24]

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[23] *Wilkinson also conducted a price-to-earnings analysis and a price-to-book-value analysis, which suggested equity values of $48.6 million and $36.3 million, respectively. Neither of these valuations has a significant degree of relevance, however. Price-to-earnings ratio is not a reliable indicator of Dunham's value because such a ratio does not take into account differences in companies' ratio of debt capital to MVIC. Moreover, price-to-book value ratio is not a reliable indicator of Dunham's value because it is well established that use*

1. The Correct Interest-Bearing Debt Figure

Wilkinson used the incorrect interest-bearing debt figure in reducing his total capital value to equity value under his guideline companies analysis. He used Dunham's interest-bearing debt figure as of January 3 1, 2001, which was $14.4 million, despite the fact that he was valuing Dunham's as of October 15, 2001. At the end of September 2001, which is the time closest to the Merger Date for which there is a debt figure available, Dunham's interest-bearing debt was $22.5 million. This has a direct dollar-for-dollar effect on Wilkinson's valuation, and results in that valuation, based on a guideline companies analysis, being $8.1 million greater than it should be.

The petitioner has two responses to this argument. First, he argues that Kern did not make a similar reduction to his analysis and instead used the

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of book value in valuation methodologies is generally not recommended. See ***Paskill v. Alcoma*** *Corp., 747* **A.2d** *549, 554 (Del. 2000) (noting that it is inappropriate to rely solely on a net asset value methodology because it does not represent the value of the corporation as a going concern); Shannon P. Pratt* ***et al., Valuing a Business: The Analysis and Appraisal of Closely Held Companies*** *230-33 (4" ed. 2000) ("book value is not a recommended business valuation method . . . [and] "it is generally inappropriate to estimate a business valuation based solely on accounting book value").*

[24] *In this Opinion, the court does not address whether its comparable companies analysis should be adjusted upward to reflect an inherent minority discount. The petitioner's expert made no such adjustment because he assumed it would be roughly offset by a marketability discount related to Dunham's status as a privately held company. See Trial Tr. at 298-99.*

$14.4 million interest-bearing debt figure. This argument is not persuasive because Kern (however erroneously) valued Dunham's as of January 3 1, 2001, when Dunham's interest-bearing debt figure actually was $14.4 million. Rather than conducting a new valuation analysis as of the Merger Date, Kern merely looked at key factors that could affect value, and how they had changed during the intervening period of time. He concluded (again, however erroneously) that Dunham's value as of the Merger Date was no greater than it had been as of January 31, 2001. Had Kern performed a new valuation, as of the Merger Date, he would have been required to include the full interest-bearing debt figure of $22.5 million to arrive at a correct equity value for Dunham's

The petitioner's second response is that because Dunham's finances short-*term inventory needs through its line of credit, as the Christmas season approaches financed inventory purchases grow, leading to an abnormally high interest-bearing debt figure in its financial statements. Therefore, the argument goes, upon review of Dunham's normalized debt level, it may not be necessary to consider this run-up of interest-bearing debt in a valuation calculation. This argument, however, does not withstand scrutiny. Wilkinson's methodology gives the petitioner the benefit of increased prospects for future revenue and earnings associated with the then-upcoming Christmas season, while at the same time effectively relieving him from his obligation to offset those prospects through the*

debt incurred in obtaining the increased inventories necessary to create the revenue and earnings in the first place. For these reasons, the court agrees that Wilkinson should have considered the full $22.5 million interest-bearing debt figure in his guideline companies analysis.

2. <u>One-Time Gains</u>

Wilkinson failed to adjust Dunham's EBITDA for a one-time non-recurring gain of $550,000, relating to the August 2001 buyout of Dunham's store lease in Janesville, Wisconsin. Although this one-time gain was not expressly identified as such in Dunham's financial statements, John Palmer, Dunham's general counsel, testified at trial that the buyout of the Janesville lease was "not typical."[25] *Palmer further testified that during the five years preceding the Merger Date, no other leases were bought* out.[26]

The petitioner focuses on the fact that the Janesville buyout was not expressly identified as a non-recurring gain in Dunham's financial statements.[27] *Because of this omission, the petitioner argues that the court should not consider that transaction to have been non-recurring.*[28] *The only evidence adduced at trial*

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[25] **Trial Tr. at 287.**
[26] ***See id.***
[27] **See Pet. Br. at 29.**
[28] ***See id.***

(which was Palmer's testimony), however, demonstrates that *the Janesville buyout actually was a one-time, non-recurring transaction. There are many reasons why an auditor might not have required Dunham's to identify the* gain *as non-recurring in the* financial *statements. For example, the Janesville buyout may not have been a material event for financial statement purposes, despite the fact that it is plainly material for the very different purposes involved in valuing a company. Accordingly, the court will reduce Wilkinson's EBITDA calculation by $550,000.*

3. The Correct EBITDA Multiple

As previously mentioned, Kern and Wilkinson essentially agree on the appropriate comparable companies for the purposes of a guideline companies analysis. Wilkinson selected his 5.2 multiple by averaging the EBITDA multiples of the comparable companies as of the Merger Date, and then reducing that average by 10%. Kern, on the other hand, discounted 48 % from the average guideline company multiple.

One of the basic principles of employing the guideline companies approach is that the chosen guideline companies should not be selected if they are dissimilar to the subject company.[29] *Those not similar are not used. There*

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[29] *See, e.g., Pratt,* supra *note 23, at 230-33.*

may be some differences between comparable companies-they may make significantly more in earnings or have a significantly higher book value. The key is that the figures gleaned from a guideline company analysis are in fact multiples, which summarize how the investing public values one dollar of earnings in a given industry.[30] *That is why these multiples are transferable. They summarize the risks facing, in this instance, large, regional sporting goods retailers very well.*

Dunham's criticizes Wilkinson's guideline companies analysis because Wilkinson did not subjectively select what he thought to be appropriate multiples from the comparable companies and instead "merely averaged" the EBITDA multiples of the companies.[31] *After selecting appropriate comparable companies, however, objectively averaging those companies' multiples is the next step in the analysis.*[32] Only *after establishing the average multiples for guideline companies does one adjust that average to account for relative risk and relative growth prospects of the subject company compared with the guideline* companies.[33] *This*

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30 *See id.*

31 *Resp. Br. at 13.*

32 *See, e.g., Pratt,* ***supra*** *note 23, at 244 (stating that* "[t]he *harmonic mean is used to give equal weight to each guideline company in summarizing ratios that have . . .* [MVIC] *in the numerator").*

33 ***See id.*** *at 244-45.*

is exactly what Wilkinson did in his analysis when he discounted the average multiples for the guideline companies by 10% before applying that multiple to Dunham's.[34] *Wilkinson chose a 10% discount to account for risks and costs such as floatation costs to Dunham's if it were to go public and its lower profitability levels relative to the guideline companies* chosen.[35] *He did not discount the multiples by more than 10% because Dunham's was growing, in terms of profitability, at a faster rate than many of the comparable* companies.[36]

Dunham's stated in its brief that in using the guideline company analysis, Kern determined that the guideline companies were trading from 3.1 to 11 times adjusted normalized EBITDA and that Kern chose a. multiple of 3.0 for Dunham's, which was "slightly smaller" than the multiple of any comparable company because Dunham's was "less profitable" with "lower growth expectations."[37] *What Dunham's failed to mention, however, is that Kern*

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[34] *Delaware case law supports the practice of calculating a weighted average and increasing or decreasing the resulting multiple to reflect the superiority or inferiority of the subject company. See* ***Bell*** *v. Kirby Lumber Corp., 413* A.2d *137, 146 (Del. 1980) (approving use of higher than average price/earnings ratio because "Kirby was among the higher quality companies in the field"); Boyer v. Wilmington Building Materials, Inc., 754* A.2d *881, 904 (Del. Ch. 1999) (discounting derived multiples by 25%* "[t]o *account for the peculiar, negative characteristics* of the subject company); Matter* of *Appraisal* of *Shell Oil Co., 1990 WL 201390, at* *23 *(Dec. 11, 1990) (finding that "Shell was a superior company to most of those studied by Morgan Stanley and should have been* priced *above the median" of comparables).*

[35] *Trial Tr. at 51-52.*

[36] *Id. at 129.*

[37] *Resp. Br. at 7.*

discounted 48% from the average guideline company multiple. Kern also could not explain why Dunham's had lower growth expectations than other guideline companies. Essentially, he disregarded the multiples.[38] *In choosing a drastically reduced multiple, Kern demonstrated that he believes the guideline companies are not truly comparable to Dunham's, which undermines his entire analysis.*

For all these reasons, the court concludes that Wilkinson chose the correct discount to apply to the average guideline company multiple, and the court will use a multiple of 5.2 to determine Dunham's MVIC.

4. The Court's Comparable/Guideline Companies Valuation

The court begins by accepting Wilkinson's basic framework, and then adjusts his valuation based on the valid objections advanced by Dunham's Reducing Dunham's EBITDA by $550,000 to account for the one-time gain from the Janesville lease buyout leads to an EBITDA figure of $9,812,200. *Applying Wilkinson's 5.2 multiple to Dunham's adjusted EBITDA results in a total value of Dunham's invested capital of* $51,023,400. *Reducing that value by* $22,500,000, *Dunham's interest-bearing debt as of October 15, 2001 (rather than January 31, 2001) ends in an equity valuation for Dunham's of* $28,523,400.

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[38] ***See** Gotham **Partners, L. P. v.** Hallwood **Realty Partners, L. P., 2003** WL 21639071, at* *14 & n.31 *(Del. Ch. July 8, 2002) (discussing the dangers of significantly deviating from the mean or median of guideline companies' multiples because the analysis becomes too biased and subjective).*

C. The Transaction Approach

1. The Prudential Transaction Does Not Provide A "Reliable Benchmark" For Measuring Dunham's Value

In March 1999, a special-purpose entity comprised primarily of Dunham's officers bought all Dunham's outstanding redeemable preferred stock and Class B common stock for $4 million from The Prudential Insurance Company of America and one of its subsidiaries (collectively, the "Prudential Transaction"). At the time of the Prudential Transaction, there were accrued but unpaid dividends on the preferred stock approximating $20 million.

Dunham's argues that at the time of the Prudential Transaction, Dunham's common stock was worth nothing, because:

> [g]iven *the fact that the Prudential entities were owed some $20 million in preferred dividends, but agreed to forego their right to seek payment of that amount, and given the fact that such dividends would have to be paid before common equity could be paid in a bankruptcy context, Prudential's decision to accept only $4 million for its interest in [Dunham's] demonstrates that* when *the Prudential Transaction occurred, the common equity had no material value . . . . Accordingly, the only fair conclusion that may be reached from the Prudential Transaction is that* [Dunham]'s *total equity value implied by the Prudential Transaction was equal to the purchase price of $4* million.[39]

[39] *Resp. Br. at* 9.

The problem with this argument is that the Prudential Transaction was not truly an arm's-length deal. Sosne testified that Prudential was frustrated with its inability to get liquidity out of Dunham's for its investment.[40] *Prudential was apparently willing to take whatever management was willing to offer for the Class B and preferred* stock.[41]

If the Prudential Transaction has significance with respect to Dunham's value as of the Merger Date, it is this: retiring the debt essentially transformed Dunham's into an entirely new company. Once members of management succeeded in purchasing the Class B and preferred shares and retiring this debt, growth was explosive and all of the financial information provided by Dunham's support this. Operating income had gone from $3.4 million in fiscal year 1999 to $9.6 million in fiscal year 2002, and net income had risen from $456,000 in fiscal year 1999 to $4.4 million for the twelve months ended September 25, 2001. Moreover, as discussed above, Dunham's own projections suggest that it expected such growth to continue well into the foreseeable future.

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[40] *Trial Tr. at 158.*

[41] *Id.*

2. *The Gart/Oshman's Transaction*

On February 22, 2001, Gart Sports Company announced it was acquiring Oshman's Sporting Goods, Inc. for $84 million in cash and company stock (the "Gart/Oshman's Transaction"). The merger ultimately closed on June 7, 2001, and its value had increased to $99 million. Both parties agree that the Gart/Oshman's *Transaction is a valid transaction to use as a basis for valuing Dunham's. That being said, the parties (and their experts) differ dramatically about what the* Gart/Oshman's *Transaction implies with respect to Dunham's value.*

Wilkinson analyzed the data surrounding the Gart/Oshman's *Transaction and concluded that it produced a MVIC to EBITDA multiple of 5.17. This multiple was arrived at by reducing Oshman's EBITDA. by approximately $7 million, which Wilkinson believed was necessary because* Oshman's *1999 income statement listed that value as a negative number under the heading "Other Operating Expense." There is no evidence regarding what this number relates to. Moreover, it seems unlikely that it is a one-time negative expenditure, because Oshman's three previous years' income statements also had negative numbers listed as "Other Operating Expenses," and the relevant figure for 1998 was in the $6 million range.*

In contrast, Kern originally found that the Gart/Oshman's *Transaction yielded a MVIC to EBITDA multiple of 4.7. After final terms of the deal were announced, Kern reduced that multiple to 3.7 times Oshman's EBITDA. To arrive at this figure, Kern used the EBITDA figure from* Oshman's *financial statements for the year ended February 3, 2001, despite the fact that the merger closed on June 7, 2001.*

There is virtually no consistency in the analyses performed by the two experts regarding the Gart/Oshman's Transaction, and there is little discussion in either of the experts' reports related to the Gart/Oshman's *Transaction. Neither Wilkinson nor Kern actually provide enough evidence for the court to make a determination about either's credibility on this subject. Neither report's appendices attempts to justify the ultimate conclusions regarding that Transaction. As such, the court concludes that neither report satisfies the burden of proof on this issue, and the court will not consider the Oshman's/Gart Transaction in its analysis.*

D. The Value Of Tavlor's Shares

The court's DCF analysis yields a value for 100% of Dunham's stock of $25,953,200. *The court's guideline companies analysis indicates a value of* $28,523,400. *These two values are reasonably close (the guideline companies valuation is approximately 9.9 % higher than the DCF valuation), and the court*

believes that the average of these two values is the most accurate value for 100 % of Dunham's stock.[42] *Therefore, the court concludes that the total value for 100% of Dunham's stock is* $27,238,300.

As of the Dunham's merger date, Dunham's had 3,000 shares of common stock outstanding. Applying the court's valuation for 100% of Dunham's stock, each share of Dunham's stock is worth $9,079.43. *Petitioner Taylor owned 20 shares of Dunham's common stock, and, accordingly, the value of his shares is* $181,588.60.

E. Taylor Is Entitled To Compound Interest On The Fair Value Of His Shares

8 **Del. C.** *§ 262(h) provides that in appraising a stockholder's shares:*

> *the Court shall appraise the shares, determining their fair value . . . together with a fair rate of interest, if any, to be paid upon the amount determined to be fair value . . . . In determining the fair rate of interest, the Court may consider all relevant factors, including the rate of interest which the surviving or resulting corporation would have had to pay to borrow money during the* pendency *of the proceeding* .[43]

Moreover, 8 **Del. C.** *§ 262(i) provides* "[t]he *Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or*

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[42] *Compare* **Gotham** *Partners, L. P., 2003* WL *21639071, at* *18 & *n.44 (valuing a company using the average of four valuations, where those valuations diverged by more than 173%).*

[43] *8 Del. C.* § 262(h) *(emphasis added).*

resulting corporation to the stockholders entitled thereto. Interest may be simple or compound as the Court may direct?' *These two sections read together "demonstrate that an interest award necessarily has two components-a rate of interest and a form of interest. The court must determine both parts in fashioning an interest award that is fair to the dissenting stockholder as well as to the surviving corporation.* "[45]

Regarding the rate of interest, "[e]ach *party bears the burden of proving the appropriate rate under the* circumstances."[46] *In this case, however, neither side submitted evidence concerning the appropriate rate of interest. Thus, the court looks to the legal rate of interest for guidance, because* "[t]he *legal interest rate serves as a useful default rate when the parties have inadequately developed the record in the issue.* "[47] *The legal rate of interest, defined by 6 Del.* C. § *2301, is 5 % over the Federal Reserve discount rate. The Federal Reserve discount rate on October 15, 2001 was 2%. Therefore, the applicable rate of interest is 7 % .*

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[44] *8 Del.* C. § *262(i) (emphasis added).*

[45] *Gonsalves v. Straight Arrow Publishers, Inc., 2002 WL* 31057465, at *9 (Del. Ch. Sept. 10, 2002).

[46] *Grimes v.* ***Vitalink*** *Communications,* 1997 WL 538676, at *1 (Del. Ch. Aug. 26, *1997).*

[47] *Chang's Holdings, S.A. v. Universal Chemical* & *Coatings, Inc., 1994* WL 681091, at *2-*3 (Del. Ch. *Nov. 22 1994); Ryan v. Tad's Enters., Inc., 709* A.2d 682, 705 (Del. *Ch.* 1996), *aff'd, 693* A.2d 1082 (Del. *1997).*

Taylor requests that interest on his appraisal award be compounded. The court agrees that Taylor should be entitled to compound interest on his award. This court has discretion when deciding whether to award compound or simple interest in appraisal cases.[48] *Although the Supreme Court has noted its concern over the "developing standard practice" of awarding compound interest in appraisal cases, it still only requires that the Court of Chancery base an award of compound interest on sound and articulated* reasoning.[49]

An award of compound interest is generally the form of interest most likely to fulfill the purposes of Delaware's appraisal statute.[50] *This is so because the award of interest pursuant to 8 Del. C.* § *262(h) supports two goals: first, the award compensates the petitioner for the loss of the use of the fair value of his or her shares during the pendency of the proceeding; and second, the award forces the corporation to disgorge any benefits it obtained from the use of the fair value of the petitioner's shares during the pendency of the* proceeding.[51]

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[48] ***See Gonsalves v. Straight Arrow Publishers, Inc.,*** *1999 WL 87280, at* *4 *(Del. Jan. 5, 1999) ("We emphasize again that the Court of Chancery has broad discretion under the appraisal statute to award either simple or compound interest").*

[49] ***Id.*** *("the [appraisal] statute provides discretion to choose [simple or compound interest] on a case-by-case basis, but requires explanation for the choice").*

[50] ***See Gonsalves, 2002*** *WL 31057465, at* *10 *(citing* ***Onti, Inc. v. Integra Bank,*** *751* A.2d *904, 926-29 (Del. Ch. 1999)).*

[51] ***Gilbert v. MPM Enterprises, Inc.,*** *709* A.2d *663, 674 (Del. Ch. 1997) (citing Grimes, 1997 WL 538676, at* *9).

An award of simple interest does not satisfy the first goal of Section 262(h) because "[i]t *is simply not credible in today's financial markets that a person sophisticated enough to perfect his or her appraisal rights would be unsophisticated enough to make an investment at simple interest.* "[52] *Moreover, an award of simple interest does not satisfy the second goal of Section 262(h) because* "[a]s *for the defendant company in an appraisal action, it is even harder to imagine a corporation today that would seek simple interest on the funds it holds . . . . Nor is it conceivable that [the defendant company's] lenders were providing . . . capital at simple rates of interest.* "[53] *Thus, awarding simple interest "would not force the defendant company to disgorge the full benefit it received from having use of the plaintiff's* funds."[54]

There is nothing presently in the record before the court that would cause it to diverge from the general principle that compound interest should be awarded in appraisal cases. For example, there is nothing in the record from which the court could conclude that the length of this litigation was the result of any intentional delay on the part of Taylor. The court concludes, therefore, that the

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[52] *Onti, Inc.,* *751* A.2d *at 926.*

[53] *Id. at 926-27 (footnote omitted).*

[54] ***Gonsalves***, *2002 WL 31057465, at* *10.

evidence supports a finding that compound interest is the most appropriate form of interest award for these parties.

The final issue to resolve is the rate of compounding for the court's interest award. There is support for the conclusion that the compounding should occur at a monthly or even daily rate,.[55] Because the court has chosen to apply the legal rate of interest, however, the appropriate compounding rate is quarterly. This is due to the fact that the legal rate of interest most nearly resembles a return on a bond, which typically compounds quarterly.[56]

F. Taylor Is Not Entitled To Recover Costs For His Expert

The petitioner has requested that Dunham's reimburse him for both his court costs and Wilkinson's expert witness fees incurred as a result of his testifying at trial. Dunham's has conceded that it has an obligation to pay court costs.[57] The only issue, therefore, is whether Dunham's should have to reimburse Taylor for Wilkinson's fees. The court concludes that Dunham's should not have to reimburse Taylor for such fees.

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[55] *See Onti, Inc.*, 751 A.2d at 927 & n.93.

[56] *See Borruso v. Communications Telesystems*, 753 A.2d 451, 461 (Del. Ch. 1999).

[57] Resp. Reply Br. at 27.

As a general principle, Delaware law does not permit the shifting of expert witness fees in an appraisal proceeding.[58] Moreover, "[i]n the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses . . . ."[59] In the current action, there was nothing presented to the court demonstrating that such an equitable exception should apply. There has been no undue delay, no showing of bad faith, or any other reason to shift the costs of an expert witness. The petitioner's expert witness costs were simply to establish the fair value of his shares?

The petitioner argues that pursuant to 10 **Del.** C. § 8906 and **Sliwinski v. Duncan**,[61] the court may award, as costs, fees for witnesses testifying as experts.[62] **Sliwinski** involved the application of Section 8906 in the context of a physician's charges in a medical malpractice case, and is inconsistent with the more specific fee shifting provisions of 8 **Del.** C. § 262(j). In addition, Section 8906 has never been applied in an appraisal case. For all these reasons, there is

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[58] See In re Radiology Assocs., Inc. Litig., 611 A.2d 485, 501 (Del. Ch. 1991) (citation omitted) ("as with any appraisal proceeding, plaintiff should bear the costs of his own expert").

[59] Cede & Co., 684 A.2d at 301 (citation omitted).

[60] See In re Radiology Assocs., Inc. Litig., 611 A.2d at 501.

[61] 1992 WL 21132 (Del. Jan. 15, 1992).

[62] See Pet. Br. at 43.

no basis for the petitioner's request that Dunham's pay his expert's fees, and his request will be denied.

G. *Taylor Is Not Entitled To An Award Of Attorneys' Fees*

The petitioner requests attorneys' fees for the first time in his Opening Post Trial Brief. The petitioner concedes that unless some equitable exception applies involving egregious misconduct, he should bear the burden of paying his own attorneys' fees.[63] *He submits that such misconduct is present in this case "based on the bad faith of [Dunham's] which . . . was* ***clearly demonstrated at trial.***"[64] *To support his bad faith argument, the petitioner primarily looks to* "[t]he *indefensibly one sided valuation offered by [Dunham's] expert witnesses . . . .* "[65] *This argument fails to satisfy the necessarily high burden to shift attorneys' fees.*

" [B]ad *faith turns on the special facts of the particular case.* "[66] *Examples of bad faith include parties misleading the court, altering their testimony, or changing positions.*[67] *None of that occurred here. This case is merely a dispute involving the value of Dunham's stock. Both sides presented experts, neither of*

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[63] ***See id.*** *at 44.*

[64] ***Id.*** *(emphasis in original).*

[65] ***Id.***

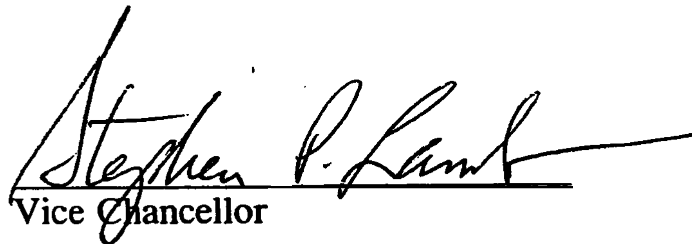
[66] ***Jacobson v. Dryson Acceptance Corp., 2002*** *WL 31521109, at* *16 *(Del. Ch.* Nov. *1,* 2002), ***aff'd, 2003*** *WL 21381092 (Del. June 13,* ***2003)*** *(citing* **Cantor Fitzgerald L.P. v. Cantor,** *2001 WL 536911, at* *4 *(Del. Ch. May* 11, 2001)).

[67] ***See Jacobson,*** *2002 WL 31521109, at* *16 *(citation omitted).*

which completely satisfied the court, but also neither of which demonstrated bad faith or intentional misconduct. There was nothing unusual about how this appraisal action proceeded. Both parties must pay their own attorneys' fees.

V.

For all the foregoing reasons, the court determines that the fair value for each share of Dunham's common stock, as of the date of the merger, was $9,079.43 *and, thus, will enter an order awarding the petitioner a total of* $181,588.60 *plus interest at the legal rate, compounded quarterly. Dunham's is also directed to reimburse the petitioner for all his court costs. The parties are directed to present an order of final judgment in conformity with this opinion within 10 days.*



Vice Chancellor