

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

RICHARD A. LE BEAU, DOROTHY N.)
LE BEAU, MICHELLE E. LE BEAU)
BRETT JORDON, BROOKE JORDAN,)
KURT R. NEBEL, JOAN M. NEBEL,)
CHRISTINE STUCKER, DAVID)
STUCKER, MARGARET M. PAVLETIC,)
JOSEPH W. PAVLETIC, D.D.S.,)
Individually and for THE)
JOSEPH W. PAVLETIC, D.D.S. IRA,)
ROBERT J. NOETZEL, D.D.S., M.S.,)
As Trustee OF THE ROBERT J.)
NOETZEL, D.D.S., M.D. LTD.)
PROFIT SHARING AND SAVINGS PLAN)
& TRUST, JOHN M. CUNNINGHAM, III,)
M. SUSAN CUNNINGHAM, AND JOHN M.)
CUNNINGHAM, As Trustee of)
THE JOHN M. CUNNINGHAM TRUST,)
Dated December 19, 1991,)

Petitioners,)

v.)

M. G. BANCORPORATION, INC.,)
a Delaware corporation, and)
SOUTHWEST BANCORP, INC., a)
Delaware corporation,)

Respondents.)

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DIANNE H. KEMPSKI

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Civil Action No. 13414

MEMORANDUM OPINION

Date Submitted: August 26, 1997

Date Decided: January 29, 1998

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Wayne J. Carey and Ronald A. Brown, Jr., Esquires, of PRICKETT, JONES, ELLIOTT, KRISTOL & SCHNEE, Wilmington, Delaware; and Frederick V. Lochbihler and David S. Barritt, Esquires of CHAPMAN AND CUTLER, Chicago, Illinois; Attorneys for Respondents

JACOBS, VICE CHANCELLOR

This appraisal action, brought under 8 Del. C. § 262, arises out of a “cash-out” merger (the “Merger”) of M.G. Bancorporation, Inc. (“MGB”) into its corporate parent, Southwest Bancorp, Inc. (“Southwest”) on November 17, 1993. The Merger consideration was \$41 per share, which the Petitioners claim was inadequate because MGB’s fair value as of the Merger date was at least \$85 per share. The Petitioners also seek 10% compound interest on their appraisal award, plus their costs and expenses including reasonable expert witness and attorney’s fees.

The Respondents contend that the fair value as of the Merger date was \$41.90 per share and that 8% simple interest is appropriate.

For the reasons discussed below, the Court concludes that (i) the fair value of MGB’s shares at the time of the Merger was \$58,514,000, or \$85 per share, (ii) the Petitioners are entitled to 8% interest compounded monthly, and (iii) the Petitioners are not entitled to an award of legal fees or expenses.

I. FACTS

A. The Parties and the Merger

The Petitioners are shareholders who owned 18,151 shares of common stock of MGB before the Merger. The Respondents are Southwest Bancorp, Inc. (“Southwest”) and its subsidiary, MGB. Before the Merger, MGB was a Delaware-

chartered bank holding company headquartered in Worth, Illinois. MGB had two operating Illinois-chartered bank subsidiaries, Mount Greenwood Bank ("Greenwood") and Worth Bancorp, Inc. ("WBC"). Both banks served customers in the southwestern Chicago metropolitan area. MGB owned 100% of Mount Greenwood and 75.5% of WBC.

Before the Merger, Southwestern owned 91.68% of MGB's common shares. On November 17, 1993, MGB was merged into Southwest in a "short form" merger under 8 Del. C. § 253. Because the Merger was accomplished unilaterally, neither MGB's board of directors nor its minority shareholders were legally required to, or did, vote on the transaction. MGB's minority shareholders were offered \$41 in cash per share in the Merger. The Petitioners rejected that offer, electing instead to pursue their statutory appraisal rights.

To assist it in setting the Merger price, Southwest engaged Alex Sheshunoff & Co. Investment Bankers ("Sheshunoff") to determine the "fair market value" of MGB's minority shares. In a report submitted to Southwest on or about October 28, 1993, Sheshunoff determined that the fair market value of MGB's minority shares was \$41 per share as of June 30, 1993.¹ Thereafter, a stockholders breach of fiduciary duty damage action was filed attacking the Merger, and this appraisal

¹Pet'rs Exhibit Number 5.

proceeding was also commenced. On July 5, 1995, this Court issued an Opinion in the companion class action, holding that Sheshunoff had performed its appraisal in a legally improper manner. The basis for the Court's conclusion was that Sheshunoff had determined only the "fair market value" of MGB's minority shares, as opposed to valuing MGB in its entirety as a going concern and determining the fair value of the minority shares as a pro-rata percentage of that value.²

B. The Petitioners' Valuation

The Petitioners commenced this appraisal proceeding on March 15, 1994. The case was tried on December 2-5, 1996. At trial the Petitioners' expert witness, David Clarke ("Clarke"), testified that as of the Merger date the fair value of MGB common stock was at least \$85 per share. In arriving at that conclusion, Clarke used three distinct methodologies to value MGB's two operating bank subsidiaries: (i) the comparative publicly-traded company approach, (ii) the discounted cash flow ("DCF") method, and (iii) the comparative acquisition technique. Clarke then added a control premium to the values of the two subsidiaries to reflect the value of the holding company's (MGB's) controlling interest in those subsidiaries.³ Lastly,

²Nebel v. Southwest Bancorp, Inc., Del. Ch., C.A. No. 13618, Mem. Op. at 9, Jacobs, V.C. (July 5, 1995).

³The Petitioners had instructed Clarke that Delaware law mandated such a premium at the subsidiary level, relying on Rapid American v. Harris, 603 A.2d 796, 804-05 (1992). In Rapid-American the Supreme Court of Delaware held that the trial court had erred by failing to include a

Clarke then added the value of MGB's remaining assets to the sum of his valuations of the two subsidiaries, to arrive at an overall fair value of \$85 per share for MGB.

What follows is a more detailed description of how Clarke performed his valuation(s) of MGB.

1. Comparative Company Approach

Clarke's comparative publicly-traded company approach involved five steps: (1) identifying an appropriate set of comparable companies, (2) identifying the multiples of earnings and book value at which the comparable companies traded, (3) comparing certain of MGB's financial fundamentals (e.g., return on assets and return on equity) to those of the comparable companies, (4) making certain adjustments to those financial fundamentals, and (5) adding an appropriate control premium. After completing the first four steps, Clarke arrived at a value for WBC of \$33.059 million (\$48.02 per share), and for Greenwood of \$20.952 million (\$30.44 per share). Clarke next determined that during the period January 1989 to June 1993, acquirors of controlling interests in publicly-traded companies had paid an average premium of at least 35%. On that basis, Clarke concluded that a 35%

'control premium' in valuing the subsidiaries of a holding company that was the subject of an appraisal. "We disagree with the trial court's characterization of that 'control premium' in this case as an impermissible shareholder level adjustment. . . . The 'control premium' . . . represented a valid adjustment to its valuation model which 'applied a [bonus] at the company level against all assets. . . ." (citing Cavalier Oil Corp. v. Hartnett, Del. Supr., 564 A.2d 1137 (1989)).

premium was appropriate, and applied that premium to the values he had determined for Greenwood and WBC, to arrive at fair values of \$43.3 million (\$62.90 per share) for WBC and \$27.1 million (\$39.37 per share) for Greenwood, respectively. Clarke then valued MGB's 75.5% controlling interest in WBC at \$32.691 million (\$47.49 per share), and MGB's 100% interest in Greenwood at \$27.1 million (\$39.37 per share), under his comparative company approach.

2. Discounted Cash Flow Approach

Clarke's DCF valuation analysis involved four steps: (1) projecting the future net cash flows available to MGB's shareholders for ten years after the Merger date, (2) discounting those future cash flows to present value as of the Merger date by using a discount rate based on the weighted average cost of capital ("WACC"), (3) adding a terminal value that represented the present value of all future cash flows generated after the ten year projection period, and (4) applying a control premium to the sum of (2) and (3).

Clarke did not create his own cash flow projections. He used the projections made by Sheshunoff at the time of the Merger, because Southwest's own management had accepted those projections when they fixed the Merger price. Clarke also accepted Sheshunoff's ten year projection period, because he independently had concluded that it would require ten years for MGB's cash flows

to stabilize. Based on a 1996 Ibbotson Associates ("Ibbotson") study of the banking industry, Clarke concluded that the appropriate "small stock" premium to be used in the capital asset pricing model ("CAPM") to determine MGB's discount rate (WACC), was 1%, and that the appropriate discount rate (WACC) for MGB was 12%. Applying that 12% discount rate, Clarke calculated the present value of WBC's future cash flows to be \$17.251 million, and WBC's terminal value to be \$14.824 million. Applying that same 12% discount rate, Clarke arrived at a present value of \$10.937 million, and a terminal value of \$9.138 million, for Greenwood.

Applying the same 35% control premium to those values of the two subsidiaries, Clarke calculated MGB's 75.5% interest in WBC at \$33.824 million or \$49.14 per share; and MGB's 100% interest in Greenwood at \$28.3 million, or \$41.11 per share.

3. Comparative Acquisition Approach

Clarke's third valuation approach, the comparative acquisition method, focused upon multiples of MGB's last twelve months earnings and its tangible book value. Those multiples were determined by reference to the prices at which the stock of comparable companies had been sold in transactions involving the sale of control. Unlike the comparative company and DCF valuation approaches, this method did not require adding a control premium to the values of the subsidiaries

because under that methodology, the parent holding company's controlling interest in the subsidiaries was already accounted for.

In valuing MGB under his third approach, Clarke identified three transactions involving community banks in the relevant geographic area that occurred within one year of the Merger. He also considered data published by The Chicago Corporation in its September 1993 issue of Midwest Bank & Thrift Survey.⁴ From these sources, Clarke determined that (i) control of WBC could be sold for a price between a multiple of 14 times WBC's last twelve months' earnings and 200% of WBC's tangible book value, and that (ii) control of Greenwood could be sold for a price between a multiple of 12 times Greenwood's last twelve months' earnings and 175% of its tangible book value. Giving equal weight to these two sets of values, Clarke valued MGB's 75.5% interest in WBC at \$28.8 million (75.5% x \$38.1 million) or \$41.84 per share, and MGB's 100% interest in Greenwood, at \$22.9 million, or \$33.27 per share.

4. MGB's Remaining Assets

Having valued MGB's two subsidiaries, Clarke then determined the fair value of MGB's remaining net assets, which included (i) a \$6.83 million note payable by

⁴That data reflected an analysis of 137 bank acquisitions announced from January 1, 1989 to June 1, 1993.

Southwest, (ii) certain intangibles that Clarke did not include in his valuation, (iii) \$78,000 in cash, and (iv) other assets worth \$2000. These assets totaled \$6.91 million, from which Clarke subtracted liabilities of \$96,000 to arrive at a net asset value of \$6.814 million (\$9.90 per share) for MGB's remaining assets.

5. Fair Value Computation

Clarke then added the values he had determined under each of his valuation methodologies, for (i) MGB's 75.5% interest in WBC, (ii) MGB's 100% interest in Greenwood, and (iii) MGB's 100% interest in its remaining assets. Under his comparative publicly-traded method, Clarke concluded that MGB's value was \$76.59 per share with no control premium, and \$96.76 per share with a control premium. Under his DCF approach, Clarke determined that MGB's value was \$74.75 per share with no control premium, and \$100.15 per share with a control premium. And under his comparative acquisitions method, Clarke concluded that MGB's minimum fair value was \$85 per share, which represented the median of the values described above.

C. The Respondents' Valuation

At trial the Respondents did not call the Sheshunoff firm as a witness, even though its valuation had served as the basis for the \$41 per share Merger price.

Instead, the Respondents relied upon the testimony of Mr. Robert Reilly (“Reilly”),⁵ who opined that as of the Merger date, the fair value of MGB common stock was \$41.90 per share -- only 90 cents per share more than Sheshunoff’s \$41 valuation. Reilly arrived at that result by performing two separate valuations: a DCF analysis and a “capital market” analysis. Reilly did not include any control premium, having determined that a control premium was inappropriate in valuing a holding company such as MGB.

1. DCF Analysis

Reilly’s DCF analysis consisted of: (1) projecting MGB’s future net cash flows available to shareholders for a period of five years after the Merger date, (2) determining an appropriate discount rate and discounting those future cash flows back to the Merger date, and (3) adding a terminal value that represented the present value of all future cash flows beyond the five year projection period. Reilly used a five year period, because in his opinion any longer interval would be too speculative. Relying on a 1992 Ibbotson study that was not specific to the banking

⁵Reilly is an expert in performing business valuations. He was formerly the National Director of Valuation Services for Deloitte and Touche and is an accredited senior appraiser and a certified public accountant. The Petitioners claim that Reilly’s entire valuation should be rejected because Reilly had no significant experience in valuing banks or bank holding companies, and was therefore not competent to value bank holding companies. Although the Court ultimately rejects Reilly’s valuations, it is for reasons that concern the merits of his valuation approaches, not his expertise.

industry, he also concluded that 5.2% was the appropriate small stock size premium to use in the CAPM for purposes of determining the WACC for MGB.

In determining an appropriate discount rate, Reilly concluded that MGB was subject to certain company-specific risks, namely, litigation involving its data processor (BYSIS) and MGB's dependence upon a single key supplier. Reilly quantified those risks at four percentage points, and on that basis concluded that the appropriate discount rate for MGB was 18%. Applying that 18% discount rate to MGB's future cash flows, Reilly valued MGB at \$29.220 million, or \$42.45 per share, on the basis of his DCF approach.

2. Capital Market Method

Reilly's second method for valuing MGB was the "capital market" method, which involved: (1) identifying a portfolio of guideline publicly-traded companies, (2) identifying appropriate pricing multiples for those companies, (3) using the multiples for the guideline companies to calculate the appropriate pricing multiples for MGB⁶ and (4) applying the multiples to the corresponding financial indicators for MGB. By this method, Reilly concluded that MGB was worth \$28.4 million, or

⁶Reilly's pricing multiples were all related to the market value of invested capital ("MVIC"). Reilly computed the ratios of MVIC to: (1) earnings before interest and taxes ("EBIT"); (2) earnings before interest, depreciation and taxes ("EBIDT"); (3) debt free net income ("DFNI"); (4) debt free cash flow ("DFCF"); (5) interest incomes; and (6) total book value of invested capital ("TBVIC").

\$41.26 per share, at the time of the Merger.

Reilly then averaged his DCF and capital market valuations, to arrive at an ultimate fair value for MGB of \$41.90 per share.

For ease of reference, the parties' respective valuation conclusions are summarized in the chart below. At the trial, Petitioners introduced evidence of what MGB's value would be if Sheshunoff's valuation were updated to the Merger date and if its minority discount were eliminated. Because of its importance to the analysis, that updated and revised valuation is also summarized below.

<u>Valuation in \$'000's:</u>	<u>WBC</u>	<u>75.5% of WBC</u>	<u>Greenwood</u>	<u>Other Assets</u>	<u>Total</u>	<u>Per Share</u>
<u>Petitioners (Clarke)</u>						
Comparative Publicly-Traded						
Method:	33,059	24,960	20,952	6,814	52,726	76.59
With Control Premium:	43,300	32,692	27,100	6,814	66,606	96.76
DCF Method:	32,075	24,217	20,079	6,814	51,110	74.25
With Control Premium:	44,800	33,824	28,300	6,814	68,938	100.15
Comparative Acquisitions						
Method:	38,100	28,800	22,900	6,814	58,514	<u>85.00</u> =fair value
<u>Respondents (Reilly)</u>						
Capital Market Method:					28,400	41.26
DCF Method:					29,220	42.45
					<u>Average: 41.90</u> =fair value	
<u>Sheshunoff (Updated)</u>						
(Without Control Premium)						
Adjusted Book Value:						<u>64.13</u>
Adjusted Earnings Value:						<u>76.80</u>

II. THE PARTIES' VALUATION CONTENTIONS

A. The Petitioners' Contentions

The Petitioners contend, for various reasons, that the \$41 Merger price did not represent MGB's fair value at the time of the Merger, and that the valuations offered by the Respondents' trial expert to support that price are fundamentally flawed. The Petitioners argue that Reilly's "capital market" approach and DCF analysis are legally deficient because Reilly failed to apply a control premium to the resulting values of the MGB subsidiaries, as Rapid-American requires.⁷ The Petitioners also claim that the Court should reject Reilly's "capital market" approach in its entirety because it is not recognized and accepted in the financial community. Alternatively, Petitioners argue that even if Reilly's capital market approach is accepted, the values he arrived at by that method must be rejected, because the MVIC-related ratios upon which Reilly relied are irrelevant and inappropriate measures to value bank holding companies. Finally, the Petitioners contend that Reilly's comparative publicly-traded company approach is flawed because Reilly's "comparable" companies were banks located outside the relevant geographic region (the Chicago suburbs) and (in certain cases) outside MGB's field

⁷See n. 3, supra.

of business.⁸

The Petitioners also claim that Reilly's DCF analysis is deficient because it is a form of a minority stock valuation that is prohibited under Delaware appraisal law.⁹ Reilly's DCF analysis is also flawed, Petitioners assert, because Reilly and Southwest seized upon the "key supplier dependence" risk and the litigation risks involving MGB's former data process service provider ("BYSIS"), as a contrivance to support an unfairly low valuation of MGB. The Petitioners further contend that Reilly erroneously relied on the 1992 Ibbotson study to determine the WACC for MGB, because the financial data contained in the more recent 1996 Ibbotson study was specific to the banking industry and, thus, more reliable. Finally, the Petitioners claim that Reilly's use of five year projections, rather than the ten year projections Sheshunoff employed, was erroneous.

⁸The Petitioners assert that MGB's fair value is even greater than what Clarke determined it to be, because Clarke's valuation omits the value of MGB's breach of fiduciary duty claims against the Respondents. The Petitioners claim that (1) Southwest engaged in self-dealing loans and usurped corporate opportunities that rightly belonged to MGB; (2) Southwest engaged in a self-dealing allocation of expenses that favored itself at the expense of MGB; and (3) Southwest wrongfully caused MGB's subsidiary banks to enter into contracts with BYSIS, its former data processing service provider, to their detriment. Because the Petitioners did not include these claims in their valuation, the Court does not address them.

⁹See n. 2; supra, Cavalier Oil Corp. v. Hartnett, Del. Supr., 564 A.2d 1137, 1144 (1989) ("In rejecting a minority or marketability discount, the Vice Chancellor concluded that the objective of a section 262 appraisal is 'to value the *corporation* itself, as distinguished from a specific fraction of its *shares* as they may exist in the hands of a particular shareholder' [emphasis in original].").

B. The Respondents' Contentions

Not surprisingly, the Respondents dispute these arguments and take the position that the Petitioners' valuation methodologies are improper and must be disregarded, on several grounds.

The Respondents first argue that it is improper to add a control premium of any kind to the value of MGB's subsidiaries, because that approach violates the requirement that the corporation be valued as a going concern. Respondents contend that Rapid-American -- the authority upon which Petitioners rely -- does not mandate the application of a control premium in this case, because in Rapid, the holding company subsidiaries at issue were involved in unrelated industries, whereas here MGB's two subsidiaries were both banks. The Respondents also argue that Clarke's inclusion of a control premium is proscribed by the command of 8 Del. C. § 262(h) that "fair value" be determined exclusive of post-merger events or other possible speculative post-merger business combinations. Respondents urge that increasing each subsidiary's value by adding a control premium, amounts to valuing MGB on the basis of the subsidiaries' acquisition value, rather than as a going concern. For these reasons, Respondents conclude that the control premia Clarke employed in performing his DCF and comparative company valuations are legally erroneous and must be rejected.

The Respondents next attack Clarke's DCF valuation on the basis that it employs a ten year projection period that, Respondents say, is inherently speculative and unreliable. Clarke's DCF valuation was also flawed (Respondents argue) because the "small stock" premium Clarke used to arrive at a 12% discount rate was derived not from the 1992 Ibbotson study that existed on the Merger date, but from a 1996 Ibbotson study that was compiled three years after the Merger had occurred. Therefore, the 12% discount rate, which is based on impermissible post-Merger data, must be rejected. Finally, the Respondents claim that in any event, Clarke's 12% discount rate was too low because it improperly failed to take into account the "key supplier dependence" risk and the risk of litigation involving MGB's former data process server, BYSIS, confronting MGB at the time of the Merger.

The Respondents also attack Clarke's comparative publicly-traded company approach. They argue that Clarke considered only two multiples -- price-to-earnings and price-to-book value -- both of which involved distortions in the debt-to-equity ratios of Clarke's selected comparable companies and MGB. Respondents further criticize Clarke for (i) relying upon comparable company stock prices as of September 30, 1993 -- six weeks before the November 17, 1993 Merger date -- rather than as of the date immediately before the Merger was announced; and (ii) using historical financial averages for the five years preceding the Merger, rather

than for the 2.75 year period before the Merger, as Reilly did.¹⁰ Finally, the Respondents contend that Clarke's valuation improperly failed to take into account the fact that MGB's subsidiaries (i) had poor prospects for growth or expansion, (ii) were located in geographic areas that did not have significant population growth, and (iii) faced significant competition.

These contentions are now addressed.

III. ANALYSIS

To determine the fair value of MGB's shares as of the Merger date, this Court must decide three issues.

The first is whether Reilly's "capital market" valuation approach is legally permissible in this case. The specific question is whether that valuation method is generally accepted or recognized in the financial community for purposes of valuing a bank or bank holding company.

Neither side contests the validity per se of either the comparative publicly-traded company or the DCF valuation approaches. Both sides claim that the other improperly applied those methodologies to MGB. That frames the second set of

¹⁰Reilly concluded that the banking industry had changed too dramatically to justify a longer projection period.

issues regarding Clarke's publicly-traded company analysis, which are: (i) did Clarke use the proper financial indicators, (ii) did Clarke erroneously rely upon stock price quotes for the six weeks preceding the Merger, and (iii) was five years an appropriate historical period to compare the financial indicators and to make future growth projections? Respecting each side's DCF analysis, the issues concern (i) the appropriate discount rate and (ii) the appropriate projection period.

The third issue is whether Clarke's comparative acquisition approach -- in which a control premium is inherent -- is legally permissible in this case.¹¹

For the reasons next discussed, the Court determines that (a) Reilly's "capital market" approach is legally impermissible, but even if valid, was improperly applied, thereby requiring the rejection of the values Reilly derived by that method; (b) both Clarke's and Reilly's DCF analyses were improperly applied, thereby requiring the rejection of the values both experts derived by that approach; (c) Clarke's comparative acquisition approach was a legally valid method to value MGB, and (d) the credible evidence of record supports Clarke's \$85 per share determination of MGB's fair value as of the Merger date.

¹¹The specific control premium issue is whether Rapid American requires including a control premium as an element of the value of operating subsidiaries whenever the parent holding company is the corporation being appraised (as the Petitioners urge), or whether a control premium is appropriate only where the subsidiaries are in different businesses (as the Respondents urge).

A. MGB's Fair Value

It is a well-established principle of Delaware law that “[t]he objective of a section 262 appraisal is ‘to value the *corporation* itself, as distinguished from a fraction of its *shares* as they may exist in the hands of a particular shareholder’ [emphasis in original].”¹² Based on that principle, this Court determined in its earlier Opinion that Sheshunoff’s \$41 valuation was impermissible under 8 Del. C. §262, because it was an appraisal not of the entire corporation as a going concern but only of a minority block of its shares.¹³ Presumably that is why the Respondents chose not to rely upon the Sheshunoff valuation or to call Sheshunoff personnel as trial witnesses. Instead, Respondents elected to rely solely upon Reilly’s valuation, which resulted in the same \$41 per share value that Sheshunoff had arrived at by a valuation approach found to be improper.

The fact that Reilly’s per share fair value determination serendipitously turned out to be only 90 cents per share more than Sheshunoff’s legally flawed \$41 valuation, cannot help but render Respondent’s valuation position highly suspect and meriting the most careful judicial scrutiny. As a matter of plain common sense,

¹²Cavalier Oil Corp. v. Harnett, Del. Supr., 564 A.2d 1137, 1144 (1989) quoting Cavalier Oil Corp. v. Harnett, Del. Ch., C.A. No. 7959, Jacobs, V.C. (Feb. 22, 1988)).

¹³See Nebel v. Southwest Bancorp. Inc., Del. Ch., C.A. No. 13618, Mem. Op. at 9, Jacobs, V.C. (July 5, 1995).

it would appear evident that a proper fair value determination based upon a going concern valuation of the entire company, would significantly exceed a \$41 per share fair market valuation of only a minority block of its shares. If Respondents choose to contend otherwise, it is their burden to persuade the Court that \$41.90 per share represents MGB's fair value. The Court concludes that the Respondents have fallen far short of carrying their burden, and independently determines that the fair value of MGB at the time of the Merger was \$85 per share.

1. *The Validity of Reilly's "Capital Market" Approach*

The Court first addresses whether Reilly's capital market approach is legally permissible. That valuation approach (to repeat) involved deriving various pricing multiples from selected publicly-traded companies, and then applying those multiples to MGB,¹⁴ resulting in a valuation of \$41.26 per share.

The Petitioners argue that Reilly's capital market valuation method is impermissible because it includes a built-in minority discount. The valuation literature, including a treatise co-authored by Reilly himself, supports that position,¹⁵

¹⁴See n. 6, supra.

¹⁵See S.P. Pratt, R.F. Reilly & R.P. Schweihs, Valuing a Business 194-95, 210 (3d ed. 1996) (explaining that comparative publicly traded companies produce a minority discounted valuation); C.Z. Mercer, Valuing Financial Institutions 198-200 and Chapter 13 (1992) (explaining that comparative publicly traded company valuation technique produces a minority valuation that requires adding a control premium to be accurate).

and Respondents have introduced no evidence to the contrary. Nor did the Respondents establish that Reilly's capital market method is generally accepted by the financial community for purposes of valuing bank holding companies, as distinguished from other types of enterprises.¹⁶ Reilly determined the ratio of MVIC to other financial measures such as EBIT, EBIDT, DFNI, DFCF, Interest Income, and TBVIC -- ratios that the record indicates are not used to value banks.¹⁷

Because Reilly's capital market method results in a minority valuation, and the Respondents have failed to establish that that approach is generally accepted in the financial community to value banks or bank holding companies, the Court must conclude that in this specific case Reilly's capital market approach is improper, and must be rejected.¹⁸

2. The Parties' Respective Applications of the Comparative Publicly-Traded and DCF Valuation Methodologies

The Court next considers (i) whether Clarke properly applied his comparative

¹⁶See Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 704 (1983).

¹⁷Indeed, one of Sheshunoff's witnesses had to ask for the definitions of EBIT and EBIDT, and Southwest's chairman and CEO testified that those measures are not used to value banks. LPC Dep. at 154:4-8.

¹⁸This conclusion should not be read as a categorical, matter-of-law determination that Reilly's capital market approach is an inappropriate method to value banks. The opposite may be true, but in this specific case the Respondents failed to discharge their burden of proof on that issue.

company analysis to MGB, and (ii) whether both sides' experts properly applied their respective DCF analyses to MGB. The validity per se of these two valuation methodologies is not in dispute.

a. Comparative Company Approach

A primary issue dividing the parties concerns the companies chosen as “comparable” to the corporation being appraised. A determination of that kind is necessarily fact intensive.

In performing his comparative company analysis, Clarke selected as comparables, banks having financial ratios, geographic locations, and demographic factors similar to those of MGB's two bank subsidiaries. Reilly, on the other hand, included companies that operated outside MGB's geographic location, in different economic environments, and in different lines of business.¹⁹ Where the valuation exercise rests upon data derived from companies comparable to the company being valued, it stands to reason that the more “comparable” the company, the more reliable will be the resulting valuation information. The Court concludes that in this case it was sounder practice to use as comparables suburban banks located in the same geographic area (as Clarke did), rather than banks located outside of WBC's

¹⁹Reilly also erred by including a Savings and Loan Institution as one of his comparable companies. MGB's two subsidiaries were commercial banks, not S&L's.

and Greenwood's immediate areas (as Reilly did). Accordingly, I find Clarke's comparable companies to be superior to Reilly's.

Another key difference between the parties' comparative publicly-traded company approaches is that Clarke used the price-to-earnings and price-to-book value financial multiples, whereas Reilly used multiples based upon the market value of invested capital ("MVIC"). Relying upon various valuation authorities and publications, the Petitioners argue that where the enterprise being valued is a bank, the relevant ratios are price-to-earnings and price-to-book value.²⁰ Reilly disagreed. He opined that it is more appropriate to compare the different financial measures as a fraction of MVIC, because that approach eliminates the distortions inherent in Clarke's financial ratios. Reilly did not elaborate on what those distortions were, however, nor did he point to specific cases where MVIC was considered an appropriate financial measure of a bank or bank holding company. Given this record, the Respondents have not persuaded the Court that MVIC is widely accepted in the financial community as a measure of the value of a bank or bank

²⁰Security State Bank v. Ziegeldorf, Iowa Supr., 554 N.E.2d 884 (1996); BNE Mass. Corp. v. Sims, Mass. Ct. App., 588 N.E.2d (1992); Estate of Howard Winston Cook v. United States, 86-2 U.S. Tax Cas. (CCH) ¶ 13,678 (June 11, 1986); Valuing Financial Institutions, C.Z. Mercer, 219-221 (1992); The Journal of Bank Auditing and Accounting, L.C. Pettit, M.D. Atchison & R.S. Kemp, "The Valuation of Small or Closely Held Banks," (Spring 1991), at 28-31.

holding company.²¹ Clarke's financial measures are generally accepted in the financial community for valuing banks, and the Court accepts them.

A third major difference between the parties' comparative company approaches is that Clarke used historical financial data going back five years before the Merger, whereas Reilly used historical financial data going back 2.75 years. In performing bank valuations, five year historical information is typically used. Reilly's position was that the banking industry had changed dramatically during the five years before the Merger, such that it was not appropriate to rely upon financial data going back that far.

At the heart of this dispute are the experts' differing assumptions about MGB's future growth prospects. The Respondents paint a bleak picture of MGB's future prospects for increasing its revenues; the Petitioners argue that MGB's future prospects were far brighter. Petitioners agree that a company's more recent historical economic averages are a good indicator of its future growth rate, but emphasize that a firm's financial trends are often more reliably evidenced by its performance over the past five years. I concur. Petitioners have demonstrated that

²¹The use of MVIC as a tool to value other kinds of enterprises is, of course, widely accepted. See, Rapid-American Corp. v. Harris, 603 A.2d 796 (1992). Again, the Court's conclusion that MVIC has not been shown to be an appropriate measure of a bank's value is fact-specific to this case, and by virtue of the Respondent's failure of proof.

MGB's historical performance, whether over the past five years, three years, or twelve months before the Merger, indicated significant future growth.²² Although MGB's subsidiary banks did face certain difficulties (specifically, a limited marketplace without high potential for growth or expansion and a primarily blue-collar residential population),²³ the Respondents have not persuaded me that this difficulty would likely prevent MGB's bank subsidiaries from maintaining their historical rates of growth.

A fourth major difference between the parties' comparative company analyses is that Reilly relied upon comparable company stock prices on the day before the Merger, whereas Clarke used price quotations six weeks before the Merger. Because the merger date (more specifically, the date before the public announcement of a merger) is normally the time that is relevant, and because the Petitioners made no effort to justify Clarke's use of stock prices going back six weeks before the Merger, the Court cannot accept Clarke's comparative company valuation, despite the validity of the technique itself. Clarke's use of six week old

²²See e.g., PX 1 at 10-26. The Petitioners also claim that the only reason MGB was not in a better position to expand was that Southwest had effectively drained MGB of its profits. (Pet'rs Reply Br. at 3.) ("Respondents do not dispute that their constant upstreaming of profits to Southwest left MGB and its subsidiaries with insufficient funds to carry on their operations, much less expand.")

²³Trial Transcript at 942-43 (Meyer).

pre-merger stock prices represents a departure from the norm without demonstrated justification.

To summarize, Reilly's capital market approach must be rejected because it was not shown to be generally accepted in the financial community for bank valuation purposes. Clarke's comparative company valuation must be rejected because it was improperly applied in this specific case. Accordingly, the only valuation methodologies remaining to be considered are (i) Reilly's and Clarke's DCF valuations and (ii) Clarke's comparative acquisition analysis.

b. The Parties' DCF Analyses

The parties' competing DCF analyses raise three questions. First, were the so-called "key supplier dependence" and "litigation risks" a proper basis for determining Reilly's 18% discount factor, or were those risks contrived solely for litigation purposes? Second, was it appropriate for Clarke to determine a 1% small stock size premium based on the 1996 Ibbotson study that was specific to the banking industry? Third, what cash flow projection period (five or ten years), and what growth rate after the fifth year, are appropriate assumptions for a DCF valuation of MGB?

Specifically, the parties' DCF valuations differ with respect to: (i) how many years into the future cash flows should be projected (ten years versus five years), (ii)

what growth rate assumption after the fifth projection year is appropriate for MGB, (iii) should the Court credit the assumptions Sheshunoff made in valuing MGB in 1993, and (iv) what discount rate is appropriate for MGB. As more fully elaborated below, the Court finds it appropriate (a) to project future cash flows for a period of ten years into the future at a constant 4% growth rate, (b) to assign a high degree of reliability to Sheshunoff's remaining DCF assumptions (except for its minority discount), and (c) to accept neither Clarke's 12% discount rate nor Reilly's 18% discount rate.

The difference between Clarke's 12% discount rate and Reilly's 18% discount rate is attributable primarily to their different estimates of MGB's cost of equity capital, and their different assessments of the company specific risks confronting MGB at the time of the Merger. Reilly selected an equity risk premium based upon a 1992 Ibbotson study indicating that an appropriate small stock premium factor was 5.2%. Clarke relied on a 1996 Ibbotson study indicating that a premium of 1% was appropriate. The problem with the 1992 Ibbotson study was that it is not specific to the banking industry. The problem with the 1996 Ibbotson study is that although it was specific to the banking industry, the Petitioners have not shown that the data contained in that study (and relied upon by Clarke) was in existence as of the Merger date. The Court, therefore, is unable to accept the 1996

Ibbotson study, and the 12% discount rate derived therefrom.

Reilly's 18% discount rate is also flawed, however, because it rests on the unsupported assumption that at the time of the Merger, MGB was subject to certain material risks that required a steep discount of MGB's projected future cash flow. Reilly placed great emphasis upon MGB's dependence upon one key supplier and upon the pending litigation involving BYSIS, MGB's data process server as a basis to conclude that MGB involved abnormal business risk to a potential acquiror. The underlying evidence that these "risks" were material is unpersuasive. No document contemporaneous with the Merger shows that Southwest's or MGB's management or boards viewed these developments as material risks. Importantly, nowhere in its valuation report did Sheshunoff allude to those risks. That fact significantly diminishes the credibility of a Southwest employee's litigation-driven trial testimony that management viewed these risks as significant. Of considerable importance also is that Sheshunoff concluded that a 10% discount factor (2% lower than Clarke's) was appropriate, and management accepted that discount assumption. Accordingly, the Court concludes that Reilly's 18% discount rate is inappropriately high and not supported by the record.

The final major difference between the parties' DCF analyses is that Clarke projected ten years of future cash flows at a constant growth rate of 4% using many

of Sheshunoff's projections; whereas Reilly projected future cash flows for only five years, at a growth rate that decreased after the fifth year, using his (Reilly's) own projections. Sheshunoff used a ten year projection period for future cash flows, and assumed a constant rate of growth. Because Sheshunoff performed its valuation at the time of the Merger, without the benefit of hindsight and when no litigation was pending, and management accepted its assumptions, the Court accepts Sheshunoff's DCF assumptions (except for its minority discount) as more appropriate than Reilly's litigation-driven (and extremely conservative) assumptions.

Because neither side has supported certain key DCF valuation assumptions by a preponderance of persuasive evidence, the Court is unable to accept either Clarke's or Reilly's discounted cash flow valuations. That leaves Clarke's comparative acquisition approach, which the Court turns to next.

2. The "Control Premium" Question and the Validity of Clarke's Comparative Acquisition Approach

Having rejected Clarke's DCF and comparative company valuations, both of which involved directly adding a control premium to the values of MGB's two subsidiaries, the Court need not decide whether the direct addition of a premium is or is not mandated by Rapid-American. Nonetheless, the Court must address the control premium issue, but in a different context. That is, the Court must decide

whether Clarke's comparative acquisition valuation, in which a control premium is implicit, is proscribed by § 262. I conclude that it is not.

In Rapid American Corp. v. Harris,²⁴ the Delaware Supreme Court held that in valuing a holding company for § 262 appraisal purposes, it was appropriate to include a control premium as an element of the fair value of the majority-owned subsidiaries. The Court said:

Rapid was a parent company with a 100% ownership interest in three valuable subsidiaries. The trial court's decision to exclude the control premium at the corporate level practically discounted Rapid's entire inherent value. The exclusion of a "control premium" artificially and unrealistically treated Rapid as a minority shareholder. Contrary to Rapid's arguments, Delaware law compels the inclusion of a control premium under the unique facts of this case. Rapid's 100% ownership interest in its subsidiaries was clearly a "relevant" valuation factor and the trial court's rejection of the "control premium" implicitly placed a disproportionate emphasis on pure market value.²⁵

The Respondents argue that Rapid-American turned on the "unique fact" that its subsidiaries were involved in three different industries. I do not read Rapid-American to hold that that "unique" fact was in any way critical to the result. The Respondents' construction of that case is too narrow. What the Supreme Court ruled is that a holding company's ownership of a controlling interest in its

²⁴Del. Supr., 603 A.2d 796, 806-07 (1992).

²⁵Rapid-American, 603 A.2d at 806-07 (emphasis in original).

subsidiaries is an independent element of value that must be taken into account in determining a fair value for the parent company. Thus, the rationale of Rapid-American applies to MGB, and the Respondents have not shown otherwise.

The Respondents also challenge Clarke's comparative acquisition approach on a different basis. Pointing to the command in 8 Del. C. § 262(h) that fair value must be determined "exclusive of post-merger events or other possible business combinations," the Respondents urge that any valuation method that includes a control premium as an element of "fair value" necessarily represents post-merger synergies proscribed by § 262(h). I cannot agree. The (implicit) control premium at issue here is not the product of post-merger synergies. Rather, that control premium reflects an independent element of value existing at the time of the merger, flowing from the fact that the parent company owned a controlling interest in its subsidiaries at that point in time. Therefore, Clarke's comparative acquisition valuation cannot be invalidated on that basis either.

Because the Respondents have not challenged Clarke's comparative acquisition approach on any valid ground, and because the Court has rejected the parties' valuations based on their other methodologies, by process of elimination the only evidence of MGB's fair value is the \$85-per share Clarke arrived at by the comparative acquisition method. Having no other adjudicated basis to value MGB,

the Court would be justified in accepting \$85 per share as the fair value of MGB, and does so -- but not by default or uncritically.

The Court is mindful that \$85 per share is more than double the Merger price. The Court is also aware of its role under § 262, which is to determine fair value *independently*.²⁶ In discharging that institutional function as an independent appraiser, the Court should, where possible, test the soundness of its valuation conclusion against whatever reliable corroborative evidence the record contains. On that score the record falls far short of perfection. Limited corroborative evidence is available, however, in the form of Sheshunoff's 1993 fair market valuation, (i) adjusted by Clarke to exclude Sheshunoff's minority discount and (ii) updated by Clarke to reflect value data as of November 17, 1993, the date of the Merger.²⁷ When Sheshunoff's 1993 valuation is adjusted in that manner, the resulting value of MGB is \$48,504,664 or \$70.46 per share with no control premium. If (for purposes of illustration) a 20% control premium were added, the resulting value would be \$56,842,796.80 or \$82.57 per share; and if the premium were 35%, the resulting

²⁶Gonsalves v. Straight Arrow Publishers, Del. Supr., 701 A.2d 357 (1997).

²⁷The Sheshunoff valuation, as thus revised, is objective in the sense that Southwest's management accepted Sheshunoff's DCF projections, and Southwest's management accepted Sheshunoff's valuation as the basis for the Merger price.

value would be \$63,096,394.40, or \$91.66 per share.²⁸ The \$85 per share fair value based upon Clarke's comparative acquisition approach fits comfortably within that (hypothetical) range of values.

B. Interest

Next addressed are the appropriate rate of interest and compounding interval. Under § 262(h), this Court is empowered to award interest in an appraisal action at whatever rate (and compounding interval, where relevant) the Court deems equitable. Because MGB's cost of debt capital at that time was 8%, the Court finds that to be the appropriate interest rate. Because the legal rate of interest had risen to 10% as of the date of the trial, the Petitioners urge the Court to award them interest at that rate. The Court declines to do so.²⁹ A 10% interest rate might arguably be appropriate had the Court found undue delay on the Respondents' part, but there has been no undue delay here.

Whether or not to award simple or compound interest is a matter within the

²⁸PX 38 shows that the updated (to reflect information available as of the Merger date) and modified (to exclude a minority discount) valuation of MGB using Sheshunoff's methodology is \$70.66 per share, which when multiplied by MGB's 688,400 shares, yields \$48,504,664 as a total value for MGB. Subtracting the \$6,814,000 of other assets, multiplying the remaining value by 1.2 to include a 20% control premium, and then adding back the \$6,814,000 of other assets, yields a valuation of \$56,842,796.80, or \$82.57 per share. Using the same arithmetic, a 35% control premium would yield a value of \$63,096,394.40, or \$91.66 per share.

²⁹Although the Court does not rest its decision on that ground, it notes that the legal rate of interest as of the Merger date was also 8%.

Court's discretion. While it may be true, as the Respondents point out, that "[a]n award of compound post-judgment interest is the exception rather than the rule,"³⁰ in today's financial markets a prudent investor expects to receive a compound rate of interest on his investment. Therefore, it is equitable and realistic for the Court to award compound interest in this case.³¹

Turning to the compounding interval, the Petitioners argue that it should be monthly. The Respondents do not address the issue. Having been furnished no reason to do otherwise, the Court concludes that a monthly compounding interval is appropriate.

C. Fees and Expenses

Lastly, the Petitioners request an award of legal fees and expenses, but provide no meaningful support for that claim. In a single conclusory sentence in their opening brief, the Petitioners state: "[i]n addition, and on account of Respondents' evidenced bad faith (before, in connection with, and following the merger), Petitioners urge the Court to assess all of their reasonable costs and

³⁰Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 302; see also Ryan v. Tad's Enterprises, Inc., Del. Ch., C.A. 10229, Jacobs, V.C. (April 24, 1996) aff'd by Order, Del. Supr., 693 A.2d 1082 (1997) (stating that compound interest is also the exception and not the rule with respect to prejudgment interest).

³¹See Grimes v. Vitalink Communications Corp., Del. Ch., C.A. 12334, Chandler, C. (Aug. 28, 1997) (holding that a monthly compounding interval is appropriate to force the Respondent to give up his gain and to fully reimburse Petitioner).

expenses of the litigation, including attorneys' fees and expert fees, upon Respondents." In their Reply Brief, the Petitioners expand upon their bad faith claim by arguing that the Respondents sought to conceal MGB's fair value by "withdrawing Sheshunoff as their expert . . . keeping Mr. Campbell away from Court . . . proffering Mr. Reilly . . . and trumping up a story about litigation risks."³²

Without more evidence than these conclusory assertions, the Court is unable to conclude that the Respondents acted in bad faith. Accordingly, the Court rejects the Petitioners' request for fees and expenses.

IV. CONCLUSION

The parties shall confer and submit an appropriate form of order.

³²Pet'rs Reply Br. at 33.