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Reis v. Hazelett Strip-Casting Corp. DE Chancery Court opinion decided January 21, 2011 [Shareholders'dispute, Fair Value, DE minority anti-oppression statutes.]

Hazelett, founded in 1929, manufactures large strip-casting machines which sell for $16 million apiece and are used in heavy manufacturing operations; since each of its machines has a long economic life, the Company sells few machines annually, and relies on spare parts and the servicing of existing equipment for day-to-day revenues. The founder's 2 sons owned unequal stakes, the elder with 70%, the younger with 30%. When the younger brother died in 2002, he willed his shares to 162 people, mostly employees and former employees of the Company. This did not sit well with his older brother, who was intent on running the Company as a family-owned business as his father before him. In order to retain control, the older brother offered the estate $1,500 per share, a number he admittedly was not supported by appraisal or any other analysis, reflecting his distaste for non-family shareholders. In 2005, the board, itself under the control of the elder brother, voted to effect a reverse stock split. An appraiser was engaged, who opined that the fair value per share was $1,600. The board amended the Company's charter to complete the transaction, but failed to file the amendment until January, 2008. The reverse stock split was challenged in Delaware Court by the beneficiaries of the younger brother's will, alleging that the board had breached its fiduciary responsibility to the minority holders by not paying "fair value." Eventually, the Court decided that the effective date of the reverse split was January 2008.

The Court stated that the whole process had not been fair and that the "entire fairness standard" would apply, in addition to shifting the burden of proof to the defendant. Under Delaware law, there are three available standards: "business judgement rule", "enhanced scrutiny" and "entire fairness standard." That the highest standard was deemed appropriate in a reverse split without any procedural protection constitutes a precedent which is protective of minority owners.

The board engaged the earlier appraisal firm to update its opinion; it came in lower at $1,500; the plaintiffs, on the other hand, had commissioned an appraisal showing a value per share of $5,490. The plaintiffs had used a guideline public company approach, but comparable firms were substantially larger than Hazelett and the Court termed the approach "meaningless." The Court also rejected a capitalization of free cash flow because it required too many normalizing adjustments and only 2 years' results had been used to justify a "projection." In the eyes of the Court, capitalizing earnings was the most appropriate method, least of which because it was used as part of the "Delaware block" methodology - more on that later.

The defendant's appraiser had made no adjustment to the historical record and projected data was simply not available. The plaintiifs's appraiser had made adjustments, but some were deemed inconsistent with Delaware law. Accordingly, the court used the defendants' report as a starting point, making the following adjustments.

R&D costs: research expenses at the Company have historically copied the industry average; during the down-turn of 2007, however, the Company used the credit to pay salaries of furloughed employees, consistent with its policy not to layoff employees in down cycles. The plaintiffs' appraiser had added the cost to earnings; the court disagreed and reversed the credit, reasoning that only a control owner can make that change.

The Company incurred a number of costs under the general heading of management perks. While the plaintiff's appraisal report never termed management's compensation as either "at market" or not, the adjustments were approved by the Court.

Non-recurring sales of fixed assets and real estate were also deemed necessary adjustments.

The Court also adjusted the tax rate to a more "normal" 47%.

The discount rates of both experts, resulting from the application of the add-on method, also required adjustment by the Court: the plaintiffs used 18% and the defendant 21%. Because of what the Court called the "inherent danger" of overestimating the company-specific risk premium, and because it was not entirely convinced that calculated earnings reflected the economic substance of the Company, it dramatically reduced the company-specific premium to 2%, which was the plaintiff's. Thus the Court determined the discount rate at 17%.

The defendant's expert had estimated long term growth at 4.4% after a conversation with management. The plaintiffs had pegged growth at 4%. "Because the defendants' expert had better access to operations ..and more incentive to be conservative," the Court calculated the capitalization rate by subtracting the higher growth, resulting in a capitalization rate of 11.6%.

Capitalizing the six year weight-averaged earnings base by the capitalization rate returns $2.44 million, to which the Court added non-operating assets without deducting selling expenses. The Court did not add research and other tax credit simply because the plaintiffs' expert "did not ask for it." It also refused to allow a credit for the moneys already paid the plaintiff during the reverse split because the money had been paid out of a line of credit, not from Company cash. The Court indicated that it would have adjusted for the cost of that borrowing, but that the plaintiff's expert did not provide the information. The Court's calculation thus stood, at this point, at the equivalent of $3,175 per share.

The Court was still troubled by the fact that the Company's book value was $7.7 million or roughly twice the value calculated by the Court. Without providing any detail, the Court reasoned that management's "self-dealing" had been responsible for the discrepancy. In order to compensate for the perceived wrong, it weighted the above value 80% and the book value 20% and ordered the fair value to be $3,845 per share, or 2.4 times what the Company had paid.

In retrospect, the Court's reasoning is based on the composite "Delaware Block" method, which was the rule before *Weinberger* in 1983. For a capital intensive business with volatile earnings, tight family control and a balance sheet reminiscent of a family holding company, perhaps justice was done to the minority owners in this manner. The Court decision can be found at http://courts.delaware.gov/opinions/download.aspx?ID=149590 then download the file reis.pdf. The decision is also available at http://www.NYNJCT-BV.com/reisDE.pdf. Please do not hesitate to call or e-mail to discuss this or any other business valuation issue.

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