Unreported Cases

INTRODUCTION

UNREPORTED CASES is a continuing feature of THE DELAWARE JOURNAL OF CORPORATE LAW. All unreported cases of a corporate nature that have not been published by a reporter system will be included. The court's opinions are printed in their entirety, exactly as received.

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CEDE & CO. v. JRC ACQUISITION CORP.

No. 18,648-NC

Court of Chancery of the State of Delaware, New Castle

February 10, 2004

Joseph A. Rosenthal, Esquire, and Herbert W. Mondros, Esquire, of Rosenthal, Monhait, Gross & Goddess, P.A, Wilmington, Delaware; and Arthur N. Abbey, Esquire, and Joshua N. Rubin, Esquire, of Abbey Gardy, LLP, New York, New York, of counsel for petitioner.

Peter J. Walsh, Jr., Esquire, and Sarah E. DiLuzio, Esquire, of Potter Anderson & Corroon LLP, Wilmington, Delaware; and Michelle A. Coffey, Esquire, and Ari C. Burstein, Esquire, of Morgan, Lewis & Bockius LLP, New York, New York, of counsel, for respondents.

CHANDLER, *Chancellor*

This action, brought under 8 *Del. C.* § 262, seeks an appraisal of 652,400 shares of 800-JR Cigar, Inc. ("Respondent," "JR Cigar" or the "Company") held of record by Cede & Co. ("Petitioner" or "Cede") for the benefit of various investment funds. This Opinion determines the fair value of those shares, together with an appropriate rate of interest. For the reasons set forth in greater detail below, I conclude that the fair value of JR Cigar stock as of the merger date is $13.58 per share. The Company must pay Petitioner $8,859,592. In addition, I award Petitioner 4.73% interest on the principal, compounded monthly, from October 4, 2000 to the date of payment.

I. BACKGROUND

A. The Stipulated Facts

On August 29, 2000, pursuant to a merger agreement dated the day before, the Rothman family commenced an offer to purchase all shares of common stock of JR Cigar that they did not already own. The Rothmans, before the offer, owned 78% of the outstanding common shares of JR Cigar. After the offer closed on September 26, 2000, the Rothmans, through an acquisition corporation owned by them, beneficially owned over 90% of the outstanding shares of JR Cigar. Because the Rothmans owned

more than 90% of the outstanding shares following the offer, the merger was accomplished pursuant to 8 *Del. C.* § 253.[1] The merger became effective on October 4, 2000.

Under the merger agreement, each share of common stock outstanding immediately before the merger was converted into the right to receive $13.00 per share in cash. From before the offer commenced, through the effective date of the merger, Cede & Co. was the record owner, on behalf of the Royce family of funds, of 652,400 shares of JR Cigar. Petitioner complied with the provisions of 8 *Del. C.* § 262 and is entitled to a determination of the fair value of, and payment for, the JR Cigar shares it held as of the date the merger became effective.

The only issue in this case is the fair value of Petitioner's shares, together with the appropriate rate of interest. The matter was tried on October 15, 2003. There were only two live witnesses: Petitioner's expert and Respondent's expert. Testimony of Lewis Rothman, JR Cigar's President and CEO, was introduced by deposition designation.

B. The Experts

Cede's expert, Charles DeVinney, has his MBA in Finance, is Vice President of Curtis Financial Group, Inc., an Accredited Senior Appraiser, and a Chartered Financial Analyst. DeVinney is in the business of appraising companies. He used two methods to value JR Cigar. First, he looked at transactions comparable to the acquisition of JR Cigar. Based on these purportedly comparable transactions, DeVinney found that JR Cigar was worth $16.80 per share as of October 4, 2000, the date the merger became effective. Second, DeVinney performed a discounted cash flow ("DCF") analysis. His DCF analysis resulted in an estimated fair value of $19.80 per share. Placing equal weight on the two valuation methods, DeVinney opined that JR Cigar was worth between $16.80 and $19.80 per share.

JR Cigar's expert, Dr. Gregg Jarrell, is a Professor of Economics and Finance at the University of Rochester's William E. Simon Graduate School of Business. Jarrell holds a Ph.D. in Business Economics and was formerly the Chief Economist for the SEC. He teaches graduate courses in finance, is well-published, and has served as an expert witness in several valuation cases. In rendering his opinion, Jarrell relied principally on a DCF analysis, but he also conducted two market-based analyses to verify his DCF analysis. First, he performed what he referred to as a "market check,"

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[1]Section 253 allows an owner of 90% of a corporation to "cash-out" the minority.

which consisted of a determination of whether other reasonably *bona fide* offers were made for JR Cigar. Second, Jarrell conducted an analysis of the control premium in this case as compared to control premiums obtained in over 2,000 other deals during a five-year period. He concluded that the fair value of JR Cigar was $12.67 per share.

As noted, both experts testified at trial. Additionally, both experts prepared a report shortly before trial summarizing their valuation work. Those reports, along with numerous other documents, were introduced as exhibits at trial.[2]

II. LEGAL FRAMEWORK

Under 8 *Del. C.* § 262, dissenting stockholders are entitled to their *pro rata* share of the "fair value" of the corporation in which they held stock before the merger. "Accordingly, the Court of Chancery's task in an appraisal proceeding is to value what has been taken from the shareholder, *i.e.*, the proportionate interest in the going concern."[3] "The application of a discount to a shareholder is contrary to the requirement that the company be viewed as a 'going concern'."[4] But the valuation is "exclusive of any element of value arising from the accomplishment or expectation of the merger,"[5] although it may "encompass known elements of value" not the product of speculation.[6]

The corporation may be valued "by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."[7] In recent years, the DCF valuation methodology has featured prominently in this Court because it "is the approach that merits the greatest confidence" within the financial community.[8] In appropriate cases, this Court has relied exclusively on DCF models.[9] Regardless of the methodology, however, this Court prefers valuations based on management projections available as of the date of the

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[2]Ex. 65 (Expert Report of Gregg A. Jarrell); Ex. 66 (Expert Report of Charles M. Devinney).

[3]*Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996) (citing *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989).

[4]*Cavalier Oil Corp.*, 564 A.2d at 1145.

[5]8 *Del. C.* § 262(h).

[6]*Cede & Co.*, 684 A.2d at 299 (citing *Weinberger v. UOP*, 457 A.2d 701, 713 (Del. 1983)).

[7]*Weinberger*, 457 A.2d at 713.

[8]*Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 702 (Del. Ch. 1996), *aff'd*, 693 A.3d 1082 (Del. 1997) (TABLE).

[9]*See, e.g., Gilbert v. MPM Enterprises, Inc.*, 709 A.2d 663, 668 (Del. Ch. 1997), *aff'd*, 731 A.2d 790 (Del. 1999).

merger and holds a healthy skepticism for post-merger adjustments to management projections or the creation of new projections entirely. Expert valuations that disregard contemporaneous management projections are sometimes completely discounted.[10]

In this proceeding, "both sides have the burden of proving their respective valuation positions by a preponderance of the evidence."[11] If neither party satisfies its burden, however, the Court must use its own independent judgment to determine fair value.[12] The Court can reject the views of both experts.[13]

III. ANALYSIS

In this section, I evaluate the respective valuations of the parties' experts. I begin with DeVinney's comparable transactions analysis, turn to the dueling DCF models, assess Jarrell's "market checks," and then reach the Court's determination as to the fair value of JR Cigar as of October 4, 2000.

A. DeVinney 's Comparable Transactions Analysis

DeVinney used the comparable transactions found in Merrill Lynch's "Presentation to the Special Committee of the Board of Directors of Leaf."[14] A special committee of JR Cigar's Board of Directors retained Merrill Lynch to advise them in connection with the then-proposed merger, and it rendered a fairness opinion dated August 28, 2000.[15] "Merrill Lynch noted that nearly all of the Comparable Transactions represent the acquisition of control of the target company which may not be directly comparable to the acquisition of a minority stake of a target company, as in the Offer and the Merger."[16] Nonetheless, "Merrill Lynch determined a reference multiple range LTM [latest twelve months] EBITDA [earnings before interest, taxes, depreciation, and amoritization] for the Company of 6.0x to 7.5x, resulting in a reference range for an implied value per Share

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[10]*See, e.g., Taylor v. American Specialty Retailing Group*, 2003 WL 21753752, at *2 (Del. Ch. July 25, 2003) (disregarding expert opinion that did not use management projections); *Gray v. Cytokine Pharmasciences, Inc.*, 2002 WL 853549, *8 (Del. Ch. Apr. 25, 2002) (same).

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

[12]*Gonsalves v. Straight Arrow Publishers, Inc.*, 701 A.2d 357, 360-61 (Del. 1997).

[13]*Id.*

[14]Ex. 3. Leaf was the codename for JR Cigar.

[15]*Id.*; Ex. 1 (Offer to Purchase).

[16]Ex. 3.

of $12.00 to $15.50."[17] Merrill Lynch found that "the most comparable transaction," one involving Swisher International, "represents 6.2x LTM EBITDA or $12.00 per share."[18] The Swisher International transaction was the most comparable because, like the JR Cigar deal, it did not involve a change of control. But even that transaction, as well as all the other "comparable" transactions, involved companies that manufacture cigars and related products.[19] JR Cigar is not a manufacturer; it only sells cigars, cigarettes, and related products.[20]

DeVinney looked at the same set of transactions as Merrill Lynch, but altered their calculations in one significant respect. One of the transactions reviewed by Merrill Lynch was Swedish Match's acquisition of General Cigar. Merrill Lynch calculated the LTM EBITDA multiple in that transaction at 10.4x. DeVinney calculated the multiple at 12.8x because he included EBITDA of General Cigar for a 13-week period ending after the transaction was announced. During this period, General Cigar's EBITDA declined, which has the effect of inflating the transaction multiple. I cannot discern any principled basis for this alteration of General Cigar's EBITDA. As DeVinney admitted on cross-examination, Swedish Match did not use the post-transaction EBITDA data in arriving at its offer price.[21] Moreover, Merrill Lynch did not use the post-transaction EBITDA data, even though it advised Swedish Match on the transaction and had "expertise in evaluating similar transactions."[22]

Moreover, contrary to DeVinney's expert report,[23] the Swedish Match transaction is not comparable to the transaction in this case. Swedish Match's acquisition of General Cigar was, unlike the going private merger here, a strategic acquisition.[24] The synergistic nature of the deal accounts for some of the premium, which DeVinney conceded on cross-examination.[25] Additionally, Swedish Match was acquiring 64% of the equity of General Cigar. Again, DeVinney testified on cross-examination

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[17]*Id.* at JRC 0325. Only some exhibits are Bates numbered. Where possible, I cite to a specific page of an exhibit by referencing its Bates number. In some circumstances, however, I must cite to whatever pagination is found in the exhibit.

[18]*Id.*

[19]Tr. at 136 (DeVinney Cross).

[20]Ex. 27 (800-JR Cigar, Inc. Form 10-K filed with the SEC for the year ended December 31, 1998) at Item 1.

[21]Tr. at 143-44.

[22]Ex. 43 (General Cigar Holding Inc. Amendment No. 2 to Schedule 14A) at 25.

[23]Ex. 66 at 17 n.11.

[24]Ex. 43 at 32.

[25]Tr. at 139:16-17 ("It would probably explain some of the premium."). *See also* Ex. 43 at 20 (describing Swedish Match transaction as a strategic acquisition).

that this "may explain some of the premium."[26] Merrill Lynch, also Swedish Match's advisor, determined that the transaction in that case was not the most comparable to the JR Cigar merger. Merrill Lynch's opinion was that the Swisher International transaction was the most comparable.[27] The Swisher transaction multiple was 6.2x, less than half of the "adjusted" multiple DeVinney derived for the Swedish Match transaction.[28]

The problems identified above render DeVinney's comparable transactions analysis unreliable. Most of these errors were exposed on cross-examination, as he was unable to fully defend his methodology. Witnessing DeVinney's testimony first-hand convinces me once again that "no substitute has ever been found for cross-examination as a means of . . . reducing exaggerated statements to their true dimensions."[29]

B. Discounted Cash Flow Analysis of DeVinney and Jarrell

The DCF method estimates the value of a business such as JR Cigar based on projected future free cash flows that are discounted to present value. Based on a DCF analysis, DeVinney concluded that the fair value of JR Cigar was $19.80 per share. Jarrell, using the same basic DCF methodology, concluded that the range of fair value of JR Cigar was from $11.76 to $13.58 per share. By way of comparison, Merrill Lynch performed a DCF analysis in connection with its fairness opinion that produced a reference range for an implied value per share of $9.49 to $12.63.[30]

The parties agree that most of the difference between the experts' DCF calculations is the result of four variables: (1) JR Cigar's estimated growth rate in perpetuity; (2) the Company's debt-to-equity ratio; (3) the *Ibbotson* equity size premium applied in the capital asset pricing model (CAPM); and (4) JR Cigar's tax rate.[31] The latter three factors collectively contribute to JR Cigar's weighted average cost of capital (WACC), which is used to discount future cash flows. I will discuss each variable in turn.

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[26]Tr. at 142:19.

[27]Ex. 3 at JRC 0325.

[28]Ex. 66 at 17. The wide divergence in transaction multiples is troubling because it violates the law of one price, which holds that in a well-informed and efficient market, similar assets should sell for similar prices, adjusting for scale. *See* BRADFORD CORNELL, CORPORATION VALUATION: TOOLS FOR EFFECTIVE APPRAISAL AND DECISION MAKING 56-57 (1993); Tr. at 229-30 (Jarrell Direct). It is notable that Jarrell raised this issue before knowing that DeVinney would use a comparable transactions analysis. Ex. 65 at 29-31.

[29]FRANCIS L. WELLMAN, THE ART OF CROSS-EXAMINATION 7 (4th rev. ed. 1948).

[30]Ex. 3 at JRC 0312.

[31]Petitioner's Opening Brief ("OB") at 7-8; Respondent's Answering Brief ("AB") at 14.

1. Growth Rate in Perpetuity

In a DCF valuation, the cash flow is projected for each year into the future for a period of years, typically five. After that point, one uses a single value representing all subsequent cash flows to calculate a company's terminal value. The terminal value may be determined by using multiples from comparable transactions, referred to as an exit multiple, or may be ascertained by assuming a constant growth rate after the initial five year forecast period, *i.e.*, the growth rate in perpetuity. The terminal value calculation is critical here because it represents well over half of JR Cigar's total estimated present value.[32]

Jarrell used the perpetuity growth approach and computed a range of values based on growth rates of 2.5% to 3.5%, rates equal to or exceeding the long-term rate of inflation.[33] DeVinney used both the comparable transactions approach and the perpetuity growth approach to calculate JR Cigar's terminal value. DeVinney used the multiple of 8.5x (ascertained in his comparable transaction analysis) and applied that multiple to JR Cigar's estimated 2004 EBITDA. DeVinney also used a perpetuity growth rate of 5%.[34] DeVinney opined that each method of calculating terminal value is equally appropriate and averaged the two indications of value.

Regardless of whether ascertaining a company's terminal value by applying a transaction multiple is appropriate as a matter of finance theory, I have already determined that the 8.5x multiple derived by DeVinney is unreliable and should not be used in any DCF analysis. As such, in determining the terminal value of JR Cigar, the analysis is necessarily limited to the appropriate perpetual growth rate. DeVinney on cross-examination agreed that this was the appropriate route if the Court concluded that his comparable transaction analysis was not valid.[35]

Although DeVinney's report is silent as to the rationale for using a 5% growth rate into perpetuity, at trial he indicated reliance on a document prepared by Fleet Bank, N.A.[36] DeVinney testified on direct examination that "it appears that there were management projections provided to Fleet that utilized a five percent growth rate through 2009."[37] The document at issue does in fact show 5% growth from 2000 through 2009 and includes small type in the lower left that reads "Management Case." Jarrell testified,

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[32]*See* Ex. 66 at Ex. B (DCF worksheet); Ex. 65 at Ex. 4 (same).

[33]Ex. 65 at 20.

[34]Ex. 66 at 25.

[35]Tr. 165:8-14.

[36]Ex. 24 (Fleet Credit Offering Memorandum). Fleet provided part of a $55 million loan to finance the merger. Ex. 1 at 38.

[37]Tr. at 60:14-16.

however, that upon conversation with JR Cigar's CFO Michael Colleton, he understood that JR Cigar had not prepared projections beyond five years.[38] Moreover, he testified that it appeared from the face of the document that Fleet merely extrapolated upon management's five-year projections.[39] This conclusion is sustainable given that only five-year projections are shown in another portion of the document that discusses the "Management Case."[40]

Petitioner is anxious to have the Fleet document characterized as a "management projection" because of the Court's preference for such projections. After reviewing the document and after considering the testimony of both experts, however, I cannot conclude with confidence that the projections in the Fleet document for the years 2004 to 2009 are actually "management projections." Petitioner attempts to create the inference that the later year projections were management's with several novel arguments that, to be candid, are mostly sophistry. The bottom line is that nothing in the document states affirmatively that JR Cigar provided Fleet with ten-year projections *and* Colleton stated that this was because JR Cigar did not give Fleet such projections.

Because I cannot safely conclude that management projected growth of 5% after 2004 does not mean that calculating JR Cigar's terminal value based on such a growth rate is inaccurate. Nor does it mean, presumptively, that Jarrell's lower perpetual growth rate of 2.5% to 3.5% is accurate. The lack of definite, long-term management projections simply means that the experts, and ultimately this Court, must ascertain some independently justifiable growth rate with which to calculate JR Cigar's terminal value.

In Jarrell's opinion, JR Cigar's likely growth rate in the long-term was only at or slightly above the rate of inflation.[41] Jarrell based this opinion initially on the fact that the management forecasted growth rate of 5% for 2000 to 2004 was modest and that it is "quite common and normal

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[38]Tr. at 261-62. Petitioner urges the Court to be skeptical of Colleton's recollections on this and certain other matters citing *Taylor*, 2003 WL 21753752, at *2, and *Gray*, 2002 WL 853549, at *8, without elaboration. These cases, if anything, support the Court's reliance on the information Colleton provided to Jarrell because in both of those cases the Court held that an expert's opinion was unreliable because it disregarded information prepared by management in favor of projections that the expert prepared on his own. In this case Respondent's expert sought the input of management. Petitioner's expert is the one that had the opportunity to seek information from management, but declined the opportunity. Tr. at 130-31. Additionally, DeVinney did not speak to any industry analysts, Merrill Lynch, or First Union, even though he is admittedly unfamiliar with the industry in which JR Cigar operates. *Id.*

[39]Tr. at 261-62.

[40]Ex. 24 at 18-19.

[41]Ex. 65 at 20; Tr. 216-18.

in discounted cash flow analysis to observe a higher growth rate in the forecast period than in the perpetuity period."[42] Jarrell buttressed this opinion with empirical and contemporaneous evidence that sales of JR Cigar's two main products, cigars and cigarettes, were on the decline.[43] Merrill Lynch's presentation to JR Cigar shows that sales of premium cigars were on the decline.[44] Rothman testified in his deposition that sales of premium cigars were on the decline.[45] And since the early 1980s, there has been a "steep and steady" decline in the domestic consumption of cigarettes.[46] Based on the foregoing, Jarrell testified that it was "conservative on behalf of the petitioners, to assume that over the long haul after 2004 that this company's sales, dollar sales, will keep up with the inflation rate."[47]

In support of using a 5% perpetual growth rate, Petitioner turns back to the Fleet document. In that document, prepared as part of a credit offering, Fleet notes JR Cigar's impressive pre-2000 results and that "the U.S. cigar market [was] expected to grow by 2.0% to 5.0% in the medium to long term."[48] Additionally, in his deposition, Rothman noted that, although cigar prices were declining, JR Cigar's revenues grew by 10.6% in 1999 and that the Company increased its market share.[49] Perhaps realizing that JR Cigar's performance before 2000 was no indication of growth beyond the year 2004, especially given the declining state of the domestic market, Petitioner offered a couple of other rationales for a 5% perpetual growth rate. First, DeVinney testified that JR Cigar could eliminate competitors in a declining market due to its advantageous distribution systems.[50] Second, Petitioner hypothesized that JR Cigar could have seized upon international sales, sales over the internet, and sales in

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[42]Tr. at 216-17.

[43]Ex. 65 at 13-15.

[44]Ex. 3 at JRC 0292.

[45]Deposition of Lewis Rothman ("Rothman Dep.") at 50-51.

[46]Ex. 67 (Report of Congress: U.S. Tobacco Production, Consumption, and Export Trends). Petitioner objected at trial to the use of this evidence by Respondent because the document is dated June 3, 2003, but this post-merger data is admissible because the declining domestic consumption of cigarettes was "known or susceptible of proof as of the date of the merger and not the product of speculation." *Weinberger*, 457 A.2d at 713.

[47]Tr. at 217:22-218:1.

[48]Ex. 24 at 4. I am not sure where Fleet finds support for the assertion that the cigar market will grow by 5% since Merrill Lynch, with its history of advising clients in the cigar industry, reached a different conclusion, as did Rothman and the Congressional Research Service. Moreover, there is no indication in the Fleet document that this reference refers to periods after 2004. It could easily refer to management's five-year projections.

[49]Rothman Dep. at 80:18-24; 221:20-222:5.

[50]Tr. at 17-18.

non-tobacco related products to grow at 5% in perpetuity in spite of a declining domestic market.[51]

As to international expansion, there is simply no record support for this theory. It is the product of speculation. As to the sale of non-tobacco related products, again, there is no record support that JR Cigar had any plans to enhance revenue in this fashion. In fact, JR Cigar's already minimal sales of fragrances and other merchandise declined in 2000 from the previous year.[52]

The most compelling rationale offered by Petitioner for JR Cigar's ability to maintain growth at 5% is through the elimination of competitors. This rationale has some historical support. Rothman testified that JR Cigar increased revenues and market share in the late 1990s even though the tobacco market was beginning to contract.[53] Notwithstanding Rothman's testimony, there is no persuasive evidence that JR Cigar's ability to sustain growth in the face of an initial market decline would have translated into long-term growth prospects. Increased market share could explain the 5% growth forecasted by management in years 2000 to 2004, but it does not follow that JR Cigar would grow by 5% per year into perpetuity. Additionally, increasing market share when the market is declining overall is not a recipe for growth: half of two is one, but all of one is still one.

The problem with ascertaining a growth rate in perpetuity is that it is an inherently speculative enterprise. Jarrell, under questioning by the Court, was refreshingly candid when he stated: "Who knows what the growth rate in perpetuity is going to be. It's a judgment call."[54] The experts, and ultimately the Court, are asked to surmise what rate a company will grow at five years into the future. This is hardly an exact science. In this type of circumstance it is difficult (if not impossible) for litigants to "prov[e] their respective valuation positions by a preponderance of the evidence."[55] Nevertheless, the Court must assess whether one expert's judgment is more defensible than the other. And, on this record, it appears that Jarrell's judgment that JR Cigar's growth rate in perpetuity is at or slightly above the rate of inflation is more credible. Jarrell used a range of 2.5% (roughly equal to the long-term rate of inflation in 2000) to 3.5% in his DCF analysis.[56] In my opinion, the upper end of that range is appropriate and fair. Using a rate of 3.5% accounts for the possibility,

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[51]*See* Ex. 67 at 26-29 (international market); OB at 10-11 (citing exhibits related to internet sales); Tr. at 17-18 (internet sales); Tr. 170-71 (non-tobacco products).

[52]Ex. 3 at JRC 0295.

[53]Rothman Dep. at 80:18-24, 222:20-222:5.

[54]Tr. 260:12-13.

[55]*M.G. Bancorporation*, 737 A.2d at 520.

[56]Ex. 65 at 20.

however marginal, that JR Cigar may be able to expand in an otherwise declining domestic market for cigars and cigarettes.

2. Debt-to-Equity Ratio

Under a DCF analysis, JR Cigar's future cash flows must be discounted to present value. DeVinney and Jarrell based their discount rates on the weighted average cost of capital ("WACC") methodology. DeVinney explained WACC quite concisely at trial: "It's the cost of equity times the percentage of equity in the capital structure plus the cost of debt times that percentage of debt."[57] The parties dispute the "percentage of debt" part of this equation, primarily because the more weight one gives to debt, the lower the discount rate and the higher the valuation.[58] Petitioner argues that the appropriate percentage of debt to ascribe to JR Cigar is 25%. Respondent urges a debt percentage of 10% or less.

Respondent's position that 10% debt is appropriate is based on three factors. First, before the merger, JR Cigar had no debt.[59] Second, Jarrell testified that at the time of the transaction JR Cigar did not anticipate any large capital expenditures and that management believed that the Company optimally was run with minimal debt.[60] Third, Jarrell noted that the only other publicly-traded retail cigar company operated with no debt.[61]

Petitioner's support for 25% debt-allocation is based on four factors. First, Petitioner points to JR Cigar's pre-IPO capital structure, which was approximately 17% debt.[62] Second, DeVinney opined that 25% debt was similar to that of comparable companies.[63] Third, Petitioner argues that JR Cigar had expansion opportunities that would require additional capital. And, fourth, Petitioner notes that JR Cigar borrowed $55 million for the merger.[64]

Reviewing the record and submissions by the parties, I am convinced that the appropriate percentage of debt for the WACC calculation is 10%. The pre-IPO structure is not indicative of JR Cigar's going-forward capital structure precisely because it was "pre-IPO." The IPO was in 1997, three

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[57]Tr. 64:24-65:4.

[58]Tr. at 164 (DeVinney Cross).

[59]Ex. 65 at 18.

[60]Tr. 200-01. As noted earlier, I am unmoved by concerns regarding Jarrell's discussions with JR Cigar's CFO, especially where, as here, DeVinney conceded on cross-examination that Colleton would have a better understanding of JR Cigar's optimal capital structure than he did. Tr. at 163-64.

[61]Tr. at 215.

[62]Ex. 71 (800-JR Cigar, Inc. Common Stock - Prospectus date June 6, 1997) at 20.

[63]Tr. 66:12-23.

[64]Ex. 1 at 38.

years before the valuation date, and the IPO was used to reduce JR Cigar's debt.[65] Moreover, the comparable companies relied upon by Petitioner are not comparable. The companies used as reference points by DeVinney are manufacturing companies, not retailers. DeVinney conceded on cross-examination that the capital structure of those companies "would be different most likely."[66] As noted above, the only other publicly-traded retail cigar company had no debt. Finally, although I agree that JR Cigar may have pursued expansion opportunities, no evidence exists to suggest that those opportunities would have required such debt as to justify a 25% capital allocation, especially since management did not plan on incurring significant debt and since the Company already had over $13 million in cash and equivalents as of June 30, 2000.[67]

Petitioner's final justification for a 25% debt allocation is that JR Cigar incurred $55 million of debt to finance the merger. Petitioner's argument is that "[t]he merger did not enhance JR Cigar's ability to borrow; therefore valuing it based on its optimal capital structure instead of its actual capital structure does not contravene, but instead comports with, 8 *Del. C.* 262(h)."[68] Although Petitioner cites to *ONTI, Inc. v. Integra* Bank,[69] that case does not support Petitioner's argument. In *ONTI*, this Court decided that certain transactions that affected the valuation were "not the product of speculation" and were in place at the time of the merger, "as Cede requires."[70] Nothing in *ONTI* supports the position the merger itself, in this case the debt incurred because of the merger, can be included as an element of value. Petitioner's consideration of such debt contravenes the valuation statute's command to appraise shares "exclusive of any element of value arising from the accomplishment or expectation of the merger."[71] Additionally, the fact that the merger did not enhance JR Cigar's ability to borrow does not condone ignoring its actual capital structure in favor of some "optimal capital structure." In *In re Radiology Assocs., Inc.*,[72] the petitioner argued that the respondent's debt to equity ratio should mimic the overall industry's debt-to-equity ratio because it was more efficacious than the respondent's actual debt-to-equity ratio. The Court dismissed this

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[65]Ex. 71 at 5 (discussion regarding "Use of Proceeds").

[66]Tr. at 163:6.

[67]Tr. at 200-01; Ex 65 at 18.

[68]Petitioner's Reply Brief ("RB") at 8.

[69]751 A.2d 904, 910-11 (Del. Ch. 1999).

[70]*Id.* at 910.

[71]8 *Del. C.* 262(h). Simply because the merger did not enhance JR Cigar's ability to borrow does not mean that the debt is not an "element of value" under the statute. The fact that the debt was incurred is itself the "element of value."

[72]611 A.2d 485 (Del. Ch. 1991).

effort because an appraisal proceeding does "not attempt[] to determine the potential maximum value of the company."[73] I must value JR Cigar, "not some theoretical company."[74]

JR Cigar had no debt before the merger. Petitioner has introduced no evidence of non-speculative plans to incur significant debt that is not due to the accomplishment of the merger. Therefore, a capital structure of 25% debt is not appropriate. A debt ratio of 10% is, however, reasonable and accounts for the probability that JR Cigar may seek to incur limited debt to pursue expansion opportunities.

3. *Ibbotson* Equity Size Premium

The parties also disagree about another component of the WACC formula—the cost of equity. A standard method of ascertaining the cost of equity is CAPM. CAPM is based on the premise that the expected return of a security equals the rate on a risk-free security plus a risk premium. Under CAPM the cost of equity is equal to the risk-free rate (the yield on 20 year Treasury bonds) plus a large company equity risk premium multiplied by the specific company adjusted beta for JR Cigar. Added to this figure is an equity size premium. An equity size premium is added because smaller companies have higher returns on average than larger ones,[75] *i.e.*, small companies have a higher cost of equity. The equity size premium for all sized companies is published by Ibbotson Associates.

Both experts used CAPM to derive JR Cigar's cost of equity, but applied different equity size premiums. Both used a chart published in *Ibbotson* to find the premium.[76] The Ibbotson chart indicates that the size premium for companies with capitalization between $192 and $840 million is 1.1%, the "low-cap" category. The premium is 2.6% for companies with capitalization below $192 million, the "micro-cap" category. DeVinney added an equity size premium of 1.1%, while Jarrell added 2.6%. Jarrell placed JR Cigar in the micro-cap category because its market capitalization, based on the traded price of the stock before the announcement of the merger (or based on the merger price), was well below $192 million.[77] On the other hand, DeVinney placed JR Cigar in the low-cap category because he "determined that the value, the market capitalization, should be more at

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[73] *Id.* at 493.

[74] *Id.*

[75] IBBOTSON ASSOCIATES, IBBOTSON, STOCKS, BONDS, BILLS AND INFLATION: VALUATION EDITION 2001 YEARBOOK 107 (2001) ("Ibbotson").

[76] *Id.* at 244.

[77] Tr. at 210-11.

the fair value implied market capitalization."[78] DeVinney made this determination because the stock price was, in his opinion, depressed.[79]

Respondent argues that basing the equity size premium on JR Cigar's implied fair value contravenes finance theory. When asked on cross-examination if the *Ibbotson* text suggested that his methodology was sound, DeVinney answered in the negative.[80] Jarrell testified that implying the fair value, rather than using a market measurement, is somewhat circular because the whole purpose of the DCF analysis is to ascertain JR Cigar's fair value.[81] Additionally, Jarrell testified that the *Ibbotson* data already incorporates illiquidity and depressed values since it is derived exclusively from traded stock prices.[82] Although one valuation textbook suggests that simply estimating the market value of the equity is appropriate for some WACC calculations,[83] it does not state whether it is appropriate to imply a fair value to determine the equity size premium, a number derived from actual market prices.

Regardless of whether or not adjusting the equity size premium based on implied fair value is appropriate in some circumstances, I ultimately determine that the record in this case does not support DeVinney's methodology. According to Petitioner, JR Cigar's stock was depressed because Rothman held an abnormally large majority position and because the minority portion of the stock was very illiquid. In order for Petitioner's argument to stand, JR Cigar's stock would have needed to be depressed by over five dollars per share—over half its value.[84] Petitioner cites to two First Union presentations as support for this positions.[85] These documents reveal that First Union believed JR Cigar's shares were discounted in the public markets because of Respondent's "[s]mall public float,"[86] i.e., the number of shares available for trading, "[s]ignificant inside ownership,"[87] and "[l]ack of research coverage."[88] But the same documents indicate that the stock was also depressed because of JR Cigar's small

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[78]Tr. at 91:8-10. In other words, DeVinney thought the Company was worth more than the market thought it was worth.

[79]Tr. at 91-92.

[80]Tr. at 151-52.

[81]Tr. at 207-208..

[82]*Id.*

[83]*See, e.g.*, Cornell, *supra* note 28, at 224-25 (suggesting iterative process for estimating equity weight).

[84]The low-cap grouping where DeVinney placed JR Cigar is reserved for companies with a market capitalization of $192 million, "implying" a "fair value" of over $15.50 per share.

[85]Ex. 41 (First Union Securities, Inc. Materials for Discussion dated Jan. 1, 2000); Ex. 70 (First Union - Materials for Discussion dated Jan. 11, 1999).

[86]Ex. 70 at 33.

[87]Ex. 41 at 10.

[88]Ex. 70 at 33.

market capitalization[89] and " [n]egative public, legal and governmental sentiment toward tobacco"[90] These documents offer mixed support for the position that JR Cigar's stock was significantly depressed because they do not quantify the extent to which the stock was depressed by illiquidity as opposed to generalized industry factors. The sour state of the tobacco market would undoubtedly depress JR Cigar's stock price, but would also depress JR Cigar's fair value.

The failure to isolate the specific impact of JR Cigar's illiquidity on its stock price undermines Petitioner's analysis. The illiquidity of a particular security is usually measured by the size of the bid/ask spread.[91] In general, the lower the liquidity, the higher the bid/ask spread. And when the spread is higher, the "discount" to a firm's fundamental value increases. Petitioner introduced no evidence regarding JR Cigar's bid/ask spread. The only evidence introduced related to JR Cigar's trading volume. That evidence shows that 7.9 million shares of JR Cigar were traded during the 12 months preceding the announcement of the merger—more than double the number of shares not controlled by Rothman.[92] During this period, JR Cigar's stock price never rose above $12.75 per share—well within the *Ibbotson* micro-cap category.[93]

Even assuming that JR Cigar's stock price was depressed because of its illiquidity, Petitioner cannot justify categorizing JR Cigar as a low-cap, rather than micro-cap, company (for the purposes of CAPM) based on this fact. CAPM identifies the expected return on a particular security, an expected return that is inputted into the WACC and used to discount JR Cigar's future cash flows to present value. The *Ibbotson* size premium number reflects the empirical evidence that smaller firms have higher returns than larger firms. Petitioner's position that JR Cigar is a low-cap company (rather than a micro-cap company) decreases the expected rate of return on JR Cigar's stock by lowering the "size premium" applied. The problem with using liquidity as a basis for justifying a lower expected return, however, is that low liquidity is associated with higher expected returns. Investors seek compensation for the high transaction costs of illiquid securities, *e.g.*, the bid/ask spread. In other words, even if JR Cigar had a higher market capitalization than the market price of its stock suggested because of its *illiquidity*, investors would still expect higher returns *because of its illiquidity*.

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[89]Ex. 41 at 10.

[90]*Id. See also* Ex. 3 at 4 (stock prices in tobacco industry depressed).

[91]Ibbotson, *supra* note 77, at 134.

[92]Ex. 10 (Stock prices and volume for 800-JR Cigar, Inc., Stand and Poor's 500 Index and the Standard and Poor's 600 Small Cap. Index from June 25, 1997 through October 5, 2000).

[93]*Id.*

Petitioner also seeks to justify the categorization of JR Cigar as a low-cap company based on its beta. A company's beta is the measure of its volatility in relation to the overall market, in this case the S&P 500. Petitioner's argument is that JR Cigar's adjusted beta, calculated by DeVinney at .62, is much lower than the betas of the other companies in its *Ibbotson* micro-cap group.[94] This argument is unavailing for several reasons. First, there is no evidence that DeVinney categorized JR Cigar as a low-cap company based on its low beta. DeVinney only testified that he thought that JR Cigar's stock was "depressed."[95] Second, Petitioner did not introduce evidence that JR Cigar's beta is outside the ranges of betas for the micro-cap category. Lastly, the size premium is not dependent on the beta of the firm. In fact, it is because the beta does not capture all the systemic risk that a size premium is included. "[E]ven after adjusting for the systematic (beta) risk of small stocks, they outperform large stocks."[96]

4. Tax Rate

Petitioner argues that JR Cigar's tax rate is 36%. DeVinney arrived at this figure after reviewing JR Cigar's income statement contained in Merrill Lynch's August 28, 2000 presentation to the JR Cigar Board.[97] The income statement does not actually list JR Cigar's tax rate, but the rate used by Merrill Lynch can be deduced by calculating the difference between the yearly EBIT and net income figures over the historical and forecast period. Merrill Lynch's figures imply a tax rate near the 36% rate used by DeVinney.[98] The August 28, 2000 presentation, as well as other documents,[99] indicate that Merrill Lynch's income statement was based on management forecasts and estimates. It is unclear from the face of these documents, however, what exactly JR Cigar management provided to

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[94]DeVinney calculated a beta of .62 based on a period beginning six months after JR Cigar's IPO. Tr. at 84-85. Jarrell calculated a beta of .67 based on a period beginning a week after the IPO. *Id.* Neither period is presumptively valid. A longer period of time, such as the period used by Jarrell, is generally preferred. A five-year period, longer than the period used by either expert, is the most common. SHANNON P. PRATT, COST OF CAPITAL: ESTIMATIONS AND APPLICATIONS 82 (2d ed. 2002). Petitioner's argument that the stock should be given time to "season" after an IPO is understandable, but I am unsure why this takes six months.

[95]Tr. at 91-92.

[96]Ibbotson, *supra* note 77, at 44. Separately, Petitioner suggests that JR Cigar's raw beta is more appropriate than the adjusted beta. Petitioner's own expert did not use the raw beta, probably because doing so is inaccurate. Betas based on observed historical data are more representative of future expectations when they are adjusted. Pratt, *supra* note 96, at 89.

[97]Ex. 3 at JRC 0306.

[98]The average tax rate for all eight years shown on the income statement is over 37%. *Id.*

[99]Ex. 1 at 11.

Merrill Lynch. Merrill Lynch's due diligence request list does not show that Merrill Lynch ever asked for JR Cigar's effective tax rate.[100] No evidence indicates that Merrill Lynch ever received such information.

Even if management did provide Merrill Lynch with information regarding its effective tax rate, the presentation upon which Petitioner relies does not imply that management gave Merrill Lynch the 36% figure that DeVinney used for his calculations. A colloquy between DeVinney and Respondent's counsel on cross-examination demonstrated that the Merrill Lynch presentation may have included other items in JR Cigar's net income, resulting in an implied tax rate lower than the actual tax rate.[101] DeVinney could have made some inquiry, but did not speak to anybody at Merrill Lynch or JR Cigar to identify the actual effective tax rate.[102]

Fortunately, the Court does not need to engage in guesswork to determine JR Cigar's tax rate. Note 6 to JR Cigar's financial statements in its 1999 Annual Report explicitly states that the tax rate was 40.9% in 1997, 40.1% in 1998, and 40.2% in 1999.[103] This information came from management.[104] Nothing indicates that management understood that the 40% tax rate would decline.[105] JR Cigar's CFO indicated that the tax rate was 40% and, generally, 40% is a common tax rate to use.[106] At the end, JR Cigar's historical tax rate published in its annual report is more reliable than speculation regarding Merrill Lynch's analysis.

5. Reconciling the Differences in the DCF Analyses

The parties anticipated that the validity of the DCF calculations would hinge on the four differing assumptions examined above. Respondent introduced a demonstrative exhibit at trial that purported to recast DeVinney's DCF analysis by integrating Jarrell's assumptions.[107] Respondent, for example, introduced a demonstrative exhibit that showed the impact that changing the tax rate had on DeVinney's DCF calculations.[108] According to Respondent, changing the four variables discussed at length in this section has the effect of reducing DeVinney's

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[100]Ex. 37 (Project Leaf Due Diligence Request List dated July 12, 2000).
[101]Tr. at 158:11-24.
[102]Tr. at 131-32.
[103]Ex. 45 at 17-18.
[104]Tr. at 154-56 (DeVinney Cross).
[105]Tr. at 159.
[106]Tr. at 211-12.
[107]Ex. 77.
[108]*Id.*, Chart A.

imputed fair value by $9.95 per share.[109] In its opening brief, Petitioner took issue with these calculations and stated that the composite effect of the four variables is to decrease DeVinney's DCF value per share by $8.03.[110] In other words, the parties put Jarrell's assumptions into DeVinney's model and came up with *two different values*.[111]

Failing to adhere to elementary principles and to "show your work," the Court was unable to ascertain the nature of the $1.92 (the difference between $9.95 and $8.03) discrepancy. Nonetheless curious as to why the DCF estimates were off by almost two dollars per share, I sought the parties input on this issue.[112] The parties' responses were less than satisfactory as they largely regurgitated exhibits already submitted at trial. Although Respondent was able to ascertain some of the discrepancy, it was ultimately unable to reconcile $0.69 per share difference.[113] Despite having the benefit of Respondent's submission, Petitioner was unable to explain the reason for *any* of the discrepancy.[114] As such, insufficient evidence has been presented to enable the Court to integrate Jarrell's assumptions (those largely accepted by the Court) into DeVinney's DCF model.[115] Consequently, the Court must rely on Jarrell's DCF model exclusively.

C. Jarrell's Market-Based Analysis

1. Measurement of Control Premiums

Jarrell, in addition to his DCF analysis, looked at how the premium paid in the JR Cigar merger compared with control premiums paid in 2,077 deals between January 1995 and August 2000.[116] For that sample, the median one-day control premium was 25% and the mean one-day control premium was 30.4%. Isolating the 31 mergers out of 2,077 where the buyer

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[109] *Id.*, Chart E.

[110] OB at 25. These estimates do not assume the use of an exit multiple in the DCF calculation, as I have determined that the exit multiple used by DeVinney is unreliable.

[111] This discrepancy is in addition to the fact that Jarrell's model generates a fair value per share that is different from using his assumptions in DeVinney's model.

[112] Letter from Chandler, C. to Counsel of 1/2/04.

[113] Letter from Walsh to Chandler, C. of 1/12/04, at 2. It is notable that some $0.83 of the discrepancy was attributed to possible calculation errors by DeVinney. *Id.*

[114] Petitioner's submission was a day late and (almost literally) a dollar short. Letter from Mondros to Chandler, C. of 1/13/04. Importantly, Petitioner did not deny that Devinney made calculation errors.

[115] This problem was compounded by Petitioner's decision to not comply with my request to "provide the Court with electronic versions (Microsoft Excel compatible) of the DCF worksheets," *e.g.*, "Exhibit 4 of Prof. Jarrell's report." Letter from Chandler, C. to Counsel of 1/2/04, at 2. Only Respondent complied with this request.

[116] *See* Ex. 65 at 21-26.

already owned 75% or more of the stock (as is the case here), Jarrell found that the median one-day control premium for those 31 transactions was 17%, as compared with the 21% premium paid by the Rothmans. Petitioner argues, among other things, that this analysis "violate[s] any concept of comparability, including the 'law of one price.'"[117] I agree.

The only thing that the transactions in Jarrell's sample have in common are that they are all transactions. The data is not segmented by industry or date. The one-day premiums vary considerable; the standard deviation is 32%.[118] Additionally, it is not clear that any analysis of premiums over all transactions has any bearing on "fair value" in an appraisal action, even if it may bear on how efficiencies arising from a merger could equitably be apportioned between the buyer and the sellers.

2. "Market Check"

Jarrell considered the fact that First Union was unable to find any interested potential acquirers and that none emerged once the deal was publicly announced at $13 per share.[119] He testified that "in my judgment, the evidence clearly indicated that there were no such offers and that there were no such folks out there willing to pay that, because if there were, they would have shown up."[120]

Although Jarrell's testimony has a certain intuitive appeal, there is insufficient record support from which a reliable conclusion can be drawn about this "market check." First Union, JR Cigar's financial advisor at the time, was only authorized to conduct a "limited market check."[121] As such, First Union only contacted two possible buyers.[122] Little can be drawn from the fact that these two buyers declined to make an offer. Additionally, simply because no rival bidders appeared after the announcement of the going private proposal does not help the Court ascertain the fair value of JR Cigar.

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[117]OB at 29.

[118]Ex. 11 (Data on mergers between January 1995 and August 200 from Thomson Financial SDC database).

[119]*See* Ex. 65 at 27-29.

[120]Tr. at 225.

[121]Ex. 69 (Special Meeting Minutes of the Board of Directors) at JRC 0033; Ex. 38 (Presentation to Board of Directors by First Union Securities, Inc.) at JRC 94.

[122]Ex. 50 (First Union Situation Overview: Proposed Offer from Lew and Lavonda Rothman) at ML 186.

D. *The Court's Determination*

The comparable transactions looked at by DeVinney are not reliable indicators of the fair value of JR Cigar. The only transaction worth noting is the Swisher International transaction that was, in the opinion of Merrill Lynch, the most comparable to the JR Cigar transaction.[123] That transaction implies a fair value of $12.00 per share.[124] Jarrell's market based analysis, the measurement of control premiums and his "market check," are not reliable indicators of JR Cigar's fair value. In my opinion, the more "reliable" indicator of JR Cigar's fair value is a DCF analysis.

The four key DCF variables identified by the parties are JR Cigar's growth rate in perpetuity, its debt to equity ratio, the equity size premium, and JR Cigar's tax rate. As discussed earlier in the Court's analysis, the appropriate growth rate in perpetuity is 3.5%, the WACC calculation should reflect a 10% debt ratio, the equity size premium included in the CAPM calculation should be 2.6, and JR Cigar's effective tax rate is 40%. Jarrell's DCF calculations include an equity size premium of 2.6 and a tax rate of 40%. Jarrell uses a range of growth rates (2.5% to 3.5%) and a range of discount rates (13% to 15%). The range of discount rates reflect a debt weighting of 0% to 10% (13% discount rate reflecting 10% debt). Looking at the upper end of Jarrell's ranges, *i.e.*, 10% debt and 3.5% growth, his DCF model produces a value of $13.58 per share.[125] Given that the parties are incapable of reconciling divergent results when Jarrell's variables are placed in DeVinney's model, I will not engage in my own quixotic attempt to do so. The fair value of JR Cigar as of October 4, 2000 is $13.58 per share.

E. *Interest*

1. Legal Framework

This Court's decision in *Gonsalves v. Straight Arrow Publishers, Inc.*[126] is an accepted method for determining the rate of interest in appraisal actions. *Gonsalves* rests on the principle that the interest award should serve two purposes. First, it should disgorge the respondent of any

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[123]Ex. 3 at JRC 0325.

[124]*Id.*

[125]Ex. 65 at Ex. 4. Jarrell calculated a discount rate of 13.12% based on a debt ratio of 10% and a beta of .67. Ex. 65 at 19. He rounded this number down to 13%. Keeping everything else the same, but substituting DeVirmey's "seasoned" beta of .62, results in a discount rate of 12.77%. I find that a discount rate of 13% is reasonable.

[126]2002 WL 31057465 (Del. Ch. Sept. 10, 2002).

benefit it received from the use of the petitioner's funds. Second, the interest award should compensate the petitioner for the loss of the use of its money. The second purpose, however, is countenanced with the understanding that the election to "reject the merger amount and to pursue appraisal does not shift to the corporation all responsibility for losses [the petitioner] may incur as a result of [its] inability to use the funds retained by the corporation" and that the petitioner can mitigate its losses and obtain perfect "compensation for the loss of the use of their funds by borrowing the fair value of their shares."[127] *Gonsalves*, and several other decisions,[128] have found that these twin purposes are served by awarding interest by weighing equally the respondent's actual costs of borrowing and, based on an objective prudent investor standard, the petitioner's opportunity cost. The prudent investor portfolio in *Gonsalves* consisted of 20% in broadly diversified common stocks, 40% in United States Treasury and corporate bonds, and 40% in money market-type instruments or their equivalent, *i.e.*, bank certificates of deposit.[129] The S&P 500 was used as a proxy for broadly diversified stocks.[130]

2. Rate of Interest

DeVinney's expert report stated that the appropriate rate of interest was 8% compounded annually.[131] Cede's position as to the appropriate rate of interest has changed twice since that report. DeVinney testified at trial that the appropriate rate was 5.5%[132] and that he had "abandoned" the proposed rate of 8%.[133] DeVinney changed his opinion about the fair rate of interest upon review of this Court's opinion in *Gonsalves*.[134] In arriving at an interest rate of 5.5% at trial, DeVinney used the *Gonsalves* approach with two exceptions.

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[127]*Grimes v. Vitalink Communications Corp.*, 1997 WL 538676, at *10 (Del. Ch. Aug. 28, 1997).

[128]*See Hintmann v. Fred Weber, Inc.*, 1998 WL 83052, at *12 (Del. Ch. Feb. 17, 1998) (Steele, V.C.); *Ryan v. Tad's Enterprises, Inc.*, 709 A.2d 682, 705 (Del. Ch. 1996) (Jacobs, V.C.); *Kleinwort Benson Ltd. v. Silgan Corp.*, 1995 WL 376911, at *10 (Del. Ch. June 15, 1995).

[129]*Gonsalves*, 2002 WL 31057465, at *13 n.59.

[130]*Id.* at *11.

[131]Ex. 66 at 28. DeVinney arrived at 8% after consideration of the rate of return of certain corporate bonds and various investment funds managed by Royce (the investment fund that Cede held Respondent's shares on behalf of). DeVinney initially gave no consideration to JR Cigar's cost of borrowing.

[132]Tr. at 115-16

[133]Tr. at 174.

[134]Tr. at 115.

First, DeVinney averaged several commonly used stock indices to serve as a proxy for broadly diversified stocks, instead of using the S&P 500 exclusively.[135] Second, DeVinney, instead of simply averaging JR Cigar's cost of borrowing and the returns of a prudent investor portfolio, weighted JR Cigar's borrowing costs at 75%. He testified that this weighting was based on Petitioner's subjective opportunity cost.[136] Specifically, DeVinney increased the emphasis on Respondent's borrowing costs because the Royce family of funds that held JR Cigar stock over the period had returns that were higher than an objective prudent investor portfolio.[137]

Respondent does not advocate using DeVinney's opinion at trial as to the fair rate of interest, but instead argues for an interest rate of 8%, *i.e.*, the rate that DeVinney originally espoused and later abandoned. In its post-trial brief, Petitioner proposes using a version of the *Gonsalves* approach to arrive at the fair rate of interest, albeit in a manipulated fashion. Petitioner advocates using the prime rate at the time of the merger, 9.5%, as JR Cigar's cost of borrowing.[138] Petitioner does not adjust that rate, however, to reflect the changes in the prime rate from the time of the merger to the date of judgment. Petitioner then weighs JR Cigar's unadjusted cost of borrowing thrice and DeVinney's prudent investor portfolio rate of return once to arrive at an interest rate of 8%.[139]

Petitioner's use of 9.5% as JR Cigar's cost of borrowing is incorrect. The parties agree that Petitioner's cost of borrowing from the time of the merger to the present has been the prime rate. And it is undisputed that the prime rate was 9.5% at the time of the merger. The prime rate, however, has declined significantly since the date of the merger. Jarrell accounted for this fact, as did this Court's opinion in *Gonsalves*.[140] The prime rate at the time of the merger may have been JR Cigar's borrowing costs three years ago, but it is not JR Cigar's actual borrowing costs during the relevant period, which is from the time of the merger to the date of judgment. In order to determine the cost of borrowing for the relevant period, one must ascertain Respondent's borrowing costs from the date of the merger and at

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[135]Tr. at 118. DeVinney, using this broadened prudent investor portfolio, calculated a return of 3.5%. *Id.*

[136]Tr. at 119-20.

[137]*Id.*

[138]The parties agree that Respondent's cost of borrowing is the prime rate. OB at 32; AB at 34.

[139]OB at 32. Those calculations actually result in a figure of 8.3%, but Respondent only argues for 8% interest.

[140]In *Gonsalves* the Respondent's cost of borrowing was "compounded monthly [from] the date of the merger." *Id.* at * 13.

regular intervals, *i.e.*, monthly, until an appropriate ending point near the judgment date. Respondent's borrowing costs should also be compounded during that period. Based on monthly compounding of the historical values for the prime rate, Jarrell calculated JR Cigar's cost of borrowing to be 5.96%.[141] Accordingly, I find that 5.96% is JR Cigar's borrowing costs, not 9.5% as suggested by Cede.

Petitioner's weighting of JR Cigar's borrowing costs more than its own opportunity cost, as reflected by a prudent investor portfolio, is also incorrect. At trial, DeVinney testified that the excess weight given to Respondent's borrowing costs was due to Cede's subjective opportunity costs.[142] DeVinney stated that because Cede's own funds achieved a rate of return around 9%, it was his judgment that JR Cigar's cost of borrowing should be given more weight.[143] In its post-trial brief, Royce makes the same assertion.[144] I reject Petitioner's position for two reasons. First, it does not make any sense for this Court to adjust for the higher, subjective opportunity cost of Petitioner by increasing the emphasis on Respondent's borrowing costs. Second, this Court rejected approaches geared towards a petitioner's subjective opportunity cost in *Gonsalves*.[145] The language of *Gonsalves* was clear: "Although the Court may look at the actual cost of borrowing by the respondent company, the Court determines the petitioner's opportunity cost based on an objective standard."[146] Several other decisions have similarly rejected consideration of a petitioner's subjective opportunity cost in awarding interest.[147] Petitioner voluntarily relinquished funds it could have otherwise invested as it pleased and cannot now argue that in hindsight it would have used those funds to achieve higher returns than the objectively prudent investor.[148] Respondent's cost of borrowing and Petitioner's opportunity cost shall have equal weight.

Although I have found that the prudent investor portfolio should have equal weight as Respondent's borrowing costs, that portion of the portfolio that represents broadly diversified common stocks does not have

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[141]Ex. 65 at 39.

[142]Tr. at 119-20.

[143]*Id.*

[144]OB at 32.

[145]2002 WL 31057465, at *12.

[146]*Id.*

[147]*See Grimes*, 1997 WL 538676, at *10; *Chang's Holdings S. A. v. Universal Chems. & Coatings*, 1994 WL 681091, at *4 (Del. Ch. Nov. 22, 1994); *Lebman v. National Union Electric Corp.*, 414 A.2d 824, 829 (Del. Ch. 1980).

[148]Petitioner also cannot argue that it is forwarding an objective standard because it only changes the weight given to the objective prudent investor portfolio. Ultimately, Petitioner advocates de-emphasizing the objective opportunity cost portion of the interest award in order to account for its returns on the Royce family of funds, a subjective consideration.

to use the S&P 500 as its exclusive proxy. *Gonsalves* does not suggest that the S&P 500 is the only representative index of the types of stocks that the prudent investor would hold. Even JR Cigar's expert noted at trial that "you have some choices"[149] and that he selected the S&P 500 simply because it is the most well known.[150] DeVinney averages a variety of indices to arrive at the rate of return of broadly diversified common stocks. There is no error with this approach, especially where, as here, the S&P 500 had the worst returns of all the major stock indices. JR Cigar's only objection to this approach is that it will result in the double counting of some stocks. This objection is without merit. In fact, this simply reflects the reality that some stocks, *i.e.*, those included in the S&P 500, are more widely held than others. As such, I find that the rate of return on the prudent investor portfolio is 3.5%, as calculated by DeVinney.

JR Cigar's cost of borrowing is 5.96%. Petitioner's opportunity cost, as measured by the objective prudent investor, is 3.5%. Giving equal weight to each element, the appropriate rate of interest in this appraisal action is 4.73%.

3. Form of Interest

The last matter for consideration is the form of interest. "The compounding interval should . . . reflect the interval available to the petitioners had they the use of their funds as well as, if possible, the interval actually received by the corporation."[151] Petitioner requests that interest be compounded daily. Although I have commented that daily compounding may be appropriate in some cases,[152] Petitioner has not introduced evidence that daily compounding is appropriate in this case. In fact, DeVinney compounded interest annually in his report.[153] JR Cigar's post-trial brief is silent regarding the compound interval, as is Jarrell's report. Jarrell does, however, compound the prime rate on a monthly basis in order to determine JR Cigar's annual borrowing costs.[154] Ultimately, given that neither side has provided evidence as to the appropriate interval, "I find that the dual purposes of compensation and restitution may only be served by a compounding interval at least as frequent as one month."[155]

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[149]Tr. at 232.
[150]*Id.*
[151]*Grimes*, 1997 Del. Ch. LEXIS 124, at *55.
[152]*See ONTI*, 751 A.2d at 927 & n.93.
[153]Ex. 66 at 28.
[154]Ex. 65 at 39.
[155]*Grimes*, 1997 Del. Ch. LEXIS 124, at *55.

IV. CONCLUSION

The fair value of Petitioner's 652,400 shares of JR Cigar stock as of the merger date is $13.58 per share. Respondent must pay Petitioner $8,859,592.00, plus interest of 4.73%, compounded monthly, from October 4, 2000 to the date of payment.

Counsel shall confer and agree upon a form of Order to implement this decision.

COMRIE v. ENTERASYS NETWORKS, INC.

No. 19,254

Court of Chancery of the State of Delaware, New Castle

February 13, 2004

Vernon R. Proctor, Esquire, and Patricia Enerio, Esquire, of The Bayard Firm, Wilmington, Delaware, for plaintiffs.

William M. Lafferty, Esquire, and Patricia Uhlenbrock, Esquire, Morris, of Nichols, Arsht & Tunnell, Wilmington, Delaware; and Douglas H. Meal, Esquire, and Emily C. Shanahan, Esquire, of Ropes & Gray, Boston, Massachusetts, of counsel, for defendants.

LAMB, *Vice Chancellor*

I.

In an earlier opinion, the court held that the defendants had breached a stock purchase agreement by not providing an "equivalent substitute" for options granted in accordance with that agreement. The defendants were under a duty to provide such a substitute pursuant to certain performance obligations found in Exhibit 7.11 to that agreement, which provides for the

substitute if an IPO of Global*Network* Technology Services, Inc. was not undertaken.

Exhibit 7.11 also provides for a similar grant of options to certain employees who are not signatories to the stock purchase agreement and were not, originally, plaintiffs in this action. A majority of those employees now seek to recover against the defendants based on the findings in the earlier opinion. The court concludes that those employees, as donee beneficiaries, have standing to bring such a suit; however, certain of those employees are barred from bringing suit because of releases signed by them as part of a severance package.

II.

BIT Management, Inc. ("BIT") was an Ontario corporation engaged in the information technology consulting and software development industry. In 2000, Cabletron Systems, Inc. ("Cabletron"),[1] a Delaware corporation headquartered in Rochester, New Hampshire, engaged in a restructuring, through which it created four subsidiaries: Aprisma Management Technologies, Inc., Enterasys Networks, Inc. ("Enterasys"), Riverstone Networks, Inc., and Global*Network* Technology Services, Inc. ("GNTS"). Under this restructuring, Cabletron planned to conduct an IPO for each operating subsidiary by the end of 2001, followed by a spin-off of the subsidiaries' remaining shares to Cabletron's existing stockholders.

GNTS, in preparation for its IPO, sought to purchase small service companies complementary to its existing business in order to diversify its revenue base. BIT was identified as a potential target and negotiations between GNTS and BIT ensued in early 2000. The resultant Stock Purchase Agreement (the "Agreement") among Cabletron, GNTS, GNTS (Canada, Inc.),[2] BIT, and the holders of all of the outstanding capital of the stock of BIT (the "BIT Stockholders") (collectively, the "Parties") was signed on August 23, 2000.

The Agreement provides for an exchange of BIT stock for a combination of cash and options to purchase stock in GNTS. Specifically, section 7.11 of the Agreement requires Cabletron to cause GNTS to adopt an option plan pursuant to terms set forth in Exhibit 7.11 attached to the Agreement. Exhibit 7.11 requires Cabletron to cause GNTS to "allocate

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[1]Cabletron merged with its former wholly owned subsidiary, Enterasys Networks, Inc. on August 6, 2001. The surviving corporation, also called Enterasys Networks, Inc., along with Global*Network* Technology Services, Inc., both Delaware corporations, are the defendants in this action.

[2]GNTS (Canada, Inc.) was an acquisition vehicle formed to aid the stock purchase.

options for 466,605 shares of GNTS stock . . . to the employees of BIT." Of those shares, 55,814 were to be issued to each of the partners of BIT (the "Partners"),[3] with the balance of shares (up to 14,512 each) to be issued to 12 non-partner former employees of BIT[4] (the "Non-Partner Employees," together with the Partners, the "BIT Group").

To protect the BIT Group in the event the defendants decided not to go forward with the GNTS IPO, the Parties agreed upon a substitution provision, which is included in Exhibit 7.11. That provision states:

> In the event that [Cabletron] determines not to pursue its current intention to cause GNTS to undergo an initial public offering prior to December 31, 2001 or determines not to pursue its current intention to distribute the stock of GNTS to the shareholders of [Cabletron] (each a "Trigger Event"), within sixty (60) days of the Trigger Event, [Cabletron] shall either (i) *provide equivalent substitute or replacement awards on the same terms and conditions to the former employees of [BIT]*; or (ii) pay $4,620,000 in the aggregate for all Options then held by the Partners and former employees of [BIT].[5]

Within a few days of the closing of the Agreement, GNTS issued to the BIT Group an aggregate of 466,605 GNTS stock options at an exercise price of $4.25. A Trigger Event occurred on July 16, 2001,[6] thus implicating the substitution provision. On August 23, 2001, Cabletron decided to provide the BIT Group with substitute or replacement options.[7] Cabletron issued these options based on the theory that the substitute or replacement options must be valued at the same amount as the original GNTS options at the date of *replacement*.[8]

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[3]The partners of BIT were Ian Cheong, Michael Comrie, Leroy Dougherty, Peter Ott, and Afshin Shams. The Partners, together with Earle Comrie, Kay Comrie, Cynthia A. Ott, Stephanie Sebastiano, Sally Seto, and Julie M. Shams are the plaintiffs in this action (the "plaintiffs").

[4]The non-partner former employees are Carrie Brody, Wayne W. Cuervo, Peter Forsythe, Glen Julien, Elizabeth Kapuscinski, Jennifer Knabenschuh, Ernie Lim, Paul Matheson, Darwin Palma, Bonnie Planchart, Ramesh Rathnam, and Donald Swora.

[5]Emphasis added.

[6]*Comrie v. Enterasys Networks, Inc.*, 837 A.2d 1, 11 (Del. Ch. 2003). The Intervenors and the defendants agreed by stipulation, for purposes of this action, to be bound by the factual and legal findings and conclusions set forth in the opinion. Further, they allowed reliance by both sides on all exhibits, trial testimony, and designated deposition testimony admitted at the trial in the underlying litigation. Stipulation Regarding Claims of Intervenors (Nov. 7, 2003) ("Stipulation").

[7]Stipulation at ¶ D(2).

[8]*Comrie*, 837 A.2d at 14.

The plaintiffs filed suit claiming that the substitute or replacement options were to be valued as the same amount as the GNTS options at the date of *issuance*.[9] The court found, in a September 4, 2003 opinion (the "September 4 Opinion"), that the plaintiffs were correct in their reading of the Agreement, and by not issuing options valued as the same amount as the GNTS options at the date of issuance, Cabletron had breached the Agreement.[10]

The court found damages in the amount of $2,190,620.[11] However, the plaintiffs only held 58.8% of the GNTS options, and were thus only entitled to an award of $1,309,991.[12] Because the Non-Partner Employees held the remainder of GNTS options, the court reserved final judgment, stating, "[i]t is entirely plausible . . . that the BIT employees who were not plaintiffs in this action are third-party beneficiaries to the Agreement, and are equally entitled to an award based on a breach of that Agreement."[13]

Pursuant to the September 4 Opinion, an order dated October 7, 2003,[14] and Court of Chancery Rule 24,[15] ten of the Non-Partner Employees[16] included in the BIT Group (the "Intervenors") moved to intervene on October 21, 2003. A complaint in intervention was filed contemporaneously with the motion. The defendants' answer contains five affirmative defenses, two of which are addressed in the briefs. Specifically, the defendants contend that the Intervenors are not donee beneficiaries of the Agreement, and thus do not have standing to bring suit. Alternatively, the defendants argue that even if the Intervenors have standing, releases signed by certain of the Intervenors serve to bar their claims.

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[9] *Id.*

[10] *Id.* at 17.

[11] See *id.* at 21 (calculating damages).

[12] *Id.*

[13] *Id.*

[14] This order provided that "any Potential Beneficiary who files a timely and proper motion to intervene will be permitted to intervene pursuant to Chancery Court Rule 24(b)." The implication of guaranteeing intervention is that the defendants would not waive any potential defenses, including a standing defense.

[15] Court of Chancery Rule 24(b) permits the court, in its discretion, to allow one to intervene in an action when a statute confers a conditional right to intervene, or when the applicant's claim and the main action have a question of law or fact in common. The application must be made according to the procedure set out in Court of Chancery Rule 24(c).

[16] Brody and Planchart did not join in the motion to intervene.

III.

Parties to an agreement may enforce the contractual terms of that agreement.[17] As a general rule, a nonparty to a contract has no legal right to enforce it.[18] This general rule yields to the notion that intended third-party beneficiaries have an enforceable right under contracts conferring a benefit to them, even though they are not parties to those contracts.[19] The general rule does apply, however, to prevent mere incidental beneficiaries from claiming enforceable rights under a contract.[20]

In *Insituform of North America, Inc. v. Chandler*, this court set out a test for whether or not one is an intended beneficiary under a contract:

> In order for third party beneficiary rights to be created, not only is it necessary that performance of the contract confer a benefit upon third parties that was intended, but the conferring of a *beneficial* effect on such third party—whether it be a creditor of the promisee or an object of his or her generosity—should be a material part of the contract's purpose.[21]

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[17]*See Triple C Railcar Serv. v. City of Wilmington*, 630 A.2d 629, 633 (Del. 1993) ("It is axiomatic that either party to an agreement may enforce its terms for breach thereof."); *Madison Realty Partners 7, LLC v. AG ISA, LLC*, 2001 WL 406268, at *4 (Del. Ch. Apr. 17, 2001) ("It is undisputed that Madison, as a signatory to the Partnership Agreement, has standing to sue for a breach of that Agreement.").

[18]*See Insituform of N. Am., Inc. v. Chandler*, 534 A.2d 257, 268 (Del. Ch. 1987) ("[T]he general rule [is] that strangers to a contract ordinarily acquire no rights under it . . ."); *Stuchen v. Duty Free Int'l, Inc.*, 1996 WL 33167249, at *9 (Del. Super. Apr. 22, 1996) ("The general rule in this state is that a stranger or nonparty to a contract has no legal right to enforce it."); *see also Guardian Constr. Co. v. Tetra Tech Richardson, Inc.*, 583 A.2d 1378, 1386 (Del. Super. 1990) ("Ordinarily, a stranger to a contract acquires no rights thereunder . . .").

[19]*See Insituform of N. Am., Inc.*, 534 A.2d at 268 (noting that the general rule applies "unless it is the intention of the promisee to confer a benefit upon such third party"); *Stuchen*, 1996 WL 33167249, at *9 ("This principle holds sway unless the parties to the contract intended to confer a benefit upon an unrelated party, making them so-called third party beneficiaries."). *See generally* 13 Richard A Lord, A Treatise on the Law of Contracts by Samuel Williston § 37:1 (4th ed 2000) ("Williston on Contracts") (discussing the rights of intended third-party beneficiaries).

[20]*See Insituform of N. Am., Inc.*, 534 A.2d at 269 ("If, however, it was not the promisee's intention to confer direct benefits upon a third person, but rather such third party happens to benefit from the performance of the promise either coincidentally or indirectly, then such third party beneficiary will be held to have no enforceable rights under the contract."); *see also* 9 Arthur Linton Corbin, Corbin on Contracts § 779C, at 36 (Interim ed. 1979) ("Corbin on Contracts") ("All others who may in some way be benefited by performance have no rights and are called incidental beneficiaries.").

[21]534 A.2d at 270.

Former Vice Chancellor Jacobs, in *Madison Realty Partners 7, LLC v. AG ISA, LLC*, summarized the elements included in this test:

> To qualify as a third party beneficiary of a contract, (i) the contracting parties must have intended that the third party beneficiary benefit from the contract, (ii) the benefit must have been intended as a gift or in satisfaction of a pre-existing obligation to that person, and (iii) the intent to benefit the third party must be a material part of the parties' purpose in entering into the contract.[22]

Thus for the Intervenors to have standing to bring suit based on the Agreement, they must show that the BIT Stockholders intended that the Non-Partner Employees benefit from the Agreement (i.e., receive the options),[23] that the benefit was intended as a gift from the BIT Stockholders to the Non-Partner Employees,[24] and that the conferral of that benefit is a material part of the Agreement's purpose.[25]

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[22]2001 WL 406268, at *5.

[23]There is conflicting precedent as to whether the requisite intent must be of the parties to the contract or of the promisee individually. *Compare Triple C Railcar Service*, 630 A.2d at 633 ("Essential to a third party's right of enforceability is the *intention of the contracting parties* to view that party as either a donee or creditor beneficiary.") (emphasis added), and *Madison Realty Partners 7, LLC*, 2001 WL 406268, at *5 ("[T]he *contracting parties* must have intended that the third party beneficiary benefit from the contract) (emphasis added), with *Insituform of N. Am., Inc.*, 534 A.2d at 268 ("It is universally recognized that where it is the *intention of the promisee* to secure performance of the promised act for the benefit of another . . .") (emphasis added), and *Guardian Constr. Co.*, 583 A.2d at 1386 ("[W]here it is the *intention of the promisee* to secure performance of the promised act for the benefit of another . . .") (emphasis added). In applying Delaware law, the United States District Court for the District of Delaware addressed this conflict. The District Could held "that under Delaware law both parties must in some manner express an intent to benefit the third-party before third-party beneficiary status is found." *Am. Fin. Corp. v. Computer Scies. Corp.*, 558 F. Supp. 1182, 1185 (D. Del. 1983).

Here, the defendants, as promisors, acknowledge that the intent element is satisfied as to them. Ans. Br. of Def's. Enterasys Networks, Inc. and Global*Network* Tech., Servs., Inc. to Intervenors' Claim for Relief, at 11 (Dec. 5, 2003) ("Ans. Br."). Thus regardless of which analysis is used, the only issue for the court to decide is the intent of the promisees, here BIT and the BIT Stockholders.

[24]No allegations have been made that the BIT Stockholders had a preexisting obligation to the Interveners. As such, the Intervenors must show that they are donee beneficiaries. *See Guardian Constr. Co.*, 583 A.2d at 1387 ("The only third parties who have legal rights are donees and creditors of the promisee.").

[25]The Restatement (Second) of Contracts eliminates the distinction between creditor and donee beneficiaries. Instead, it tests only for whether one is an intended beneficiary. Specifically, it states:

> (1) Unless otherwise agreed between promisor and promisee, a beneficiary of a promise is an intended beneficiary if recognition of a right to performance in the beneficiary is appropriate to effectuate the intention of the parties and either

The intent of the BIT Stockholders' to bestow rights on the Non-Partner Employees is plain from the face of the Agreement.[26] When a promised performance is rendered directly to the beneficiary, "it is presumed that the contract was for the beneficiary's benefit."[27] Here, Exhibit 7.11 directs the defendants to grant options directly to the Non-Partner Employees. This differentiates the present facts from the facts considered in *Insituform*, where members of a board of directors argued that a stock-voting agreement, which none of the members had signed and which obligated the signatories to either abstain from voting their stock or to vote their stock in unanimity for existing members, created a right to "continued tenure" in the board members for the entire term of the stock-voting agreement.[28] Although the board members "surely were potentially benefited by performance of the promises"[29] contained in the stock-voting agreement, that benefit was incidental to that agreement. Here, the Agreement directs the defendants to issue performance directly to the Non-Partner Employees.

Further, even if one were to look beyond the face of the Agreement, an intent to benefit the Non-Partner Employees is clear. The Partners and Non-Partner Employees had set an expectation that "in the event of a sale or IPO [the Non-Partner Employees] would receive in the range of 10% to 15% of the value in cash and stock."[30] In deposition testimony designated by the defendants at trial, Mr. Comrie, the former managing partner of BIT, explained how this expectation was set:

> There was nothing particular that had occurred other than when we were hiring them, we had indicated to them that

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(a) the performance of the promise will satisfy an obligation of the promisee to pay money to the beneficiary; or

(b) the circumstances indicate the promisee intends to give the beneficiary the benefit of the promised performance.

Restatement (Second) of Contracts § 302 (2004). Further, the introductory note to this chapter of the Restatement points to the "recognition of the power of promisor and promisee to create rights in a beneficiary by manifesting an intention to do so." While this test has not yet been adopted by the Delaware courts, the ALI's adoption of it is of note, and the standing of the Non-Partner Employee's under this test is even stronger.

[26]Since the BIT Stockholders owned all of the outstanding shares of the capital stock of BIT, the opinion addresses the intent of BIT and the BIT Stockholders simply as the intent of the BIT Stockholders.

[27]Williston on Contracts, § 37:7, at 55. *See also id.* § 37:8, at 70 ("In the typical case, where the promisor has undertaken to render performance directly to the beneficiary, the intent to benefit the third party will be clearly manifested.").

[28]534 A.2d at 268-70.

[29]*Id.* at 269.

[30]DX 6.

> at some point down the road they may be able to share in the company. We had a profit sharing-an informal profit sharing plan and we had actually looked at ways in which we could make our employees, quote unquote, owners or part owners in the organization and we looked at employee-looked at devising some way that they could have some ownership in the company in the field that they were working in for themselves.[31]

Exhibit 7.11 is a manifestation of intent to fulfill this expectation. Contrary to the defendants' assertion, "[a]ny benefit that accrued to the BIT employees as a result of the performance of the Stock Purchase Agreement" was not simply the product of the defendants' efforts.[32] The Intervenors have shown intention to benefit the Non-Partner Employees, thus meeting the first prong of the *Insituform* test.

Moreover, the Intervenors have clearly shown the BIT Stockholders' intent as donative. In order to show *donative* intent, one must show that the promisee intended to make a gift of the promisor's performance to a third party.[33] The defendants claim that the options granted to the Non-Partner Employees were not the BIT Stockholders' to give—that the drafting of the option requirement into the Agreement did not cut into the consideration the BIT Stockholders would otherwise have been paid for their stock in BIT.[34] Findings in the September 4 Opinion, as the defendants' own brief points out, clearly prevent this argument. "GNTS had always represented to BIT that it was willing to pay at least 6 times and up to 7 times BIT's revenues, which resulted in a valuation between $8.8 million and $10.23 million, of which approximately $5.6 million was paid in cash."[35] As the defendants acknowledge, the remainder of the consideration was to be paid in options.[36] The options granted pursuant to Exhibit 7.11 represent the remainder of consideration to be paid. Exhibit 7.11, then, grants 40.2% of

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[31]Comrie Dep. at 95-96.

[32]Ans. Br. at 15.

[33]Williston on Contracts § 37:8, at 73; *see also* Corbin on Contracts § 774, at 5-6 ("The third person is a donee beneficiary if the promisee who buys the promise expresses an intention and purpose to confer a benefit upon him as a gift in the shape of the promised performance.").

[34]The defendants argue that the absence of a provision calling for a reversion to the Partners of that portion of options not exhausted by the grants to the Non-Partner Employees evidences lack of donative intent. While such a provision would evidence an intent, lack of such a provision does not suggest lack of such intent. Similarly, the Intervenors' argument that the lack of a "no third-party beneficiary" clause indicates an understanding that there were beneficiaries does not hold water.

[35]*Comrie*, 837 A.2d at 38 n.91, *reprinted in* Ans. Br. at 13.

[36]Ans. Br. at 14.

the options, which represents approximately 19% of the total consideration (i.e., the negotiated performance), to the Non-Partner Employees. This requirement is in line with the "set expectations" of the BIT Stockholders and Non-Partner Employees described in Mr. Comrie's deposition.[37] This is clear evidence of donative intent.[38]

Finally, the grant of options to the Non-Partner Employees is a material part of the purpose of the Agreement. Where the effect on a third party, "while a benefit to [that party] and intended, [is] merely a means through which the benefit that motivated the contract was sought to be achieved for the signatories," even if that third party is not merely incidental to the contract, that third party takes no rights under the contract.[39] Thus in order to gain rights under a contract, the beneficial effect to the third party must be material to the purpose of the contract.

The defendants assert that the granting of options to the Non-Partner Employees was merely instrumental to achieving the BIT Shareholder's purpose of maximizing shareholder value. The e-mail relied upon by the defendants to show maximization of value as the sole purpose of the contract, however, does not lead to this conclusion. The defendants point to an e-mail sent by Mr. Shams to the BIT Partners in which Mr. Shams comments on a draft term sheet circulated among those partners.[40] In that e-mail, Mr. Shams states that he had "two intentions" when forming the company: being able to help run a company and financial reward. Based on this, the defendants assert that donating to the Non-Partner Employees a portion of the consideration would be at odds with the BIT Stockholders' purpose for entering into the Agreement. The conclusion simply does not flow from the premise. One cannot conclude the purpose of entering into the Agreement from a stated purpose of starting BIT in the first place. Further, in the e-mail, Mr. Shams implores the other Partners not to lose

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[37]Comrie Dep. at 95-96. The defendants argue that there can be no donative intent because Mr. Comrie pressed for an all-cash deal during negotiations. *See* Comrie Dep. at 77-79. However, there is no evidence that should Mr. Comrie have succeeded in obtaining an all-cash deal, he would not have passed on a similar percentage of compensation to the Non-Partner Employees. The only definitive evidence presented is that the Non-Partner Employees received a percentage of the expected value of the deal.

[38]The defendants argue that because the non-partner BIT Stockholders did not receive options, the logical route of this conclusion, in the absence of an agreement among the BIT Stockholders to share the value of options, is that the non-partner BIT Stockholders intended to donate a disproportionate percentage of consideration to the Non-Partner Employees. How the BIT Stockholders intended to divide that portion of consideration provided to the Partners, but not the non-partner BIT Stockholders, is outside the scope of this analysis. The analysis only requires a showing of intent that the Intervenors made a gift of the promisors' performance. Exhibit 7.11 clearly shows this.

[39]*Insituform*, 534 A.2d at 270.

[40]DX 17.

sight of the "effect that [the deal] would have on everyone involved, *including the employees*."[41]

The record shows, as discussed above, the purpose of the BIT Stockholders in entering into the contract included conferring a benefit to the employees. The option grant is material to that purpose and thus the third prong of the *Insituform* test is met. The Intervenors, having met the test set out in *Insituform*, are donee beneficiaries of the Agreement and thus have standing to bring suit to enforce their rights under Exhibit 7.11 of that Agreement.

IV.

Although the Intervenors have standing to enforce rights under the Agreement, the defendants allege several of the Intervenors signed, in conjunction with severance packages, releases preventing them from bringing claims they might otherwise have had. In construing the releases, the court looks to the overall language of the releases to determine the parties' intent, which is controlling.[42] If the language of a release is clear, the court will give effect to that language. If the language is ambiguous, "'it must be construed most strongly against the party who drafted it.'"[43]

A. Forsythe and Lim

There is no evidence that either intervenors Forsythe or Lim signed any release. They are thus entitled to damages in accordance with the calculations used in the September 4 Opinion to determine the plaintiffs' rights. Damages are to be calculated, however, on the basis of the October terminations of Forsythe and Lim and the effects of those terminations on the vesting schedule.

B. Cuervo, Julien, Knabenschuh, Swora

Intervenors Cuervo, Julien, Knabenschuh, and Swora (the "Release Signatories") each signed identical releases. The pertinent language of the releases state:

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[41]Id. (emphasis added).

[42]*See Corporate Prop. Assoc. v. Hallwood Group*, 817 A.2d 777, 779 (Del. 2003); *Adams v. Jankouskas*, 452 A.2d 148, 156 (Del. 1982).

[43]*Corporate Property Assoc.*, 817 A.2d at 779 (quoting *Adams*, 452 A.2d at 156).

> FOR AND IN CONSIDERATION OF the special payments and benefits to be provided to me in connection with my separation of employment, as set forth in a Memorandum dated April 11, 2002 from Enterasys Networks, Inc., I . . . hereby release and forever discharge Enterasys Networks, Inc. ("Enterasys") and its Affiliates . . . and Cabletron Systems, Inc. ("Cabletron") and its subsidiaries and other affiliates and all of the respective past and present officers, directors, shareholders, members, managers, employees, agents, general and limited partners, joint venturers and representatives of any of the foregoing, the successors and assigns of Enterasys and its Affiliates and Cabletron and its subsidiaries and other affiliates, and all others connected with any of them (all collectively, the "Released"), both individually and in their official capacities, jointly and severally from any and all actions, causes of action, contracts, covenants, whether express or implied, claims, demands for damages, including disability, life or other insurance claims, indemnity benefits, costs, interest, loss or injury of every nature and kind whatsoever and howsoever arising whether statutory or otherwise, which I may have had, may now have or may hereinafter have, *in any way relating to the hiring of, the employment by and the cessation of my employment by the Released parties*.[44]

The Release Signatories argue that because the releases initially refer to an April 11, 2002 memorandum, which provides terms for termination of employment, the language releasing claims relating to the "hiring of, and the employment by" should be construed narrowly. They base this argument on the premise that "Delaware law is clear that words of general application used in a release 'which generally follow a specific recital of the subject matter concerned are not to be given their broadest significance but will be restricted to the particular matter referenced to in the recital.'"[45]

The releases here are different from previous releases considered by Delaware courts. In *E.I. DuPont de Nemours & Co. v. Florida Evergreen Foliage*, for example, the Delaware Supreme Court considered whether a general release of all claims, whether known or unknown, in a settlement

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[44]Emphasis added. The releases are in the Affidavit submitted to this court by Douglas H. Meal on December 5, 2003.

[45]*E. I. DuPont de Nemours & Co. v. Fla. Evergreen Foliage*, 744 A.2d 457, 460 (Del. 1999) (quoting *Adams*, 452 A.2d at 156).

agreement, following a preamble alluding to the action being settled, prevented a future claim for fraudulent inducement. The Supreme Court focused on whether a releasee should be held to "release a claim for fraud in the execution of the release itself," and decided it should not.[46] In *Adams v. Kankouskas*, the Delaware Supreme Court interpreted a general release narrowly. That court's opinion, however, was based on the fact that the general release followed a specific *release*, not a specific *recital*. The releases in this case contain no such bifurcation.

Here, although stating that the releases are given in consideration of payments and benefits provided in the termination memorandum, the language of the releases specifically limits them to any action relating to the hiring of, employment by, and cessation of employment of the signatory. In seeking standing to assert their rights, the Intervenors linked their right to the options directly to their employee relationship with the defendants. Further, the options vested according to a schedule that depended on the Intervenors' continued employment with Cabletron, GNTS, or "any of their Affiliates." Under the clear, unambiguous language of the releases, the Release Signatories released their rights to bring a claim under Exhibit 7.11.[47]

Further, the intention of the parties, which is controlling, is manifested by what each of the Release Signatories agreed to have removed from the releases. Each of the Release Signatories attempted to add handwritten language to his or her own release, stating "[e]xception to the above limited to Delaware litigation between sellers and buyers of BIT Management Inc initiated on or about Nov. 13, 2001."[48] The Release Signatories all authorized the removal of this language at the request of BIT. This explicit removal further shows that the parties' intent was not to include the Delaware litigation.[49]

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[46]*Id.* at 461.

[47]The reliance of the Release Signatories on *Fischer v. Fischer*, 1999 WL 1032768 (Del. Ch. Nov. 4 1999), is misplaced. *Fischer* looked at the parties' intent to determine whether a separation agreement between former spouses served to bar one former spouse's breach of fiduciary suit against the other former spouse. The court held that a release designed to cover the division of marital property could not foreclose a derivative suit by one spouse as shareholder against another spouse as director. The court determined "the parties never intended the release to discharge a claim arising outside the marriage relationship." *Id.* at *4. The claim in the current case is directly related to the subject matter of the release.

[48]One of the releases contained the abbreviation "Inc.," and three did not. Swora's additional handwritten language did not contain the words "limited to."

[49]The Release Signatories seem to imply that their agreement to the removal of the additional language should not be valid because of estoppel, or alternatively because it was achieved as a result of duress. The Intervenor's Reply Brief, states that "Enterasys' own human resources consultant, Robert McCormack . . . expressly advised Cuervo, Julien, Knabenschuh, and Swora to include the handwritten language in the releases." Intervenors Reply Br. In Support of

The Release Signatories, because they have signed the releases, are estopped from bringing suit against the defendants under Exhibit 7.11 of the Agreement.

C. Rathnam

Intervenor Rathnam's release is substantially similar to those of the Release Signatories. It states:

> IN CONSIDERATION of the payment to me of the amounts specified [in a separate letter] . . . I, **Ramesh Rathnam** . . . hereby release and forever discharge **Global Network Technology Services**, a subsidiary of **Cabletron Systems, Inc.** along with all parents, subsidiaries, affiliates and associated companies, and together with all respective officers, directors, employees, servants and agents and their successors and assigns (hereinafter collectively referred to as the "Releasee") jointly and severally from any and all actions, causes of action, contracts, covenants, whether express or implied, claims, demands for damages, including disability, life or other insurance claims, indemnity benefits, costs, interest, loss or injury of every nature and kind whatsoever and howsoever arising whether statutory or otherwise, which I may heretofore have had, may now have, or may hereinafter have, *in any way relating to the hiring of the employment by and the cessation of the employment of the Releasor by the Releasee.*[50]

Although there is no attempted insertion and subsequent removal of additional language, as there is in the cases of the Release Signatories, the clear language of this release, for the same reasons discussed above, prevents Rathnam from bringing a claim against the defendants under the Agreement.

Their Claims for Relief 11-12 n. 3 (Dec. 19, 2003) ("Reply Br."). Other than a statement being made, the brief does not set forth other elements of estoppel.

Further, the Release Signatories argue that, should they not have agreed to the removal of language, they would have only been entitled to the "paltry two weeks pay required by applicable Ontario law." Reply Br. at 13. They essentially argue that there is duress because, had they not signed, they would not be entitled to the additional severance offered on top of what the Ontario legislature deemed appropriate. This is not a valid argument for duress.

[50]Emphasis added. This release is also included in the Meal Affidavit.

D. Matheson, Palma, Kapuscinski

Although releases from intervenors Kapuscinski and Palma were submitted to the court, it is not clear from the record whether they signed those releases. Similarly, it is not clear whether intervenor Matheson, whose release mirrored that of Cuervo, Julien, Knabenschuh and Swora, agreed to accept the terms of the release without the proposed handwritten carve-out. Further factual development is required before the court can determine whether any of these intervenors released any claims they might otherwise have had.[51]

V.

For the foregoing reason, judgment will be entered for intervenors Forsythe and Lim, and against the Release Signatories. The parties are instructed to present an order in conformity with the calculations used in the September 4 Opinion (while keeping in mind the termination dates of Forsythe and Lim and the resultant effect on the vesting schedule) within 30 days. The parties are further instructed to update this court within 30 days as to the status of the Matheson, Palma, and Kapuscinski claims.

IN RE EBAY, INC. SHAREHOLDERS LITIGATION

No. 19,988-NC (Consolidated)

Court of Chancery of the State of Delaware, New Castle

January 23, 2004
Revised February 11, 2004

Carmella P. Keener, Esquire, of Rosenthal Monhait Gross & Goddess, P.A., Wilmington, Delaware; and H. Adam Prussin, Esquire, and Ronen Sarraf, Esquire, of Pomerantz Haudek Block Grossman & Gross LLP, New

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[51]In a February 9, 2004, letter to the court, counsel to the defendants indicated that it has initiated steps toward developing this record.

York, New York, of counsel; and Peter S. Linden, Esquire, and Mark Strauss, Esquire, of Kirby, McInerney & Squire, LLP, New York, New York, of counsel, for plaintiffs.

Lawrence C. Ashby, Esquire, and Philip Trainer, Jr., Esquire, of Ashby & Geddes, Wilmington, Delaware; and Stephen C. Neal, Esquire, Michael G. Rhodes, Esquire, Grant P. Fondo, Esquire, Jeffrey S. Karr, Esquire, and Aaron P. Arnzen, Esquire, of Cooley Godward LLP, Palo Alto, California, of counsel, for defendants eBay Inc., Philippe Bourguignon, Scott D. Cook, Dawn G. Lepore, Pierre M. Omidyar, Howard D. Schultz, Jeffrey S. Skoll, and Margaret C. Whitman.

Jesse A. Finkelstein, Esquire, and John D. Hendershot, Esquire, of Richards, Layton & Finger, P.A., Wilmington, Delaware; Gandolfo V. DiBlasi, Esquire, and John L. Hardiman, Esquire, of Sullivan & Cromwell, LLP, New York, New York, of counsel, for defendant The Goldman Sachs Group, Inc.

CHANDLER, *Chancellor*

Shareholders of eBay, Inc. filed these consolidated derivative actions against certain eBay directors and officers for usurping corporate opportunities.[1] Plaintiffs allege that eBay's investment banking advisor, Goldman Sachs Group, engaged in "spinning," a practice that involves allocating shares of lucrative initial public offerings of stock to favored clients. In effect, the plaintiff shareholders allege that Goldman Sachs bribed certain eBay insiders, using the currency of highly profitable investment opportunities—opportunities that should have been offered to, or provided for the benefit of, eBay rather than the favored insiders. Plaintiffs accuse Goldman Sachs of aiding and abetting the corporate insiders breach of their fiduciary duty of loyalty to eBay.

The individual eBay defendants, as well as Goldman Sachs, have moved to dismiss these consolidated actions for failure to state a claim and for failure to make a pre-suit demand on eBay's board of directors as required under Chancery Court Rule 23.1. For reasons I briefly discuss below, I deny all of the defendants' motions to dismiss.

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[1]Two separate derivative actions were filed (C.A. No. 19988 and C. A. No. 19996) and the Court consolidated them on December 3, 2002, with the complaint in C.A. No. 19988 treated as the operative complaint.

I. BACKGROUND FACTS

The facts, as alleged in the complaint, are straightforward. In 1995, defendants Pierre M. Omidyar and Jeffrey Skoll founded nominal defendant eBay, a Delaware corporation, as a sole proprietorship. eBay is a pioneer in online trading platforms, providing a virtual auction community for buyers and sellers to list items for sale and to bid on items of interest. In 1998, eBay retained Goldman Sachs and other investment banks to underwrite an initial public offering of common stock. Goldman Sachs was the lead underwriter. The stock was priced at $18 per share. Goldman Sachs purchased about 1.2 million shares. Shares of eBay stock became immensely valuable during 1998 and 1999, rising to $175 per share in early April 1999. Around that time, eBay made a secondary offering, issuing 6.5 million shares of common stock at $170 per share for a total of $1.1 billion. Goldman Sachs again served as lead underwriter. Goldman Sachs was asked in 2001 to serve as eBay's financial advisor in connection with an acquisition by eBay of PayPal, Inc. For these services, eBay has paid Goldman Sachs over $8 million.

During this same time period, Goldman Sachs "rewarded" the individual defendants by allocating to them thousands of IPO shares, managed by Goldman Sachs, at the initial offering price. Because the IPO market during this particular period of time was extremely active, prices of initial stock offerings often doubled or tripled in a single day. Investors who were well connected, either to Goldman Sachs or to similarly situated investment banks serving as IPO underwriters, were able to flip these investments into instant profit by selling the equities in a few days or even in a few hours after they were initially purchased.

The essential allegation of the complaint is that Goldman Sachs provided these IPO share allocations to the individual defendants to show appreciation for eBay's business and to enhance Goldman Sachs' chances of obtaining future eBay business. In addition to co-founding eBay, defendant Omidyar has been eBay's CEO, CFO and President. He is eBay's largest stockholder, owning more than 23% of the company's equity. Goldman Sachs allocated Omidyar shares in at least forty IPOs at the initial offering price. Omidyar resold these securities in the public market for millions of dollars in profit. Defendant Whitman owns 3.3% of eBay stock and has been President, CEO and a director since early 1998. Whitman also has been a director of Goldman Sachs since 2001. Goldman Sachs allocated Whitman shares in over a 100 IPOs at the initial offering price. Whitman sold these equities in the open market and reaped millions of dollars in profit. Defendant Skoll, in addition to co-founding eBay, has served in various positions at the company, including Vice-President of

Strategic Planning and Analysis and President. He served as an eBay director from December 1996 to March 1998. Skoll is eBay's second largest stockholder, owning about 13% of the company. Goldman Sachs has allocated Skoll shares in at least 75 IPOs at the initial offering price, which Skoll promptly resold on the open market, allowing him to realize millions of dollars in profit. Finally, defendant Robert C. Kagle has served as an eBay director since June 1997. Goldman Sachs allocated Kagle shares in at least 25 IPOs at the initial offering price. Kagle promptly resold these equities, and recorded millions of dollars in profit.

II. ANALYSIS

A. Demand Futility

Plaintiffs bring these actions on behalf of nominal defendant eBay, seeking an accounting from the individual director defendants of their profits from the IPO transactions as well as compensatory damages from Goldman Sachs for its participation (aiding and abetting) in the eBay insiders' breach of fiduciary duty. Court of Chancery Rule 23.1 requires that a shareholder make a demand that the corporation's board pursue potential litigation before initiating such litigation on the corporation's behalf. When a plaintiff fails to make a demand on the board of directors, the plaintiff must plead with factual particularity why the demand is excused.

eBay's board of directors consists of seven members. Three are the individual defendants-Whitman, Omidyar and Kagle; defendant Skoll is not presently a director. All four of these individual defendants received IPO allocations from Goldman Sachs. As a result, the three current directors of eBay who received IPO allocations (Omidyar, Whitman and Kagle) are clearly interested in the transactions at the core of this controversy.

Although the other four directors of eBay (Cook, Lepore, Schultz and Bourguignon) did not participate in the "spinning," plaintiffs allege that they are not independent of the interested directors and, thus, demand is excused as futile. Since three of the seven present eBay directors are interested in the transactions that give rise to this litigation, plaintiffs need only demonstrate a reason to doubt the independence of one of the remaining four directors. Plaintiffs allege that directors Cook, Lepore, Schultz and Bourguignon all have "close business and personal ties with the individual defendants" and are incapable of exercising independent judgment to determine whether eBay should bring a breach of fiduciary duty action against the individual defendants. Plaintiffs allege, for example, that Schultz is a member of Maveron LLC, an investment

advisory company in which Whitman has made significant personal investments. More significantly, plaintiffs allege that Cook, Lepore, Schultz and Bourguignon have received huge financial benefits as a result of their positions as eBay directors and, furthermore, that they owe their positions on the board to Omidyar, Whitman, Kagle and Skoll.

eBay pays no cash compensation to its directors, but it does award substantial stock options. For example, in 1998, when Cook joined eBay's board, it awarded him 900,000 options at an exercise price of $1.555. One fourth of these options (225,000) vested immediately, and an additional 2% vests each subsequent month so long as Cook remains a director. In 1998, after Cook had joined the board, eBay adopted a director's stock option plan pursuant to which each non-employee director was to be awarded 30,000 options each year (except for 1999, when no additional options were awarded). As of early 2002, Cook beneficially owned 903,750 currently exercisable options, and an additional 200,000 shares of eBay stock. The complaint notes that the exercise price on 900,000 of the options originally awarded to Cook is $1.555 per share. At the time the complaint was filed in this case, eBay stock was valued at $62.13 per share. At an exercise price of $1.555, Cook's original option grant is thus worth millions of dollars. In addition, the stock options awarded in 2000, 2001 and 2002, which are not yet fully vested, and will never vest unless Cook retains his position as a director, are worth potentially millions of dollars.

The complaint further alleges that director Schultz, Lepore and Bourguignon are similarly situated. That is, the stock options granted to these directors, which are both vested and unvested, are so valuable that they create a financial incentive for these directors to retain their positions as directors and make them beholden to the defendant directors. As a result, plaintiffs contend that it is more than reasonable to assume that an individual who has already received, and who expects to receive still more, options of such significant value could not objectively decide whether to commence legal proceedings against fellow directors who are directly responsible for the outside directors' continuing positions on the board.

I need not address each of the four outside directors, as I agree with plaintiffs that the particularized allegations of the complaint are sufficient to raise a reasonable doubt as to Cook's independence from the eBay insider directors who accepted Goldman Sachs' IPO allocations. Defendants resist this conclusion by pointing out that Whitman, Kagle, Omidyar and Skoll, collectively with management, control 40% of eBay's common stock, which they argue is insufficient to allege control or domination. Defendants also contend that the options represent past compensation and would not effectively disable a director from acting fairly and impartially with respect to a demand. These arguments are unpersuasive in these circumstances.

First, defendants must concede that certain stockholders, executive officers and directors control eBay. For example, eBay's form 10-K for the fiscal year ending December 31, 2000 notes that eBay's executive officers and directors Whitman, Omidyar, Kagle and Skoll (and their affiliates) own about one-half of eBay's outstanding common stock.[2] As a result, these eBay officers and directors effectively have the ability to control eBay and to direct its affairs and business, including the election of directors and the approval of significant corporate transactions. Although the percentage of ownership may have decreased slightly from the time eBay filed the 2000 10-K, the decrease is insufficient to detract from the company's acknowledgement that these four individual defendants control the company and the election of directors.

Second, although many of the options awarded to Cook and the other purported outside directors have in fact vested, a significant number of options have not yet vested and will never vest unless the outside directors remain directors of eBay. Given that the value of the options for Cook (and allegedly for the other outside directors) potentially run into the millions of dollars, one cannot conclude realistically that Cook would be able to objectively and impartially consider a demand to bring litigation against those to whom he is beholden for his current position and future position on eBay's board. With the specific allegations of the complaint in mind, I conclude that plaintiffs have adequately demonstrated that demand on eBay's board should be excused as futile.

B. Corporate Opportunity

Plaintiffs have stated a claim that defendants usurped a corporate opportunity of eBay. Defendants insist that Goldman Sachs' IPO allocations to eBay's insider directors were "collateral investments opportunities" that arose by virtue of the inside directors status as wealthy individuals. They argue that this is not a corporate opportunity within the corporation's line of business or an opportunity in which the corporation had an interest or expectancy.[3] These arguments are unavailing.

First, no one disputes that eBay financially was able to exploit the opportunities in question. Second, eBay was in the business of investing in securities. The complaint alleges that eBay "consistently invested a portion of its cash on hand in marketable securities." According to eBay's

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[2]A 10-K is appropriately considered in ruling on a motion to dismiss, especially when referenced in the complaint.

[3]*See Broz v. Cellular Info. Sys. Inc.*, 673 A. 2d 148, 155 (Del. 1996) (listing factors to find corporate opportunity).

1999 10-K, for example, eBay had more than $550 million invested in equity and debt securities. eBay invested more than $181 million in "short-term investments" and $373 million in "long-term investments." Thus, investing was "a line of business" of eBay. Third, the facts alleged in the complaint suggest that investing was integral to eBay's cash management strategies and a significant part of its business. Finally, it is no answer to say, as do defendants, that IPOs are risky investments. It is undisputed that eBay was never given an opportunity to turn down the IPO allocations as too risky.[4]

Defendants also argue that to view the IPO allocations in question as corporate opportunities will mean that every advantageous investment opportunity that comes to an officer or director will be considered a corporate opportunity. On the contrary, the allegations in the complaint in this case indicate that unique, below-market price investment opportunities were offered by Goldman Sachs to the insider defendants as financial inducements to maintain and secure corporate business. This was not an instance where a broker offered advice to a director about an investment in a marketable security. The conduct challenged here involved a large investment bank that regularly did business with a company steering highly lucrative IPO allocations to select insider directors and officers at that company, allegedly both to reward them for past business and to induce them to direct future business to that investment bank. This is a far cry from the defendants' characterization of the conduct in question as merely "a broker's investment recommendations" to a wealthy client.

Nor can one seriously argue that this conduct did not place the insider defendants in a position of conflict with their duties to the corporation. One can realistically characterize these IPO allocations as a form of commercial discount or rebate for past or future investment banking services. Viewed pragmatically, it is easy to understand how steering such commercial rebates to certain insider directors places those directors in an obvious conflict between their self-interest and the corporation's interest. It is noteworthy, too, that the Securities and Exchange Commission has taken the position that "spinning" practices violate the obligations of broker-dealers under the "Free-riding and Withholding Interpretation" rules.[5] As the SEC has explained, "the purpose of the interpretation is to protect the integrity of the public offering system

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[4]Defendants' counsel implied at oral argument that these investments were so risky that defendants may have lost money on some or all of them. That is a factual assertion that certainly contradicts allegations in the complaint, but of course I may not consider it on a motion to dismiss.

[5]*See Approval of Amendment to Free-riding and Withholding Interpretation*, NASD Notice 98-48, 1998 WL 1707944, at *1 (July 1998).