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2004 WL 286963

UNPUBLISHED OPINION. CHECK COURT RULES BEFORE CITING.

Court of Chancery of Delaware.

CEDE & CO., Petitioner,
v.
JRC ACQUISITION CORP., L & LR, Inc., and 800-JR Cigar, Inc., Respondents.

No. Civ.A. 18648-NC.
|
Submitted Dec. 5, 2003.
|
Decided Feb. 10, 2004.

Attorneys and Law Firms

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

MEMORANDUM OPINION

CHANDLER, J.

***1** 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.

***2** 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," 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 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

***3** 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 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 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]

***4** 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.

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]

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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]

***5** 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, 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 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]

***6** 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

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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 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, 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*

***7** 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]

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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 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 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]

***8** 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 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.

***9** 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 position. [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 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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***10** 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 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*

***11** 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 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 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"*
***12** 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.

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 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*

***13** 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.

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 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.

***14** 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 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*

***15** 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]

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.

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All Citations

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Footnotes

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

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).

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.

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).

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.

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.

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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.

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.

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.

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.

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.

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).

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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).

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.

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.

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.*

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.

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.

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108 *Id.,* Chart A.
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.
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.
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 DeVinney'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).
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.
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.
141 Ex. 65 at 39.
142 Tr. at 119-20.
143 *Id.*
144 OB at 32.
145 2002 WL 31057465, at *12.

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146 *Id.*

147 *See Grimes,* 1997 WL 538676, at *10; *Chang's Holdings S.A. v. Universal Chems. & Coalings,* 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.

149 Tr. at 232.

150 *Id.*

151 *Grimes,* 1997 Del. Ch. LEXIS 124, at *55, 1997 WL 538676.

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, 1997 WL 538676.

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