Hanover Direct, Inc., Shareholder's Litigation

Scott R. Miller

This discussion of a recent Delaware Chancery Court decision emphasizes the importance of a complete and competent valuation analysis by the expert witness. The primary issue in the case was whether minority shareholders of the target company in a going-private merger received fair value for their common stock shares. According to the Delaware Chancery Court, the judicial decision came down to a battle of the experts. However, unlike the typical case of this type, this judicial decision was entirely one-sided. The Delaware Chancery Court concluded that one expert's opinion was completely unreliable while the other expert's opinion was overwhelmingly persuasive.

Introduction

In *Hanover Direct, Inc., Shareholder's Litigation*,[1] the Court of Chancery of Delaware ("the Chancery Court") ruled on a shareholder dispute in which several Hanover Direct, Inc. ("Hanover") shareholders ("Plaintiffs") alleged that the share price accepted by the Hanover board of directors ("the Board") in a November 2006 going-private merger did not reflect fair value. Among those identified as defendants were Hanover, the Board, and the acquiring company Chelsey Direct LLC ("Chelsey") (collectively the "Defendants").[2]

The offer price for the outstanding shares that were not owned by Chelsey was a significant discount to the price that Hanover stock traded at on the pink sheets during the six months prior to the merger agreement.

At the time of the merger proposal, Chelsey owned approximately a 77 percent interest in Hanover, including approximately 92 percent of the Hanover voting rights.[3]

The Hanover Board was comprised entirely of members affiliated with Chelsey.

Due to the inherent conflict of interest of a board lacking any independent members, determining that the offer price was indeed a "fair price" was a key to the Defendants' case. Common to this type of dispute, the judicial decision was ultimately based on the testimony of the valuation experts and on their opinions of the Hanover common stock fair value at the time of the merger.

In its decision, the Chancery Court described one expert's opinion as "completely unreliable." Therefore, the Chancery Court assigned no weight to the testimony of that expert.

The Defendants' valuation analyst offered an opinion that the share price received was fair. The valuation analyst opined that the claims on the Hanover capital by debtors and preferred stock holders exceeded the Hanover enterprise value. The expert also opined that the Hanover common stock had no intrinsic value at the time of the merger.

The Chancery Court determined that this valuation analyst's testimony was overwhelmingly persuasive in his use of three different valuation approaches.

Conversely, the Plaintiffs' valuation analyst offered an opinion that the share price received by the minority shareholders of Hanover was grossly unfair. The analyst opined that, based on the market approach, the fair value of the Hanover common stock was significantly greater than the offer price accepted by the Board.

However, the Chancery Court ruled that the Plaintiffs' valuation analyst testimony was completely unreliable due to the following factors:

1. The inconsistency of the valuation, with changes during the lead-up to the trial, and in real-time when the valuation analyst was on the witness stand
2. The analyst's demeanor while explaining her methodology
3. An attempt to submit a new valuation post-trial
4. The inclusion of outlier data points
5. The exclusion of certain other data points
6. The reliance on only one valuation method—a comparable companies analysis

The Facts of the Case

Hanover was a direct marketing company that had deteriorating financial performance since the late 1990s. At the time of the merger proposal, Chelsey controlled 77 percent of the Hanover stock and 92 percent of the Hanover voting rights.

Chelsey proposed a going-private merger that would result in the Hanover common stock not owned by Chelsey to be cashed out at $0.25 per share. Following the merger, the shares held by Chelsey would be voided, since Chelsey would then have full control of Hanover.

The Board retained independent legal and financial advisers to guide it through the merger. On November 27, 2006, the Hanover board of directors, which consisted entirely of members affiliated with Chelsey, approved the merger proposal on the basis that the $0.25 offer price exceeded the fair value of the Hanover common stock.

Given that Chelsey controlled a percentage of the voting rights sufficient to approve the merger, the merger was closed on April 12, 2007.

Following the merger approval, several stockholders filed suit, claiming that the $0.25 per share received did not reflect fair value. The dissenting shareholders claimed that the fair value of the Hanover common stock at the time of the merger was $4.75 per share.

Plaintiffs' Position

On December 22, 2006, two Hanover shareholders filed an amended complaint following the announced execution of the November 27, 2006, merger agreement between Chelsey and Hanover.[4]

The amended complaint was a follow-up to a previous complaint relating to a prior but withdrawn going-private proposal by Chelsey.

In the complaint, Hanover, Chelsey, and the Board were named as defendants. The complaint alleged that:

1. the consideration of $0.25 per share to the common stockholders was grossly inadequate;
2. each of the members of the Board had conflicts of interest in approving the merger with Chelsey;
3. the merger was approved without the benefit of a fairness opinion;
4. the valuation analysis relied on by Hanover and the Board was flawed for a number of reasons, including that it did not take into account the market price of the Hanover common stock;
5. Chelsey opportunistically timed the transaction to freeze out the minority shareholders during a time of depressed revenues; and
6. the proxy was materially false and misleading.

The dissenting shareholders claimed that for these reasons, the Defendants breached their fiduciary duties of due care and loyalty to the minority shareholders of Hanover.

The dissenting shareholders based their claims on, among other things, the following arguments:

1. There was a conflict of interest. Based on the composition of the Board and the Hanover capitalization, even with 100 percent of the minority shareholders opposing a merger, Chelsey could approve the transaction.

   After the independent board members resigned following a prior failed merger (within a year of the merger agreement in question), they were not replaced with new independent members.
2. The financial results of Hanover at the time of the merger were improving as opposed to deteriorating. According to the annual report filed on March 31, 2006, income from continuing operations, net income applicable to common shareholders, and revenue all increased relative to the prior year.

   Revenue in the first nine months of 2006 (directly preceding the merger approval) increased by 5.6 percent over the first nine months of 2005.
3. On February 27, 2006, Hanover received a proposal from Chelsey to acquire the remainder of the Hanover common stock for $1.25 per share, a discount to the prior day trading price of $2.55.

In connection with this proposal, Hanover formed a special committee of independent directors to evaluate the proposal. Hanover also retained outside counsel and an independent valuation adviser.

After numerous downward revisions to the concluded fair value range of the Hanover common stock, the independent advisers still believed a fair range of values exceeded the proposal of $1.25 per share.

4. After the Board was advised by the independent valuation experts that a fair range of values exceeded the $1.25 proposal, Chelsey withdrew the offer. Soon after the withdrawn offer, each of the members of the special committee resigned from the Board and were not replaced with independent board members.

   Additionally, after expressing the opinion that a fair range of values exceeded the $1.25 proposal, the independent valuation adviser was not asked to render a fairness opinion, and was not asked to perform additional services for Hanover.

5. After being unpleased with the analyses and conclusions of the valuation advisers retained in connection with the $1.25 proposal, the Board retained a new valuation adviser.

   Despite the common stock trading at a value of $1.30 at the time the report was issued, the new valuation adviser concluded that the Hanover common stock had no value. This second valuation supported the lower second offer from Chelsey of $0.25 per share.

6. The offer price of $0.25 per share represented a 79 percent discount to the trading value of the Hanover common stock prior to the announcement of the proposed transaction. This price discount is in contrast to a price premium that is typically paid in a control transaction.

7. Although Hanover's shareholders had the right to accept the $0.25 offer price or pursue appraisal rights, Hanover and its directors did not provided the minority shareholders with material information concerning the value of Hanover. This omission prevented them from making an informed decision.

Additionally, the dissenting shareholders claimed that the analysis performed by the second independent adviser was flawed in a number of ways including the following:

1. The reliance on management's self-serving projections
2. The understatement of certain comparable public company multiples
3. The exclusion of comparable public companies and comparable transactions without explanation
4. Overstatement of the Hanover weighted average cost of capital discount rate
5. Inconsistent assumptions including the selection of exit pricing multiples.

Defendant's Position

The Board, Hanover, and Chelsey all claimed that the per share merger price of $0.25 was in the best interest of Hanover's stockholders other than Hanover and Chelsey.[5]

The principal factors considered by the Board in the decision to accept the merger proposal included the following:

1. The valuation analysis of an independent adviser
2. The current and historical financial condition of Hanover
3. The history of the business
4. The lack of better offers from an outside party
5. The favorable terms and structure of the merger

Among other factors, Hanover argued the following reasons for accepting the merger price of $0.25 per share:

1. The Board engaged an outside valuation analyst with experience in the industry and with recent industry merger and acquisition transaction experience. The Board instructed the valuation analyst to "use the direction which would achieve a higher enterprise valuation of Hanover and a higher valuation for the holders of the Hanover common stock."

   Despite these instructions, the independent valuation analyst concluded that there was no fundamental value to the common shares of Hanover stock.

2. The Hanover financial condition had deteriorated in recent years. The historically profitable flagship divisions suffered decreasing profits. EBITDA (earnings before interest, taxes, depreciation expense, and amortization expense) decreased in the recent year.

Increasing costs related to outside factors weighed on the profitability of Hanover.

Credit facilities were scheduled to come due within the next year, with no assurance of refinancing. The costs of remaining public were also a drain on Hanover's resources.

3. Hanover was delisted from the American Stock Exchange and traded on the pink sheets prior to the merger. There were no investment analysts following the common stock, and there were substantial insider holdings, resulting in an illiquid market for the stock.

   Average trading volume was less than 20,000 shares per day from January 1, 2003, through November 1, 2006, making it difficult to sell a substantial portion of a common stockholder's position in Hanover.

4. The Board had received only one offer to purchase Hanover between the initial proposal from Chelsey to take Hanover private and the revised offer from Chelsey.

   The Board expressed the opinion that, given up-to-date financial information, the one offer received would not give any value to the common shareholders (despite the original offer of $1.35 per share, a 440 percent premium to the Chelsey offer of $0.25).

5. The terms of the merger were favorable to the common stockholders. The merger was a cash consideration and would therefore provide liquidity and certainty to Hanover's public stockholders.

   Due to the lack of independence of the Board, provisions were taken to allow for cancellation of the merger. The merger agreement (a) allowed Hanover to solicit third-party bids and (b) had no termination fee.

The Board also recognized the following negative factors concerning the merger:

1. The historic trading price exceeded the offer price.
2. The transaction did not require approval by the majority of the minority shareholders.
3. There was a lack of a special committee or independent board members to evaluate the merger.
4. There was no fairness opinion.

That is, prior to the merger agreement, the valuation adviser did not provide an opinion on the fairness of the merger consideration to be offered to the shareholders not affiliated with Chelsey.

The Issue in Question

The Chancery Court referred to this as a typical case involving the recapitalization of a troubled company. Due to the fact that the Board was self-admittedly not independent of Chelsey, the deciding issue in this dispute would be the fair value of the common stock at the time of the merger.

The Court determined that the key decision element of this case was whether the merger price was fair. A secondary issue was whether the board of directors of Hanover conducted a fair process in its decision to accept the merger.

Issue of Fair Value or Fair Price

It was the task of the valuation experts to convince the Chancery Court of the fair value of the Hanover common stock at the time of the merger. The definition of fair value may differ from the definition of fair market value, and virtually no state specifically equates fair value with fair market value.[6]

Fair market value refers to a price at which a hypothetical willing seller and a hypothetical willing buyer, both being informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so. Fair value has been defined as:

> The value of the shares immediately before the effectuation of the corporate action to which the shareholder objects using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal, and without discounting for lack of marketability or minority status except, if appropriate, for amendments to the certificate of incorporation pursuant to section 13.02(a)(5).[7]

In a going-private transaction, fair price and fair value generally:

1. will be determined based in part upon the advice to the special committee by its independent financial adviser and
2. will be supported by a fairness opinion issued by the adviser.[8]

> “. . . the Court relied entirely on the Defendants’ expert’s opinion, referring to his valuation as ‘overwhelmingly persuasive.’”

Various valuation approaches and analyses may be used in estimating fair value. Speculative pro forma data and projections relating to the synergies accomplished in the merger are typically not permitted in the fairness opinion analysis.

Analysis options available to financial advisers in estimating the fair value may include the following:

1. Discounted cash flow analyses
2. Comparable company stock price analyses
3. Comparable transaction analyses
4. Asset valuations
5. Market valuations
6. Reconstructed market value valuations

Specifically, Schedule 13E-3 (an SEC document filed in the case of a going-private merger) lists the following factors that will “normally” be important in determining fair value:

- Current market prices
- Historical market prices
- Net book value
- Going concern value
- Liquidation value
- The price paid in purchases by the company or its affiliates over the previous two fiscal years
- Any report, opinion, or appraisal received by the company or its affiliates relating to the transaction’s fairness
- Other firm offers during the preceding two years for merger, consolidation, or sale of assets of the company sought in order to exercise control

However, the importance of these factors will vary widely on a case-to-case basis. As in the case of Hanover, the market prices for its common stock prior to the merger agreement may have reflected speculative as opposed to intrinsic value. The company also reported a negative book value at the time of the merger agreement.

The Fair Value Decision

The Chancery Court stated that the valuation aspect of the case came down to a battle of the experts. After assessing the strength and credibility of the valuation experts’ respective testimonies, the Court relied entirely on the Defendants’ expert’s opinion, referring to his valuation as “overwhelmingly persuasive.” The Chancery Court concluded that the Plaintiffs’ expert’s opinion was completely unreliable for a host of reasons. Accordingly, the Court concluded that the merger price of $0.25 was entirely fair.

The Defendants’ valuation analyst was identified as an experienced valuation expert who had previously appeared in the Chancery Court of Delaware. To arrive at an opinion of the Hanover enterprise value, the analyst used three different approaches:

1. A discounted cash flow analysis (income approach)
2. A comparable companies analysis (market approach)
3. A comparable transaction analysis (market approach)

The Chancery Court stated that the expert relied on a data set that raised no issues of reliability, and was assured by the fact that the valuation analyst used multiple approaches that supported one another’s conclusions.

The Plaintiffs’ valuation expert used a methodology that left the Chancery Court with no confidence in her valuation. The most serious concerns with the expert’s valuation included the following:

1. “The real-time change in petitioners’ analyst’s valuation while she testified from the witness stand, as well as several changes in the expert’s valuation report in the lead-up to trial”
2. “The expert’s demeanor in attempting to explain to [the chancellor] why her valuation methodology and its unique approaches were reliable and worthy of confidence, however different those approaches were from more common, clear, and convincing methodologies”
3. “The unprecedented attempt by petitioners’ counsel to submit a new valuation in their post-trial answering brief”
4. “The expert’s inclusion of data points that seemed to be at worst outliers and at best a failure by the expert to adjust appropriately even for the possibility that these data points were outliers”
5. “The expert’s seeming disregard for earlier data points”

6. "Most importantly, the fact that the expert's valuation was based entirely on one valuation technique—a comparable companies analysis—rather than on a blend of techniques"[9]

The Chancery Court determined that the value in question was easily decided in favor of the Defendants' expert due to the overwhelming persuasiveness of his evidence and arguments relative to the opposing expert.

Issue of Fair Process

In the case of a change of control merger, a company's board of directors may be liable for a breach of loyalty relating to shortcomings under *Revlon*.[10] Delaware corporate law has set a precedent known as the Revlon Duties, requiring a board of directors to set its singular focus on attaining the highest reasonable value for the stockholders when confronted with a sale of the company.

Possible violations of the Board's Revlon Duties included the following:

1. The lack of a special committee of independent directors to evaluate the offer
2. The lack of a fairness opinion of the merger consideration to be offered to the shareholders not affiliated with Chelsey prior to the merger acceptance

Additionally, the Board's lack of loyalty to the minority shareholders must be called into question, considering each of the Board member's interest in the acquiring company.

Fair Process Ruling

Despite the possible breaches, the Court determined that the process followed by the Board did not raise any doubt. The state of Hanover at the time of the merger, and the fact that the Board retained independent legal and financial advisers, convinced the Court of the validity and nonbias nature of the Board's decision to approve the merger. The Court determined that there was no evidence that the transactional process was "manipulated, timed, or tainted," leading to the common stockholders of Hanover receiving an unfair price in the merger.

The lack of a compelling, or even adequate, argument by the Plaintiffs' expert may have allowed the Chancery Court to comfortably dismiss the possibility of a breach of fiduciary duty on the part of the Board. By presenting no convincing evidence that the offer price of $0.25 was unfair to the minority shareholders, the Plaintiffs did not give the Chancery Court incentive to look further into the process it underwent in accepting the offer.

Valuation Issues

One unique aspect of this case comes not from the decision, but the manner in which the Chancery Court arrived at its decision. The Court emphasized that the decision turned entirely on the fact that one expert's opinion was completely unreliable.

In contrast to a more typical ruling in which a court may consider arguments from each opposing expert, in this case the Court relied entirely on the opinion of the valuation expert, and completely dismissed the opinion of the Plaintiffs' expert.

In cases involving dueling experts, the valuation professionals often rely on similar methodologies and battle over inputs such as betas, discount rates, revenue projections, and calculations used in the determination of an appropriate cost of capital.

In this case, the Court ruled that one expert's methodology was so flawed that it did not merit further examination of these, or similar, inputs.

Apart from procedural flaws (including real-time changing of her valuation while on the witness stand), the Chancery Court identified three detrimental aspects of the Plaintiffs' expert valuation:

1. "The expert's inclusion of data points that seemed to be at worst outliers and at best a failure by the expert to adjust appropriately even for the possibility that these data points were outliers"
2. "The expert's seeming disregard for earlier data points"
3. "The fact that the expert's valuation was based entirely on one valuation technique"[11]

Although the Chancery Court noted that no single preferred or accepted valuation methodology under Delaware law establishes beyond question a company's value, there are commonly accepted methodologies that a prudent expert should use in coordination with one another to demonstrate the reliability of their valuation analysis.

The Chancery Court inferred that if a valuation expert concludes similar values using a market approach and an income approach, then the Court has more confidence that both methods are accurately used to value the company.

The Chancery Court also emphasized the importance of clearly and persuasively explaining the inclusion or omission of outliers. With a clear

explanation of the treatment of outliers, the Court has more confidence that the data set is less likely to lead to a biased or skewed valuation.

According to the Chancery Court, the Plaintiff analyst did a poor job of implementing these key factors. Due to the unreliable nature of the Plaintiff analyst's data, along with the absence of multiple valuation techniques that serve to cross-check one another's results, the Court did not place any weight on the analyst's opinion of $4.75 per share.

Summary and Conclusion

This judicial decision emphasizes the importance of a complete and diligent analysis by a valuation expert, and the use of generally accepted valuation methods. Evidence against the Defendants included the following:

1. The lack of a single director on the target company's board that was independent of the acquiring company
2. A stock price of the target company that, in the six months prior to the merger proposal, ranged from a low of 240 percent of the offer price to a high of 520 percent of the offer price
3. The recommendation of an outside independent financial adviser to demand a per share price in excess of the original $1.25 offer
4. A potential offer from a third party within months of the transaction that originally proposed $1.35 per share, $1.10 more than the agreed upon merger.

Additionally, of the eight guidelines recommended in a Schedule 13E-3 (as described in the Fair Value section of this discussion), Hanover and the Board had at least partial contradictions with no fewer than half the guidelines.

Arguments could be made for the Board's lack of consideration concerning:

1. current market prices,
2. historical market prices,
3. prior reports and opinions received by Hanover relating to the transaction's fairness, and
4. other firm offers during the two years prior to the merger.

Despite these factors, the Chancery Court clearly and unquestionably sided with the Defendants, agreeing that the common equity of Hanover had no value. The deciding factor of the case was not the Board's independence or its adherence to all recommended procedures, but rather the competence of the valuation analyses presented by the two sides.

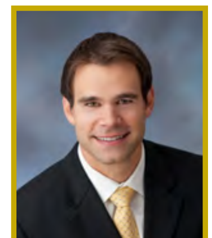
In the judicial decision, the Chancery Court stressed the importance of:

1. clearly and accurately presenting and explaining a valuation opinion,
2. following the appropriate court procedures,
3. excluding or adjusting outlier data points,
4. including appropriate data points, and
5. following generally accepted procedures, specifically considering different valuation methods that serve to complement each other and instill confidence in the audience.

By failing to properly consider these important factors, the Plaintiff valuation analyst left no doubt in the Court's ruling. Conversely, the Defendant valuation analyst (1) inclusion of multiple valuation techniques which complemented each other and (2) explanation of data points both included and excluded, instilled enough confidence in his valuation to overcome the process issues in this case.

Notes:

1. *In re Hanover Direct, Inc. Shareholders Litigation*, Consol. C.A. No. 1969-CC, 2010 WL 3959399 (Del. Ch. Sept. 24, 2010).
2. SEC Form 8-K filed by Hanover Direct, Inc., December 22, 2006, p. 1.
3. SEC Schedule 14A filed by Hanover Direct, Inc., March 7, 2007, p. 13.
4. SEC Form 8-K filed by Hanover Direct, Inc., December 22, 2006.
5. SEC Schedule 14A filed by Hanover Direct, Inc., March 7, 2007.
6. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business*, 5th ed. (New York: McGraw-Hill, 2008)
7. Model Business Corporation Act, 1999 revision.
8. Darrel A. Rice, Esq. "Going Private Transactions–An Overview," *Insights* (Winter 2009), p. 7.
9. *In re Hanover Direct, Inc. Shareholders Litigation*, Consol. C.A. No. 1969-CC, 2010 WL 3959399 (Del. Ch. Sept. 24, 2010), p. 2.
10. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
11. *In re Hanover Direct*.



Scott R. Miller is an associate in our Portland, Oregon, office. Scott can be reached at (503) 243-7504 or at srmiller@willamette.com.