IN THE SUPREME COURT OF THE STATE OF DELAWARE

HUFF FUND INVESTMENT PARTNERSHIP d/b/a MUSASHI II LTD. and BRYAN E. BLOOM,	
Petitioners-Below Appellants/Cross-Appellees,	No. 348, 2014
v.	(Appeal from Court of Chancery C.A. No. 6844-VCG)
CKx, INC.,	
Respondent-Below Appellee/Cross-Appellant.	REDACTED VERSION Dated: October 28, 2014

RESPONDENT-BELOW APPELLEE/CROSS-APPELLANT CKX, INC.'S REPLY BRIEF ON CROSS-APPEAL

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In further support of its cross-appeal, Respondent-Below/Appellee/Cross-Appellant CKx, Inc. ("CKx") hereby respectfully submits this Reply Brief in response to the opposition brief filed by Petitioners-Below/Appellants/Cross-Appellees Huff Fund Investment Partnership d/b/a Masashi II Ltd. and Bryan E. Bloom (together, "Petitioners" or "Huff").

SUMMARY OF ARGUMENT

1. CKx raises three errors made by the Chancery Court below that, if corrected, would each reduce the fair value judgment obtainable by Petitioners. In their opposition papers, Petitioners fail to identify a credible legal rationale or evidentiary basis that can rebut CKx's cross-appeal points.

2. First, it is Petitioners that contend that the Chancery Court was required to implement a different valuation methodology and abused its discretion by relying on the market-tested Merger Price. If this Court agrees with Petitioners' contention—which contravenes settled precedent and ignores the economic reality of the marketplace—then only the discounted cash flow (DCF) analysis of CKx's economist, Jeffrey Cohen, presents a reliable valuation alternative offered by the parties. Having had to abandon their own meritless DCF theory—perhaps because they recognize that it relied on management's invalid projections—Petitioners now attack Cohen's DCF analysis as "pessimistic speculation" because Cohen, like the Chancery Court, correctly rejected those same unrealistic cash flow projections

prepared by CKx management as a selling tool. Yet the cash flow assumptions adopted instead by Cohen provided for a reasonable four percent (4%) growth rate in the base case that, if anything, was *optimistic* given the undisputed record evidence that *American Idol's* ratings were in free fall and Fox was expressly exercising strong leverage in contract negotiations. Thus, if this case is remanded, the Court should direct the Chancery Court to conduct a DCF analysis utilizing Cohen's reasonable assumptions.

3. Second, in seeking to avoid a further reduction of the Chancery Court's $5.50 per share judgment, Petitioners ignore the plain language of 8 *Del. C.* § 262(h), which expressly provides that the Chancery Court's fair value determination is "exclusive of any element of value arising from the . . . expectation of the merger . . . ." As the Chancery Court has recognized, the cost savings generated by a going-private transaction are the types of value arising out of the expectation of a merger that must be subtracted from a fair value determination. Here, we submit that the Chancery Court abused its discretion by refusing to credit contemporaneous documentary evidence in Apollo's investment memorandum and elsewhere demonstrating that its $5.50 bid was premised in part on $4.6 million ($0.29 per share) in expected savings as a result of the going-private transaction. That evidence showed clearly that those cost savings were a quantifiable and necessary element of the transaction price. Contrary to

Petitioners' assertion that detailed testimony was necessary, the Chancery Court had ample evidence before it to justify a reduction under Section 262(h), particularly with respect to the $2.3 million in "going-private" line items and other cost savings that Apollo itself identified as arising out of the merger.

4. Finally, neither the Chancery Court nor the Petitioners have identified any provision of Section 262(h) that prohibits a prepayment of a partial judgment by CKx with full statutory interest. CKx was not avoiding statutory interest but looking to provide Huff with exactly what it says it has been deprived of—full use of a significant principal amount of merger consideration to invest or distribute as it sees fit, along with the statutory interest on that amount in accordance with the "carefully-constructed" statutory scheme. Huff's meritless protest that such a partial judgment prepayment would trigger a tax obligation for the entire judgment is entirely unsupported by auditor opinion or case law, as any contingent final judgment is not yet taxable income under the "open transaction" doctrine. Petitioners' adherence to their position reveals their true improper arbitrage objectives. Indeed, after the Chancery Court's judgment, Petitioners even refused to accept full payment of the appraised value of their shares plus interest. An appraisal action should not be an opportunity to buy a debt security at favorable interest rates. This Court should not tolerate Petitioners' gamesmanship.

ARGUMENT

I. IF ITS RELIANCE ON THE MERGER PRICE WAS ERROR, THE CHANCERY COURT IMPROPERLY REJECTED THE ADJUSTED CASH FLOW PROJECTIONS PREPARED BY CKX'S ECONOMIST

Petitioners argue in their papers that notwithstanding the high level of deference this Court grants to the Chancery Court's appraisal findings, the Chancery Court's reliance on the market-tested Merger Price was an abuse of discretion. Consequently, they assert that the Chancery Court should be required to undertake an independent valuation in accordance with methodologies such as a DCF or comparable companies analysis.[1] If Petitioners are correct—which they are not—CKx has demonstrated that the Chancery Court erred by rejecting the DCF analysis prepared by CKx's expert as a key determinant of CKx's fair value. (CKx Br. at 39-42.)[2]

In response, Petitioners assert that the Chancery Court rejected Cohen's projections because they were "pessimistic" and in conflict with management's "presumpti[vely]" valid cash flow projections. (Opp'n Br. at 22-

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1 In support of their argument against prepayment (addressed below), Petitioners cite an unpublished academic article by Korsmo and Myers. (Appellant's Amended Reply Brief on Appeal and Cross-Appellee's Amended Answering Brief on Cross Appeal (hereinafter "Opp'n Br.") at 35.) Unsurprisingly, however, Petitioners neglect to draw the Court's attention to other sections of the article in which the authors advocate a "safe harbor" for acquirers "where they can demonstrate that the merger price was subjected to a genuine market test." (*See* AR431-32.) Citing the Chancery Court's opinion in this case, the authors observe that "it makes little sense to allow a law-trained chancellor—even the experts on the Delaware Court of Chancery—to second-guess the price set by the market." (*Id.*)

2 Citations to "CKx Br. at __" refer to Respondent-Below/Appellee/Cross-Appellant CKx, Inc.'s Corrected Answering Brief on Appeal and Opening Brief on Cross-Appeal, filed September 16, 2014.

23.) But the Chancery Court did not reject Cohen's approach because it contravened management's projections. To the contrary, it concluded that management's projections were unreliable, as did Cohen and now Petitioners, who have abandoned their own DCF analysis on appeal because it was predicated on those unreliable projections. The Chancery Court found that it could not conclude that Cohen's cash flow projections under a new Fox contract were "any more reliable than management's prediction." (Ex. A at 26.)[3] This is where the error lay, an error that Petitioners sidestep.

There is no dispute that Cohen's cash flow projections mirrored CKx management projections in all respects except for his rejection of the "unreliable" $20 million increase in the *Idol* "fixed fee" that the Chancery Court found had not been prepared in the ordinary course of business of the Company. (*Id.* at 25.) Petitioners contend that this projection was entitled to a presumption of reliability (*see* Opp'n Br. at 23), but the Chancery Court correctly rejected that premise. It held that the additional $20 million in projected fees was included in management's projections "not because [it] constituted management's estimate of the most likely outcome of contract negotiations [with Fox], but because a high estimate of future licensing payments from Fox could generate value for CKx in

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[3] Citations to "Ex. __" refer to exhibits attached to Respondent-Below Appellee/Cross-Appellant CKx, Inc.'s Corrected Answering Brief on Appeal and Opening Brief on Cross-Appeal filed September 16, 2014.

the short-term in the form of lower interest rates and a potentially higher merger price." (Ex. A at 25.)

The Chancery Court's conclusion was supported by "overwhelming evidence" in the record. (*Id.*) Every witness who was involved in creating the projections testified unambiguously that they were "optimistic" and represented only CKx's opening ask in its renegotiations with Fox:

- CEO Michael Ferrel: "[The projections] are just the best case scenario[s] of what would be a very advantageous outcome if Fox were to agree to an ask that would lead to that conclusion." (B734-35.)

- CFO Tom Benson: "[F]or purposes of evaluating the company's value in a sale scenario or providing projections to a prospective buyer," the company "ought to take a more optimistic view." (A1529.)

- VP for Finance Scott Frosch: "It would be fair to say that this document was prepared for an outside seller with probably an optimistic view of what we thought the company was going to do for the next couple years . . . . The truth is, we were in the middle of negotiations and we didn't know if we were going to improve or not improve." (B1009.)

Petitioners' suggestion that these projections somehow represented management's "best estimate" (*see* Opp'n Br. at 25) therefore is not credible.

Petitioners' related attempt to exaggerate *Idol's* performance—and by extension their argument that CKx could extract higher fees from Fox—is also belied by the record. The undisputed facts show that there was no reasonable basis to believe that Fremantle and CKx could extract better terms from Fox. By the time of the Merger: (i) *Idol*'s Nielsen ratings for the 18-49 demographic had fallen almost 50 percent from their 2006 peak (and 2011 ratings had declined over the prior year);[4] (ii) *Idol*'s ad revenue was down;[5] (iii) for the first time the show would be facing significant competition from *X-Factor* and *The Voice*;[6] (iv) CKx had little practical leverage given Fox's perpetual license and Fremantle's contractual rights;[7] and (v) Fox was well aware of its bargaining power over a declining *Idol* asset and expressly had informed CKx that it was intent on *reducing* its payments for *Idol*.[8]

Instead of uncritically accepting the $20 million "sales case" increase in the face of this record evidence, Cohen examined the history of *Idol* and the contracts between 19E and Fox. He created three alternative scenarios for the outcome of renegotiations, each of which was grounded in record evidence indicating reasonable alternative growth levels for *Idol* and CKx. (*See generally* CKx Br. at 41-42; B1050-53.)

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4 (*See* B1082; B1129-32; A1487.) [redacted] (B1130-32.)

5 (A1417-18.)

6 (B1126-27; B1134.)

7 (A1478-79; A1485-86.) [redacted]

8 (A1490-91; B830-31 ("[W]hat Fox is offering for next season amounts to approximately $10mm less than what we made this season."); B832-35.) Even Petitioners' industry expert could not bring himself to say that Fremantle and CKx had substantial leverage—he went no further than claiming that the parties' negotiating positions were "balanced" and conceded that Fox was not interested in accommodating CKx. (A1440.)

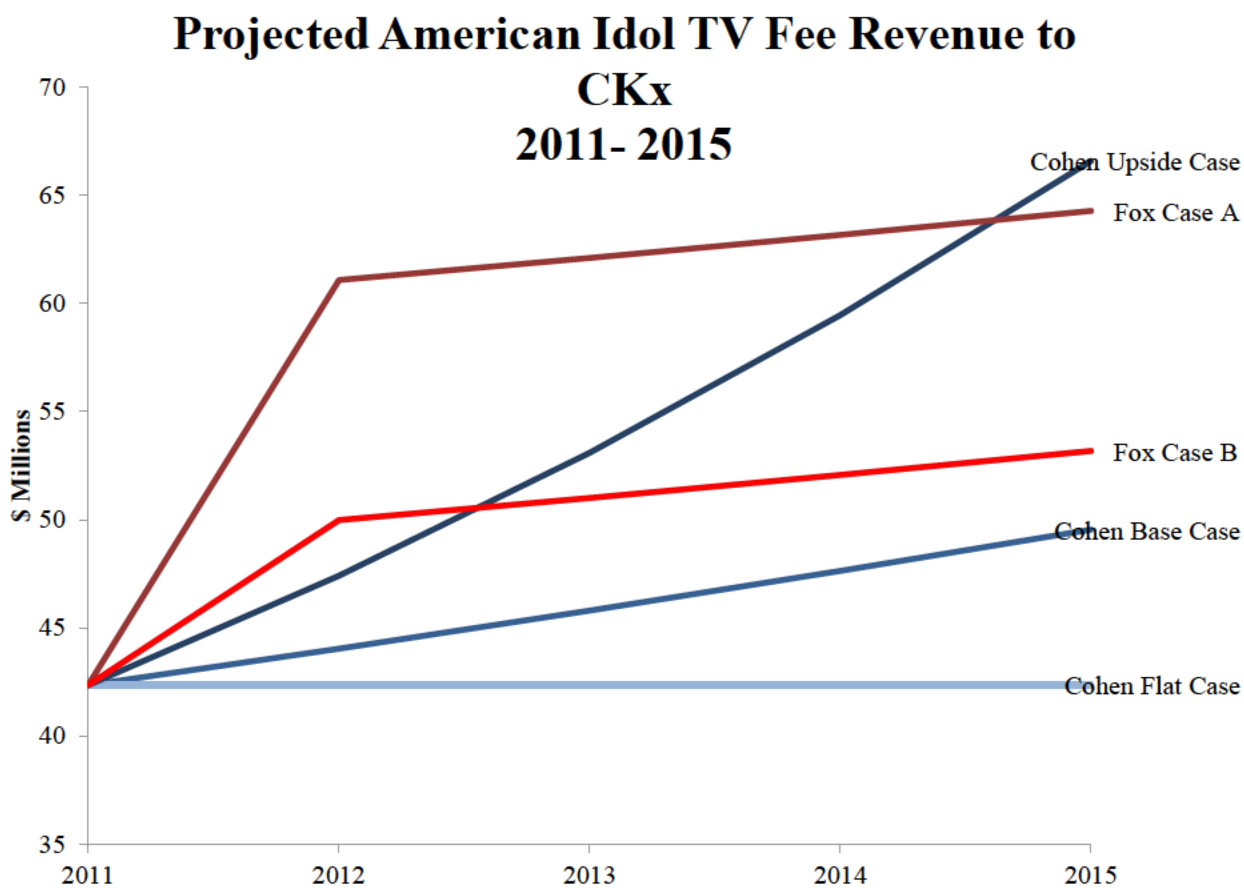
If anything, Cohen's assumptions worked in Petitioners' favor. Contrary to Petitioners' mischaracterizations, these three scenarios neither were "pessimistic" nor "decrease[d]" CKx cash flows from *Idol*. (Opp'n Br. at 22, 23.) To the contrary, Cohen's "upside" case and "base" case projections *increased* fees significantly from *Idol* each year between 2011 and 2015, despite extensive evidence of the show's maturity and ratings decline. (CKx Br. at 41.) Even in his third, or "downside" case, Cohen held *Idol* fees flat over the projection period, and did not decrease anything. (*Id.*) But even a downside case that decreased fees would have been a reasonable assumption [redacted] (*Cf.* B1136-37.)

[redacted]

[redacted]

Moreover, Cohen's adjustments dovetailed with adjustments that CKx's CEO made to the projections during the sales process. CEO Michael Ferrel instructed CFO Tom Benson to reconsider the projections after Fox made clear in negotiations that it was expecting total payments to CKx to decrease. As explained by Benson at trial, Ferrel, "having been in the room and in the negotiations with Fox, was concerned that a $20 million increase was too high for [CKx] to be assuming" because Fox had already indicated "they did not think we were entitled to any increase." (A1539-41.) Benson thus asked Gleacher to revise the projections. (A1540-42; B527; CKx Br. at 17-19.) Gleacher consequently used two sets of cash flow projections in its DCF: the "Fox A Case," which was based on the most optimistic projections, and a "Fox B Case," which assumed an increase that was $10 million less. (A1752; A280; A283-86.)

The following chart compares projected *Idol* revenue in Cohen's three cases with Gleacher's "Fox A Case" and "Fox B Case." [redacted]



(A203; A285; B1090-91.)[9] The chart confirms that Cohen's three cases did not reflect a "doomsday projection" decreasing *Idol* fees, but rather prudent growth assumptions. These assumptions are reasonably based on the record evidence, not

9 Excluded from the chart are projected revenues from *Idol*'s foreign tape sales, which were unaffected by the Fox negotiations and did not vary among the projections.

the unduly optimistic predicate that CKx would secure a $20 million increase per year from Fox for a declining *Idol*.

In an effort to discredit Cohen's approach, Petitioners manufacture their own chart purporting to show that other "contemporaneous" projections compared favorably with management's optimistic projections. (Opp'n Br. at 24.) But they mix apples and oranges. The three highest lines on their chart (denoted "A", "B" and "C") are derived from *Apollo* numbers that reflect *Apollo* adjustments. As made clear at trial, Apollo made pro forma accounting adjustments to CKx's reported OIBDAN numbers, which resulted in as much as a $25 million difference on the historical 2010 numbers alone. (*See* A631 (discussing "Adjusted EBITDA" as compared to "historical reported OIBDAN"); *compare* A628 (CKx Adjusted EBITDA for 2010 was $92.2 million) *with* A138 (CKx OIBDAN for 2010 was $65.4 million).) Further, the Apollo numbers that Petitioners cite all include additional projected cash flow from a significant redevelopment of Graceland, which Apollo intended to pursue *after* acquiring CKx but which CKx itself had abandoned. (A1470-72.) These Apollo projections are simply not comparable to pre-merger CKx projections.

Petitioners also skew their chart by omitting several projections. Notably, they omit Gleacher's "Fox B Case," which would have been $10 million below the "D/E" line;[10] and they omit Cohen's upside case, in which projected revenue in 2015 would have ended *above* all of CKx management's projections. In other words, when corrected, Petitioners' chart would look similar to the chart CKx sets out above.

In sum, Petitioners cannot credibly attack Cohen's adjustments because he concluded that management's projections were unreliable. The Chancery Court squarely reached the same conclusion. Petitioners' argument, moreover, never reaches the crux of the Chancery Court's error in failing to adopt the Cohen assumptions that were consistent with the court's own findings. As CKx demonstrated in its opening papers, valuation experts regularly make reasonable adjustments in valuations in appraisal cases, and future earnings are always subject to some uncertainty. (*See* CKx Br. at 42-43.) The Chancery Court erred by not giving credence to the reasonable Cohen projection adjustments that were grounded in the evidence and thus reliable. Accordingly, if this Court rejects the Chancery Court's market-based valuation, it should conclude that the Chancery Court abused its discretion by not adopting the Cohen projection assumptions that can support a valid DCF methodology for valuing CKx.

[10] Petitioners' "E" line is a version of their "D" line that contained a minor computational discrepancy that was subsequently corrected. It was not a separate contemporaneous projection. (*Compare* A368 *with* B816.)

II. THE CHANCERY COURT ERRED IN NOT REDUCING THE FAIR VALUE TO ACCOUNT FOR EXPECTED COST SAVINGS ARISING FROM THE MERGER

The parties do not dispute that if a portion of the $5.50 Merger Price relied upon by the Chancery Court is value "arising from the accomplishment or expectation of the merger" under Section 262(h), that component of value must be subtracted from the fair value determination of CKx. (*See generally* CKx Br. at 44-47.) The issue here is what the evidence showed. Because the contemporaneous Apollo investment memorandum and related documents demonstrated on their face that the $5.50 bid was grounded in part on cost savings that Apollo expected to secure from the merger, most prominently through public-to-private company savings that could only be accomplished by this transaction, the Chancery Court abused its discretion by failing to reduce the fair value of CKx.

Petitioners initially attempt to counter CKx's argument by resorting to semantics, asserting that only a narrow definition of "synergistic value" qualifies for a reduction. (Opp'n Br. at 26-27.) Yet they have no answer for the settled jurisprudence holding that public-to-private cost savings are precisely the types of value contemplated by Section 262(h). *See In re Emerging Commc'ns, Inc. S'holders Litig.*, 2004 WL 1305745, at *14 (Del. Ch. June 4, 2004). The Court of Chancery has recognized that "[i]t stands to reason that when a public company goes private, cost savings in some amount will be achieved." *Id.*

Next, Petitioners contend that the Chancery Court correctly rejected CKx's requested reduction because there was no testimony on the issue, no detail underlying the estimate and no cost information. But the Chancery Court had unambiguous documentary evidence admitted into evidence that provided ample support for a reduction in CKx's fair value. (B1322-29.)

The plain language of the Apollo Investment Memo states that: "Through our diligence and with the help of our advisers we have identified an additional $4.6 million of public-to-private and other corporate expense savings which would be achieved in a take-private transaction context." (A211; *see also* A220.) Initially, $2.3 million of that amount was identified in the supporting documents as "Apollo Identified Savings," which included very specific cost savings line items that only could have been secured through a public-to-private transaction. (B572.) For example, Petitioners do not and cannot contest that the value of savings from items such as "Elimination of NASDAQ listing fee" and "directors fees" arise only because a private CKx would not have to incur those expenses that the public CKx was required to incur. (*Id.*) No testimony or additional detail is necessary to demonstrate why the value of these items could *only* have been realized through Apollo's acquisition of CKx that took the company private.

Petitioners assert that the Chancery Court correctly rejected the $2.3 million in Apollo-identified savings because that savings is not "merger-specific." (Opp'n Br. at 28.) But the record shows: (i) Apollo believed that this cost savings could be accomplished as a result of the merger and thus incorporated that savings into the $4.6 million dollar savings estimate it reported to senior management, banks and the investment community (B550; B730; B826; B863; B911; B1000); (ii) Apollo based its $5.50 Merger Price bid in part on the $2.3 million as savings that "would be achieved in a take-private transaction context" under its ownership of CKx (A211); and (iii) there was not a shred of evidence that any such savings initiatives would have been undertaken by CKx management if CKx remained a stand-alone entity. The pertinent inquiry is whether that $2.3 million in Apollo-identified cost savings was part of the value inherent in the $5.50 Merger Price. Because it indisputably was, the Court erred by refusing to adjust CKx's fair value figure to that extent.

Petitioners' suggestion that CKx did not introduce any cost evidence is specious. Relying upon record evidence, Mr. Cohen submitted an affidavit demonstrating his calculations that included the costs that Apollo anticipated to achieve the cost savings. (BR8-10.)

Finally, Petitioners identify a [redacted] management fee paid to Apollo after the transaction and assert that this "dwarf[s]" any deduction for cost savings synergies. (Opp'n Br. at 28-29.) But this fee cannot be tied to the cost savings here. [redacted] Petitioners merely speculate to the contrary.[11]

[11] Petitioners also point to change-in-control payments connected with the merger, but fail to explain why these costs should be used to offset Apollo's expected cost savings, or are even related to the fair value of CKx shares. An acquirer always has to pay transaction costs in connection with a merger, none of which are included in the fair value of the shares of the appraised company, which is valued as a "going concern." *Cf. Cavalier Oil Corp.* v. *Harnett*, 564 A.2d 1137, 1144 (Del. 1989).

III. THE CHANCERY COURT ERRED BY NOT PERMITTING CKX TO MAKE A PREPAYMENT OF $3.63 PER SHARE TO PETITIONERS IN ORDER TO STOP THE RUNNING OF STATUTORY INTEREST

In its opening brief, CKx demonstrated that there was no valid legal basis for the Chancery Court's denial of CKx's "Prepayment Motion," in which CKx proposed to pay Petitioners an unconditional tender of $3.63 per share plus full accrued statutory interest on that portion of the final "judgment." In opposition, Petitioners misconstrue CKx's position by emphasizing that the appraisal statute provides that statutory interest should accrue "***through the date of payment of the judgment***." (Opp'n Br. at 31-32 (quoting 8 *Del. C.* § 262(h)) (emphasis in original).) But CKx has never contended otherwise. CKx proposed to pay an undisputed partial "judgment" amount as well as all attendant statutory interest. Statutory interest would continue to run on the delta between the prepayment and the residual judgment amount that would later be entered. The Chancery Court thus committed legal error in concluding that such prepayment is in any way incompatible with Section 262(h). (CKx Br. at 48-50.)

Unable to cite any language within Section 262 or other legal authority barring prepayment,[12] Petitioners contend that the Prepayment Motion conflicts with the "purpose of the [appraisal] statute." (Opp'n Br. at 33.) As

[12] Petitioners offer no support for their pronouncement that interest must continue to accrue "[u]ntil there is a final, non-appealable appraisal award." (Opp'n Br. at 33.) *Cf. ONTI, Inc.* v. *Integra Bank*, 1999 WL 160131, at *1 (Del. Ch. Mar. 2, 1999) (rejecting the contention that "the Court of Chancery cannot issue a judgment until the completion of the appraisal process").

"unsecured creditors" of CKx, Petitioners argue that they were denied the use of their money, and that they might have garnered even higher returns than those prescribed by the statutory interest rate by "invest[ing] . . . in equity markets." (*Id.* at 32-33.) Yet the indisputable effect of prepayment would be to permit Petitioners to gain access to the $3.63 per share principal amount, plus accrued interest, to invest or otherwise use however they see fit, while simultaneously limiting their exposure to what they claim is a risky credit.

Accordingly, Petitioners' citation to an unpublished article opining that the statutory interest rate "undercompensates" certain appraisal petitioners (*id.* at 35 (quoting AR405)) is beside the point. Neither party is challenging the level of the statutory interest, and whether it is at the appropriate rate is not an issue before the Court. But to the extent that Petitioners cite the article to argue that the statutory rate may not fully defray the credit risk borne by a petitioner during an appraisal proceeding (AR405), the granting of the prepayment motion would mitigate precisely that risk. Petitioners' refusal to accept CKx's offer (and a subsequent, post-judgment offer to tender the full $5.50 amount) suggests that their agenda here is pure arbitrage.

To rebut that inference, Petitioners contend that accepting the prepayment of $3.63 would be prejudicial because it might trigger a tax obligation for the full judgment amount before such an amount is recovered. (Opp'n Br. at 34 (citing AR321-25).) Yet they fail to support this illusory concern through citation to any legal or tax authorities or the submission of an opinion from any auditor or tax specialist, instead offering only an affidavit from Petitioner Bloom.[13]

There is no such danger of tax exposure here. As a threshold matter, Petitioners' objection was founded on speculation that the prepayment and payment of the final judgment will come in different reporting periods. (*See* B1318.) But any payments would have been made within the same reporting period. And even assuming this was a valid issue, any partial payment of a judgment would not have triggered tax exposure for the full amount of a higher, undetermined final judgment. That final judgment would be governed by the common law "open transaction" doctrine (*see* B1318-19), which applies to contingent payments when their market value is not "reasonably ascertainable." Treas. Regs., 26 C.F.R. § 1.1001-1(g)(2)(ii); *see also id.* at § 15a.453-1(d)(2)(iii). Under the "open transaction" doctrine, Petitioners would have income only when the amount becomes reasonably determinable or to the extent of prepayments received; they would not be required to estimate an unknown final judgment and pay tax on that amount. *Fisher* v. *United States*, 82 Fed. Cl. 780 (2008), *aff'd without opinion*, 333 Fed. App'x 572 (Fed. Cir. 2009).

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13 Bloom's affidavit presents only hearsay, [redacted] (*See* AR323.)

To alleviate Petitioners' unfounded tax concerns, CKx offered to indemnify them for any negative tax consequences incurred as a result of accepting a partial payment—an offer Petitioners rejected. (Ex. B at 2-3.) Petitioners' actions demonstrate that their tax concerns are mere pretext and that they are seeking to avoid payment in order to extract punitive statutory interest from CKx. Nothing in Section 262(h) prevents CKx from ameliorating those effects.

CONCLUSION

For the foregoing reasons, CKx's cross-appeal should be granted.

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Dated: October 16, 2014

CERTIFICATE OF SERVICE

I hereby certify that on October 16, 2014, true and correct copies of the foregoing documents were served upon the following counsel of record via File & Serve*Xpress*:

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