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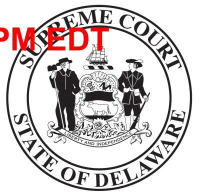

IN THE SUPREME COURT OF THE STATE OF DELAWARE

AMERICAN COMMERCIAL LINES, INC.,	§	No. 230, 2013
	§	
Respondent Below, Appellant, Cross-Appellee,	§	
v.	§	On Appeal from C.A. No. 6369 in the Court of Chancery of the State of Delaware
IQ HOLDINGS, INC.,	§	
Petitioner Below, Appellee, Cross-Appellant.	§	

IQ HOLDINGS, INC.'S REPLY BRIEF ON CROSS-APPEAL

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ARGUMENT

V. THE COURT OF CHANCERY'S ADOPTION OF ACLI'S EXPERT'S MODIFICATIONS TO MANAGEMENT'S PROJECTIONS WAS CONTRARY TO DELAWARE LAW.

A. Standard of Review

ACLI argues that IQ has waived any complaint about the Court of Chancery's findings relating to the ACLI sale process. *See* Appellant's Reply Brief on Appeal and Cross-Appellee's Answering Brief on Cross-Appeal (hereinafter "RB") at 20. This is wrong: IQ's argument, as well as the evidence cited in support of that argument, was presented to the court below. A-362–64. ACLI also incorrectly contends that IQ is challenging the credibility of witnesses, but IQ actually relies on ACLI's witnesses to demonstrate that the Court of Chancery erred in applying legal precepts. *See* IQ Holdings, Inc.'s Answering Brief on Appeal and Opening Brief on Cross-Appeal (hereinafter "IQ Br.") at 37. Accordingly, this decision is reviewed *de novo* by this Court. *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1142 (Del. 1990).

B. Merits of Argument

ACLI does not dispute that *In re Emerging Commc'ns, Inc. S'holders Litig.*, the only case the Court of Chancery relied on for using ACLI's litigation-driven forecast, does not support an adjustment of management's projections. C.A. No. 16415, 2004 WL 1305745 (Del. Ch. May 3, 2004). Instead, ACLI misconstrues the testimony of its witnesses and the evidence offered at trial.

1. None Of ACLI's Trial Witnesses Were Involved In Developing The Strategic Initiative Savings.

To support the Court of Chancery's ruling, ACLI lists a number of terms used to describe the strategic initiative savings, RB at 2–3, but almost all of these descriptions came from ACLI's expert herself, or were the hindsight characterizations of ACLI employees who were not involved in developing the savings.

Only two of the descriptions of the strategic initiative savings listed by ACLI were made by an executive who worked on projecting them: ACLI's former CFO, Thomas Pilholski. And both characterizations were part of Pilholski's testimony that the projections were in fact reasonable. The first, "unidentified cost savings," accompanied Pilholski's testimony that the July Projections represented a plan that management "could reasonably expect to execute" even with "about $40 million dollars of unidentified cost savings." B-302 at 67:10–13. The second, "significant challenges incorporated into them," truncates Pilholski's explanation that the projections incorporating the strategic initiatives were reasonable and achievable. *Id.* at 45:18–23 ("it was a reasonably prepared plan based on a wide set of assumptions, based on the environment we saw at that point in time that we thought we could achieve with significant challenges incorporated into them").

Although ACLI claims that Bryant was involved in preparing the projections and that ACLI's expert, Melissa Knoll, had discussions with Pilholski, RB at 23 n.

40, both claims are incorrect and are contradicted by the witnesses' own testimony. Bryant admitted that she had not developed any of the assumptions behind the projections. A-202 at 274:22–275:7; A-205–06 at 289:7–290:5; A-207 at 295:1–4. And Knoll admitted she never spoke with Pilholski. A-240 at 426:8–20. Likewise, ACLI's suggestion that Noltemeyer was involved in preparing the projected savings is contradicted by both Noltemeyer and Bryant. RB at 23; A-195 at 254 7:11; A-202 at 274:22–275:7. Further, ACLI's contention that Bryant "did her best" to not have hindsight bias does not change the fact that, according to her own testimony, she could not avoid it. A-208 at 298:8–10.

In contrast to ACLI's expert, IQ's expert relied on the testimony of Pilholski in applying management's actual projections in his valuation. Pilholski, the CFO in charge of developing the projections, testified that ACLI management prepared the July Projections without knowing about any proposed transaction to acquire the company, the July Projections reflected the best currently available estimates and good faith judgments by management about the future financial performance of the company as a going concern, and the July Projections represented a management plan that management believed it "could reasonably expect to execute." B-296 at 42:6–43:13; B-302 67:10–11. ACLI's contention that IQ's expert, David Fuller, "openly rejected" Pilholski's deposition testimony that the savings were "completely speculative" makes no sense because Pilholski never said the strategic

initiatives or any aspect of management's projections were "speculative." RB at 24; B-284–319.

2. The Strategic Initiative Savings Included Four Detailed Components Developed By Management, Further Demonstrating That Reducing Them From Management's Projections Was Unsupported.

In an effort to undermine the strategic initiatives, ACLI describes the four detailed components that management included in the projected savings. RB at 3–4.

ACLI claims that scheduled service has never been implemented and is the "shakiest" of the savings, according to testimony of people who were not involved in developing this strategic initiative. RB at 3. But this after-the-fact view is contradicted by ACLI's 10-Q for the period ended September 30, 2010 (certified by the CEO and the CFO on November 5, 2010, just a month before the Valuation Date), which described the success ACLI had already achieved in implementing this strategic initiative. A-1499–1501 at 38–39 ("Our scheduled service initiative continues to move through the first of two phases of implementation. . . . Where we have completed Phase 1 work, we have been able to test new schedules and performance with great results. . . . The actions we have taken as a result of scheduled service reviews have also allowed us to provide the same or better service at lower costs. In the quarter, using the standardization model and beginning to run more dedicated lane service, we reduced the number of boats in

use without compromising service to customers and saved approximately $4.8 million in the nine months ended September 30, 2010.”).

ACLI’s reliance on the contradictory testimony of uninvolved witnesses cannot conceal the Court of Chancery’s error in reducing the “claims” component of the strategic savings. ACLI argues that this initiative involved reducing training, which could lead to an increase in insurance claims. RB at 3. But ACLI’s expert testified that she thought the savings she eliminated here would have come from an increase in training in order to reduce insurance claims. A-215 at 326:23–327:5 (“In terms of the claims item here, the company anticipated that it could, through the implementation of training programs and safety programs—they hoped to be able to bring down their insurance premiums and their accident rate, such that the cost of claims over the long-term would be less.”). Plainly it did not matter to Knoll what the strategic initiatives actually were: she eliminated half the projected savings because that was her goal, not because she understood the underlying business plan.

And although ACLI argues that savings on claims, as well as the final two components of the savings, “sales mix” and “maintenance,” were duplicative, this charge is not supported by any evidence. Bryant explained that she did not believe any specific cost savings were counted twice and she knew of no actual duplication within the savings. A-207 at 294:7–24 (“Q. You used the word ‘duplication of

these savings.' When you say that, do you mean that there were specific cost savings that were put in twice within your financial model that were counted for twice? A. Not exactly. . . . The strategic initiatives were a nonspecific reduction in both barge and boat expense. So maybe duplicative isn't the right word, but it definitely was an incremental savings on top of the specific savings that was included in the base case.") Again, according to Pilholski, these incremental savings were reasonable and reflected management's best good faith judgments. B-296 at 42:6–43:13; B-302 67:10–11.

Moreover, as with its discussion of the various components of the strategic initiatives, ACLI's statement that the strategic initiatives were "listed separately" in ACLI's projections is misleading. In reality, the strategic initiative savings were always included in the "Materials, Supplies & Other" line item on the income statement, and no projections exist in which this line item did not include the strategic initiative savings. A-206 at 291:22–292:19; A-239 at 425:1–426:7.

3. The Court of Chancery Erred Because Potential Buyers of ACLI Did Not Receive Accurate Information About Management's Projections.

ACLI's assertions that ACLI's proxy statement disclosed higher free cash flows than management's July Projections, and that potential buyers of ACLI who signed confidentiality agreements had access to management's full July Projections, are both flat wrong. RB at 26–27.

Andrew Martin, the Bank of America Merrill Lynch ("BAML") advisor to ACLI's Special Committee, testified that BAML did not approach any potential buyer until after Platinum signed a deal because Platinum insisted on exclusivity. AR-236 at 80:10–81:3. Martin further explained that the companies that expressed interest in ACLI during the go-shop period were at an information disadvantage to Platinum. Specifically, these companies were given an asset valuation and the summary projections set out in ACLI's proxy, but were deliberately not given ACLI's more detailed management projections because of "competitive concerns." AR-237 at 83:20–84:9. IQ has already demonstrated that the summary projections in the proxy statement did not include management's projections for 2015 and 2016, contained other errors such as a failure to account for changes in deferred taxes, and inaccurately represented the deferred investment case as having been prepared by management. IQ Br. at 35. ACLI does not challenge these important facts, except to wrongly suggest that ACLI had some role in projecting the deferred investment case.[1]

[1] ACLI incorrectly states that the Deferred Investment Case was prepared "with the assistance of management." RB at 4. Pilholski testified unequivocally that it was BAML's work, not ACLI's. B-293 at 31:3–17 ("Q. Do you remember any discussions with [BAML] about what they needed to do or to—to get to that deferred investment case? A. They prepared the initial version of the—and then we had a discussion over some of the high level assumptions. And that was basically it."); B-304 at 75:9–10 ("I would not speculate to how [BAML] prepared the deferred investment case."), 75:19–25 (Q. "The deferred investment case was based on work [BAML] did from data the company provided but not projections? The company never made those projections? A. We never prepared those projections. We had a relatively high level discussion of the assumptions once they were prepared."). Noltemeyer agreed that ACLI did not prepare

Platinum, on the other hand, got management's detailed July Projections through 2016. AR-228 at 51:13–25. Indeed, BAML believed Platinum needed the July Projections to get to a higher bid: "They did not have the business plan that we had, and it was thought that could be provided to them, and they could get to a better number." AR-229 at 50:17–25. Martin further explained that Platinum got these projections to demonstrate "the potential opportunities in the business." *Id.* Even though BAML knew Platinum needed access to these projections to justify a higher price, there is no question that other potential buyers never saw this information. As such, the Court of Chancery's findings that "the market check that American conducted shows that actual buyers did not fully credit the undiscounted projections" and that the proxy statement disclosed a version of management projections "incorporating all of the Strategic Initiative Savings" are not supported by the evidence. PTO at ¶7.

4. The Court of Chancery Erred in Applying the Legal Precept Disfavoring Litigation Projections That Incorporate Hindsight Bias

"[*P*]*ost hoc*, litigation-driven forecasts have an untenably high probability of containing hindsight bias and other congnitive distortions." *Cede & Co. v. Technicolor, Inc.*, C.A. No. 7129, 2003 WL 23700218, at *7 (Del. Ch. Dec. 31, 2003), *rev'd in part on other grounds*, 884 A.2d 46 (Del. 2005). Knoll prepared a

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the Deferred Investment Case, A-200 at 269:2–14, and Bryant did not even know what it was until after her deposition. B-348 at 36:5–25; A-207 at 297:10–11.

post-hoc, litigation-driven forecast. A-247 at 456:13-19 ("My job was to make a judgment as to what was suitable for valuation purposes, not what was suitable for running a business . . ."). Bryant, on whom Knoll relied, admitted her hindsight bias in questioning the strategic savings. A-208 at 298:8-10 ("I am considering that the strategic – the scheduled service has not gone anywhere."). The Court of Chancery erred in not applying Delaware's law disfavoring after-the-fact, litigation-driven forecasts that incorporate hindsight bias.

VI. ACLI HAS NOT IDENTIFIED ANY SUPPORT FOR THE COURT OF CHANCERY'S INCLUSION OF THE "OTHER NON-CASH OPERATING ACTIVITIES" LINE ITEM IN ITS VALUATION.

ACLI cannot obscure the fact that there is absolutely no evidence about what is in the "Other Non-Cash Operating Activities" line item for the projection period. Rather, ACLI argues only that the evidence shows what might have been included in the "Other Operating Activities" line item from ACLI's 2009 10-K (found at A-1382).

Although the components included in the projected "ONCOA" line item are plainly a matter of fact, ACLI relied on its expert's speculation, and chides IQ's expert for not engaging in the same kind of speculation. To support this argument (which ignores the reality that there is no evidence from a witness with knowledge about what was included in the projection line item), ACLI selectively quotes Fuller's trial testimony, in which he stated that *some* decomposition of the line item is possible. RB at 28. From this, ACLI concludes that Fuller "could have determined" the components of this line item "but did not do so." *Id*. at 29. In reality, Fuller testified that "while there's some decomposition of it that's possible if you study carefully the other pages in the fleet reinvestment update, ultimately there's no discussion about what is included in the other noncash category." A-169 at 149:19–23 (emphasis added). Fuller went on to testify that "while I looked at some differing descriptions of that item in the various reports and briefs that have

to do with this, I noted that there was a -- even within those documents -- a large lack of consistency in terms of description from ACLI about what was even in it. So as I sit here right now, I don't think that there's <u>any evidence</u> that would show exactly what the assumptions were associated with that as a necessary use of cash in this operation." *Id.* at 150:10–18 (emphasis added).

And ACLI has still provided no support for what is actually in this line item or why it should be included in a DCF analysis. In an effort to explain the components of the line item, ACLI again attaches to its brief a chart it derived from ACLI's 2009 10-K and suggests that in the projections, the 2009 line item called "Other Non-Cash Operating Activities" comprised Debt Retirement Costs, Debt Issuance Cost Amortization, Impairment and Loss on Sale of Summit Contracting, Gain on Property Disposition, Other Operating Activities, and a portion of Accounts Receivable Operating Activities line items. RB at Ex. A. But while ACLI's chart includes a line called "Other Operating Activities/Other Non-Cash Operating Activities," ACLI's 2009 10-K does not include any line item with that name. A-1348. And the negative projections in the other non-cash operating activities line item bear no relation to the positive $22,580 projection for 2009. ACLI has simply not shown whether any of these various components are included in the July Projections or their significance after 2009, but only suggested that some of these components are <u>not</u> included in the projections. RB at 30. ACLI

also makes the conclusory assertion that "[m]any of the ONCOA components, like operating activities and accounts receivable, indisputably belong in free cash flows." *Id.* But ACLI has failed to show that operating activities or accounts receivable are included in this line item; indeed, both operating activities and accounts receivable are already included in ACLI's July Projections exclusive of this line item. B-453.

The PTO included no mention of this line item, and ACLI has provided no evidence of what the amounts in the line item actually were or why they should be included in a DCF analysis. Thus, there was no basis for the Court to include this item in the valuation. Because there is no support in the record for including this line item and the line item was not included as a result of an orderly and logical deductive process, the Court of Chancery abused its discretion by not excluding this line item from its valuation.

VII. THE COURT OF CHANCERY'S USE OF KNOLL'S BETA AND SMALL STOCK PREMIUM VALUES WAS NOT THE RESULT OF AN ORDERLY AND LOGICAL DEDUCTIVE PROCESS.

The Court of Chancery's reasoning for adopting Knoll's beta actually supports using Fuller's calculated beta. ACLI argues that Knoll consulted a number of betas before selecting ACLI's Barra predicted beta, but even though she considered other betas, she relied on only a *single* beta, which the Court of Chancery said it thought was less persuasive, while Fuller actually relied on multiple betas by averaging observed Bloomberg adjusted betas of other publicly traded waterway transportation companies to derive a meaningful beta for ACLI.

ACLI provides three reasons to adopt Knoll's beta calculation, each of which is flawed. RB at 32. First, ACLI argues that IQ has not shown that Knoll's beta was unreasonable. *Id.* ACLI does not explain or provide support for why this showing would overcome the fact that the Court of Chancery's finding was not the result of an orderly and logical deductive process; nevertheless, Knoll's use of a single Barra predicted beta was inappropriate for valuation of ACLI. Fuller did not rely on ACLI's own beta because "the purpose of the exercise is to determine what ACLI is worth without respect to what it was trading for prior to the transaction or the transaction price. If all you had to do was look at the value or the pricing of ACLI at those points in time, it would be unnecessary to do a valuation of the company at all. So I looked at statistics, whether you're talking

about valuation multiples or betas or other financial ratios that are used in the analysis, not relating to the way investors have priced ACLI but the way investors were currently and had in the past priced similar companies." A-2052 at 183:12–184:2. Knoll contravened this logic by simply applying a single market beta for ACLI, specifically the Barra predicted beta, for which Knoll does not know the formula. A-255 at 486:4–7; *see also Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 520 (Del. Ch.) ("the Barra forecasting model is proprietary, and cannot be reverse-engineered. The Barra predictive beta, which is a forecast of a stock's future looking beta using past data, is based on a thirteen-factor model, but the weight given to each of the factors is not publicly available. . . . Consistent with these realities, [the expert] himself does not fully understand the details of how the Barra model works and, thus, I cannot rely on his advocacy of it."), *aff'd*, 11 A.3d 214 (Del. 2010). Additionally, ACLI cannot deny that because Knoll does not know what specific risks her single Barra predicted beta incorporated, use of Knoll's beta was unreasonable when used with her small stock premium, which accounts for risks already incorporated in her beta.

Second, ACLI argues that Fuller's beta was calculated from companies that are not comparable to ACLI because the Court of Chancery found that both experts' comparable companies were insufficiently comparable to ACLI. RB at 32. However, the Court of Chancery's discussion of both experts' comparable

companies only discussed these companies in the context of the experts' comparable companies analyses, which were direct valuations of ACLI from multiples of these companies. It does not follow that the observed betas of other publicly-traded waterway transportation companies should not be used in calculating an unlevered beta for ACLI as part of a DCF analysis. *See* A-2137.

Third, ACLI argues that Fuller should not have used an adjusted beta. *Id.* But Delaware law supports use of an adjusted beta. *See Cede & Co. v. JRC Acq. Corp.*, C.A. No. 18648-NC, 2004 WL 286963, at *10 n.96 (Del. Ch. Feb. 10, 2004) ("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."); *see also* Shannon P. Pratt & Roger J. Grabowski, *Cost of Capital* 130 (3d ed. 2008) ("Over time, a company's beta tends toward its industry's average beta"). Accordingly, Fuller's calculation of a beta from comparable Bloomberg adjusted betas was appropriate.

ACLI states that IQ's argument that Knoll's small stock premium captures the same risks that are accounted for in her Barra beta is somehow "misleading" because Fuller's unsystematic risk premium is comparable to a small stock premium, RB at 33 n.53, but this ignores the fact that, unlike Knoll, Fuller did not apply a beta that already specifically incorporated risk for ACLI's size. A-2124; A-1948. Further, ACLI's suggestion that ACLI's market capitalization on the

Valuation Date was in the ninth decile is wrong. A-1948 at ¶22; B-187; A-2107. Indeed, Knoll admitted that the ninth decile market capitalization was a result of her own valuation, while the public market valuation indicated a market capitalization in the eighth decile. A-1984 at 37:6–11 ("what we looked at was a combination of something that did consider what my results of my valuation were, which would have indicated a ninth decile size premium, but also what the company's public stock price would have indicated, <u>and that public stock price indicated an eighth decile</u>") (emphasis added). Finally, while IQ agrees with ACLI that IQ is not appealing the Court of Chancery's equity risk premium determination, ACLI is incorrect that this finding has anything to do with Fuller's unsystematic risk premium, which is completely independent from Fuller's equity risk premium. RB at 35; A-2123–2124.

In reality, Fuller's unsystematic risk premium was based on the available market valuation of ACLI, which was in the eighth decile on the Merger Date, while Knoll's analysis incorrectly averaged this value with the ninth decile of small stock premium, which carried more risk than a company the size of ACLI. Accordingly, the beta and small stock premium applied by the Court of Chancery were error, not the result of a logical deductive process.

CONCLUSION

IQ respectfully requests that this Court affirm the Court of Chancery's cost of debt findings. Further, IQ requests that this Court reverse the Court of Chancery's use of modified cost projections; inclusion of the unsupported "other non-cash operating activities" line item; and use of an inappropriate beta and small company stock premium.

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