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IN THE SUPREME COURT OF THE STATE OF DELAWARE

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<tr><td>MERLIN PARTNERS, LP and AAMAF, LP,

Petitioners-Below,
Appellants/Cross-Appellees,

v.

SWS GROUP, INC. and HILLTOP SECURITIES HOLDINGS LLC,

Respondents-Below,
Appellees/Cross-Appellants,

v.

LONE STAR VALUE INVESTORS, LP and LONE STAR VALUE CO-INVEST II, LP,

Petitioners-Below,
Cross-Appellees.</td><td>)
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CASE BELOW:

Court of Chancery
of the State of Delaware
Cons. C.A. No. 10554-VCG</td></tr>
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APPELLANTS'/CROSS-APPELLEES' REPLY BRIEF ON APPEAL AND ANSWERING BRIEF ON CROSS-APPEAL

PRICKETT, JONES & ELLIOTT, P.A.
Marcus E. Montejo (DE Bar No. 4890)
Kevin H. Davenport (DE Bar No. 5327)
Eric J. Juray (DE Bar No. 5765)
Chaz L. Enerio (DE Bar No. 6228)
1310 North King Street
Wilmington, Delaware 19801
(302) 888-6500
Attorneys for Petitioners-Below, Appellants/Cross-Appellees Merlin Partners, LP and AAMAF, LP

Dated: November 6, 2017

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NATURE OF PROCEEDINGS

In their Opening Brief,[1] Petitioners argued that the trial court made errors in fact and law in its determination of SWS's fair value. Specifically, Petitioners appeal three issues: (i) that the trial court erred as a matter of law by placing weight on a size premium not reflective of the trial court's holding on the operative reality of SWS as of the Merger Date; (ii) that the trial court erred as a matter of fact in assuming that none of SWS's $194 million in excess capital was distributable as of the Merger Date, and erred as a matter of law by (a) inadvertently imposing a minority discount on the dissenting stockholders, and (b) misapplying legal precedent that destroyed the present value of SWS's excess capital in contradiction to fundamental principles of finance; and (iii) that the trial court erred as a matter of law by not considering evidence of unfair dealing and price as relevant factors, including external markers of value such as a higher bid from Stifel and Hilltop's contemporaneously prepared internal board of directors presentations that valued SWS on a stand-alone basis at a significantly higher value than the trial court's appraised value of $6.38 per share. In their Answering Brief,[2] Respondents deny each issue.

[1] Appellants' Opening Brief (referred to herein as "Opening Brief" or "POB"). Capitalized terms are defined in the Opening Brief.

[2] Appellees/Cross-Appellants' Answering Brief on Appeal and Opening Brief on Cross-Appeal (referred to herein as "Answering Brief" or "RAB").

Respondents also raise three issues on cross-appeal. Respondents argue: (i) that the trial court abused its discretion by placing weight on the size premium advocated by Petitioners; (ii) that the trial court abused its discretion by adopting the equity risk premium advocated by Petitioners; and (iii) that the trial court erred by determining that the exercises of in-the-money warrants by Hilltop and Oak Hill, which were not conditioned or contingent on the Merger, after SWS reset the record date to vote for the Merger, were part of SWS's operative reality as of the Merger Date. Petitioners deny each issue cross-appealed by Respondents.

This is Petitioners' reply brief in further support of their appeal, and answering brief to Respondents' cross-appeal.

REPLY ARGUMENT ON APPEAL

I. THE TRIAL COURT ERRED BY ASSIGNING WEIGHT TO A SIZE PREMIUM THAT CONTRADICTED ITS FINDING OF SWS'S OPERATIVE REALITY ON THE MERGER DATE

In their Opening Brief, Petitioners argued that the trial court erred as a matter of law[3] by placing weight on the size premium advocated by Respondents' expert, Richard Ruback (4.2%), because it did not reflect the operative reality of SWS as of the Merger Date.[4] The size premium Petitioners advocated below (2.69%) was the only size premium evidence presented at trial that reflected SWS's operative reality as of the Merger Date.[5] The trial court ruled that SWS's operative realty as of the Merger Date included the 15,217,391 shares issued to Oak Hill and Hilltop after exercising their warrants, but it nevertheless assigned 50% weight to Ruback's size premium, which he calculated excluding those shares.[6]

Having ruled for Petitioners on the operative reality of SWS with respect to the warrant exercises, the trial court erred as a matter of law by not relying solely on the only size premium evidence presented at trial that reflected SWS's operative reality as of the Merger Date. Respondents ignore the legal question and instead

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[3] Petitioners maintain that *de novo* review applies. Respondents do not contest that *de novo* review applies. POB 26.

[4] *Id.* 26-30.

[5] *See id.*

[6] Op. 37-39, 48-49.

contend that the trial court's inconsistent rulings are supported because one can simply "multiply[] the 48,115,828 shares Petitioners say were part of SWS's operative reality by the unaffected stock price of $6.06 . . . ."[7] Respondents cite no expert evidence to support these lawyer-calculations (or any trial evidence), because their expert instead testified that including the warrants would push him into another decile.[8] Respondents attack Petitioners for "distort[ing] the record" by stating that "Ruback conceded that if he included the warrants, he would be pushing himself into the wrong decile."[9] But it was Respondents who first stated that "inflating SWS's market capitalization with warrants is inappropriate because it could push SWS into the wrong decile," citing Ruback's trial testimony.[10]

Moreover, Clarke agreed with Ruback that exercise of the warrants was favorable news for SWS and would have driven its market capitalization well into the 9th decile.[11] Even according to Respondents, eliminating the debt would have had a positive effect on SWS's stock price considering their insistence that SWS would have had trouble repaying the debt.[12] Trial evidence presented in

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[7] RAB 30.

[8] A3622 (citing A283 at 730:11-16 (Ruback)).

[9] RAB 31.

[10] A3622.

[11] A543-A544.

[12] RAB 10.

contemporaneous documents prepared by SWS management further showed that the warrants operated as an anchor on SWS's stock price, supporting Clarke's assumption that eliminating the debt would have positively affected the stock price.[13] The evidence uniformly contradicts Respondents' lawyer-calculation, and it should be rejected.[14]

Respondents offer no basis in law or fact to support the trial court's inconsistent ruling on size premium, nor can any be found in the Opinion. The trial court's holding on size premium should be reversed with instructions that for purposes of calculating SWS's cost of equity to determine its fair value in accordance with Section 262, the appropriate size premium is 2.69%.

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[13] AR7; A543.

[14] Respondents' lawyers also overlook that the total shares the trial court used to determine fair value was 50,139,294. Thus, on a fully diluted basis – because all warrants were in the money – Respondents' "arithmetic" yields an "adjusted market capitalization" of $303.8 million even at $6.06, which falls in the 9th decile.

II. THE TRIAL COURT ERRED IN ITS TREATMENT OF SWS'S EXCESS CAPITAL

In their Opening Brief, Petitioners argued that the trial court erred as a matter of fact and law in its treatment of SWS's excess capital.[15]

A. The Trial Court's Erroneous Assumptions

Petitioners' Opening Brief identified erroneous assumptions the trial court made with regard to SWS's excess capital.

The trial court assumed excess capital could not be added to a DCF valuation unless the excess capital would be distributed (*i.e.* paid) directly to stockholders.[16] In response, Respondents argue that "[n]o part of the court's holding turned on whether SWS would actually make the 'massive distribution' Clarke imagined."[17] But Respondents concede several pages later that "[t]he court's holding was based on its factual finding that SWS could not distribute any additional cash" and "the Court of Chancery held that SWS did not have the capacity to dividend excess capital."[18] Thus, Respondents admit the trial court's holding was based on whether excess capital would be paid to stockholders.[19]

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[15] POB 31-42.

[16] *Id*. 32-33; Op. 40-41.

[17] RAB 41.

[18] *Id*. 46.

[19] Respondents further admit that capital has the same value if it is paid to stockholders or reinvested at the cost of capital. RAB 43 n.160; A295 at 778:12-779:10 (Ruback).

Indeed, the trial court (i) incorrectly assumed that in Clarke's analysis "SWS would distribute to shareholders over half of its pre-merger market capitalization," (ii) questioned whether a "distribution would be possible from a regulatory prospective," and (iii) relied on the fact that management's projections did not "assume a bulk distribution."[20] Thus, the trial court improperly put upon Petitioners a burden to prove that excess capital would actually be paid out of SWS to its stockholders. For purposes of determining SWS's fair value on a going-concern basis, actual plans to pay a dividend is irrelevant.[21]

The trial court also ignored incontrovertible evidence that management did not deploy its excess capital.[22] Specifically, Petitioners presented evidence that SWS projected its excess capital to grow with its Tier 1 Risk-Based Capital Ratio increasing from 26.23% in 2015 to 35.61% in 2017 – nearly six times the minimum ratio of 6.0% and more than double the 15.3% that the court in *PNB* found resulted in substantial excess capital.[23] Respondents offer no rebuttal—nor did they at trial—and cannot because it is indisputable that the $100 million lent to SWS by Hilltop

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[20] Op. 41-42.

[21] POB 32-37.

[22] *Id*. 34-36.

[23] A2087; POB 35-36.

and Oak Hill never left SWS's balance sheet.[24] Respondents' silence concedes the point.

The trial court also ruled that it could not judge how much capital could be distributed without altering downward projected cash flow; but this was erroneous because, as Clarke testified, any effect would be *de minimis*.[25] Respondents respond that all capital was generating revenue and Petitioners were just quibbling with the projected return.[26] The question, however, is not whether the excess capital generates any revenue, but whether the revenue generates a return on capital greater than its cost. Petitioners presented uncontested evidence at trial that:

- SWS let $30 million sit for years earning 0.01%, far less than the 8% it paid to borrow those funds from Hilltop;[27]
- SWS's Tier 1 Risk-Based Capital Ratio was projected to increase, which means SWS was not projecting to increase its leverage to generate returns on capital in excess of its cost;[28]

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[24] POB 6-13. Rather, Hilltop and Oak Hill contractually obligated SWS to maintain the $100 million in excess capital. A1427.

[25] POB 37.

[26] RAB 44.

[27] POB 6-7; A2023-A2024; A2578.

[28] POB 11-12.

- SWS projected to maintain $100 million in cash and hundreds of millions of low yield investments;[29] and
- Jeremy Ford told Hilltop's board of directors that Hilltop was "Buying Excess Capital" and Hilltop used SWS's cash to pay transaction costs and the Merger Consideration.[30]

On appeal, Respondents do not dispute any of these facts or explain how using cash or selling low yield investments would have anything other than, as Clarke testified, a *de minimis* effect on projected revenue.

Respondents argue that federal regulators may not have permitted SWS to distribute its excess capital.[31] At trial, Respondents did not rely on actual statements from regulators to support this contention; those communications were shielded by privilege.[32] Instead, Respondents relied on trial testimony from the witnesses they controlled, which in any event, referred to supposed comments by regulators made before Hilltop and Oak Hill exercised their warrants and eliminated $87.5 million of debt. Moreover, as Respondents admit, excess capital did not need to be extracted from the business; it could have been reinvested at SWS's cost of capital, returning

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[29] POB 12; A109-A110 at 250:6-251:12 (Edge).

[30] POB 14-15; A843-A844; A894; A904.

[31] RAB 45.

[32] A3836.

the same present value to SWS's stockholders.[33] Furthermore, even if federal regulators would not allow SWS to do anything with the capital at a given point in time, that cannot render the capital worthless forever. Capital does not vanish or become worthless because of some temporary limitation on its use.

Finally, Respondents argue that nothing could be distributed because the Management Projections were the "subject of binding negotiations with federal regulators."[34] This is false.[35] The record proved that the Management Projections were formed by (i) extending 18 months of projections (prepared a year earlier) to three years at Sandler's request and then (ii) reducing those projections to create a "Downside Case."[36] The record further proved the Management Projections increased the Tier 1 Risk-Based Capital Ratio to 35.61%.[37] Even under the corrective actions of the Operating Agreement, which had been terminated, SWS was only required to maintain a ratio of 6.0%.[38] Nothing about the Management

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[33] A295 at 778:12-779:10 (Ruback); A216 at 570:7-19 (Clarke).

[34] RAB 45.

[35] This argument should be rejected outright in any event, as SWS withheld all documents and communications with regulators based on bank examiner privilege. A3836 (citing *Chesapeake Corp. v. Shore,* 771 A.2d 293, 301 (Del. Ch. 2000) (giving no weight when evidence is shielded by privilege)).

[36] A39 at 15:6-16:14 (Sterling).

[37] A2087.

[38] A2660.

Projections justifies excluding excess capital from SWS's valuation forever, as was done by Ruback and the trial court.

The trial court's assumptions with regard its treatment of SWS's substantial excess capital were abuses of discretion that should be reversed.

B. The Trial Court Imposed a Minority Discount

The trial court's focus on planned dividends imposed an impermissible minority discount on dissenting shares.[39] Respondents deny this, but first argue that "Petitioners never suggested that Respondents' position would impose a minority discount" and therefore, the argument should not be considered on appeal.[40] Petitioners, however, repeatedly argued below that Ruback's approach to excess capital is "contrary to our Delaware case law…[and] contrary to Hilltop['s] [valuation]. And, in effect, it's a penalty on minority stockholders for lack of control of the corporate machinery."[41] The argument was preserved.

Respondents further argue that the trial court "held that SWS did not have the capacity to dividend excess capital."[42] In doing so, however, Respondents admit the

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[39] POB 38-40.

[40] RAB 45.

[41] A3663-A3664; *see also* A3204 ("[T]o not consider this value is to 'impose[] a penalty upon [the dissenters] for lack of control,' which is impermissible under Delaware law.") (citing *Cede & Co. v. Technicolor, Inc.,* 684 A.2d 289, 299 (Del. 1996) and *Cavalier Oil Corp. v. Harnett,* 564 A.2d 1137, 1145 (Del. 1989)); A3360 (same).

[42] RAB 46.

trial court found SWS had excess capital. And Respondents' contention with respect to capacity is undercut by the fact that Respondents do not (and did not) try to rebut Clarke's opinion that any adjustment to projected revenue in the Management Projections for excess capital would be *de minimis*. That is because it is indisputable that SWS had more than enough cash and low-yield liquid government securities to cover the amount that Clarke treated as distributable excess capital.[43]

Delaware law does not allow for the exclusion of valuable assets not required to generate operational cash flow from a company's going-concern value just because management did not plan to pay the value to stockholders as a dividend.[44] The trial court erroneously was "persuaded that [Ruback's] approach [wa]s correct given the treatment of cash flows in the management projections."[45] Though it may have been inadvertent, the trial court applied an impermissible minority discount on the dissenting shares by focusing on SWS's dividend policy and its decision must be reversed.

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[43] *Supra* pp. 7-9.

[44] POB 38-39.

[45] Op. 41.

C. The Trial Court's Holding is Contrary to Delaware Law and Ignores Elements of Present Value

SWS had $194 million of excess capital.[46] Clarke's model distributed $117.5 million of excess capital consistent with *Dunmire v. Farmers & Merchants Bancorp of W. Pa., Inc.,* 2016 WL 6651411 (Del. Ch. Nov. 10, 2016) and *In re PNB Holding Co. S'holders Litig.,* 2006 WL 2403999 (Del. Ch. Aug. 18, 2006).[47] In their Opening Brief, Petitioners argued that:

- The trial court adopted Ruback's model, which followed neither *Dunmire* nor *PNB*;[48]
- The trial court's approach reduced the present value of excess capital from $1.45 per share to $0.07 per share;[49] and
- The trial court's approach is contrary to *PNB*, which ruled that it was "inappropriate to assume that PNB would retain cash simply to remain well above the well-capitalized threshold."[50]

Respondents did not respond to these arguments or explain how the trial court's approach is consistent with either *PNB* or *Dunmire.*

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[46] A3107-A3108; A359-A361; POB 10.

[47] A361

[48] POB 41-42.

[49] *Id.* 41.

[50] 2006 WL 2403999, at *27; POB 40.

Instead, Respondents first argue that Clarke's approach was inconsistent with *PNB,* because he distributed capital at the start of the projection period, as the court did in *Dunmire*.[51] SWS was larger than PNB (with over 16 times more assets)[52] and had more than double the Tier 1 Risk-Based Capital Ratio that the court found made PNB "exceptionally well-capitalized" (15.3% vs. 35.61%, where the minimum ratio was 6.0%).[53] *PNB*, 2006 WL 2403999, at *26. As a result, SWS had far more excess capital than PNB ($194 million compared to $7.1 million). *Id.* at *27. PNB's relative size and lesser excess capital allowed the court to make a rational adjustment to the five-year financial projections that quickly utilized PNB's excess capital. *Id.* Here, however, the Management Projections did not project a long enough period (three years) or a sufficient amount of net income for the *PNB* approach to be used in isolation.[54] As a result, Clarke's method used both approaches, accounting for $87.5 million as of the Merger Date like in *Dunmire,* and accounting for an additional $30 million as in *PNB*. And like *PNB*, Clarke's use of $117.5 million of SWS's $194 million of excess capital left SWS well-capitalized into perpetuity. Just

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[51] RAB 48-49.

[52] A2087 (showing total assets and Tier 1 Risk-Based Capital Ratio).

[53] A2660.

[54] In *PNB*, the five year projection period projected a total of $13.126 million net income, compared to $7.1 million of excess capital. 2006 WL 2403999, at *29. Here, the SWS three year Management Projections projected a total of $100.823 million net income, compared to $194 million of excess capital. A472.

like the trial court, Respondents' reliance on *PNB* fails to acknowledge the stark differences in the excess capital at issue, and the result is the very outcome held to be unreasonable under *PNB* – holding substantial excess capital into perpetuity.

Respondents next argue, in a footnote, that the court's approach in *Dunmire* of adding excess capital to a DCF valuation is inapplicable here because the trial court found SWS's excess regulatory capital was deployed.[55] As a threshold matter, and discussed *supra* at pp. 7-9, SWS's excess capital was not "deployed," it was parked in cash or low yield risk free assets. But critically, Respondents concede that if the trial court had not incorrectly determined that excess capital was "deployed," it would be appropriate under *Dunmire* to add that value to a DCF analysis.[56] As explained above, SWS's excess capital was not deployed, so Clarke's use of the approach utilized in *Dunmire* was reasonable, and the trial court erred by not adopting the same approach.

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[55] RAB 48 n.173.

[56] *Id.*

III. THE TRIAL COURT ERRED BY NOT TAKING ACCOUNT OF ALL RELEVANT FACTORS OF UNFAIR DEALING PRESENTED AT TRIAL

In their Opening Brief, Petitioners argued that the trial court erred by not taking account of all relevant factors of unfair dealing presented at trial.[57] While neither party relied on the deal price in valuing SWS, that does not mean unfair dealing is irrelevant or that the deal price was derived by random chance. Unfair dealing doctrinally robs the trial court from the best evidence of fair value of a corporation – the market price set in a fair, robust sales process. *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 2017 WL 3261190, at *1 (Del. Aug. 1, 2017). This case presents a perfect case in point – a higher bid of $8.65 per share disadvantaged and cut-down by faithless fiduciaries. The trial court cannot overlook this; the trial court also should not have overlooked Hilltop's contemporaneously prepared stand-alone valuation of SWS, and the fact that the Special Committee meeting minutes explicitly rejected $7.00 per share because it undervalued SWS, or SWS's tangible book value, particularly when SWS had previously rejected Sterne Agee's $7.50 per share cash offer in favor of Hilltop's investment because the offer was a substantial discount to tangible book value.[58]

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[57] POB 43-54.

[58] Op. 11.

In their Answering Brief, Respondents first argue that Petitioners did not present this issue to the trial court below, and thus failed to preserve the argument for appeal.[59] Petitioners raised this argument below at A3216 (explaining that Hilltop's unfair dealing and the tainted sales process is an "element[] of value that properly may be considered in an appraisal" (quoting *Glassman v. Unocal Exploration Corp.,* 777 A.2d 242, 248 (Del. 2011)); A3508 ("While this Court has looked to the merger price as the best evidence of fair value where a thorough sales process was run and negotiations were at arms-length, the record in this case reveals just the opposite. The only reasonable conclusion that can be drawn from this record is that Hilltop would have had to pay significantly more than $7.75 per share to acquire SWS in an arm's-length transaction."); and A3372 (arguing that the "disloyal conduct by Hilltop and SWS's directors and officers in selling the Company" is support for the fact that "[a]ll relevant data points show that SWS was worth substantially more than $7.75 per share."). The argument was preserved.

A. The Unfair Sales Process Was Not Considered By the Trial Court

Hilltop used its position as an insider to unfairly tilt the sales process in its favor, and the Special Committee played along.[60] Hilltop initiated, structured,

[59] RAB 55-56.

[60] POB 45-51 (summarizing evidence).

negotiated, and obtained approval for the Merger on unfair terms.[61] The Special Committee shirked its duties, if not actively collaborated with Hilltop.[62] Respondents do not dispute that these are relevant factors under Section 262. Rather, Respondents claim that the "trial court did not credit the various claims of unfair dealing."[63] That is a mischaracterization. It is one thing for the trial court to weigh these relevant factors as its charge under Section 262 requires, then decide they are unpersuasive; it is another for the trial court to erroneously assume it does not need to consider the evidence because it does "not find the merger price reliable."[64]

Respondents defend Hilltop's unfair dealing. Respondents argue that Petitioners' claim of unfair "timing" is unfounded because the trial court did not find, for purposes of adopting Petitioners' three-stage DCF model, that SWS was poised for a turnaround.[65] Respondents ignore:

- The January 9, 2014 Hilltop board of directors presentation prepared and presented by Jeremy Ford that stated, "[t]iming is appropriate if

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[61] *Id.*

[62] *Id.*

[63] RAB 58.

[64] Op. 3.

[65] RAB 58.

transaction is to occur . . . DALLAS [SWS] performance poised to improve with increasing interest rates and stock market";[66]

- That Hilltop secretly and deceptively[67] conducted due diligence on SWS for more than three months before publicly approaching the SWS board of directors with its $7.00 per share offer;[68] and
- That Jerry Ford "blew his top" when the Special Committee suggested it wanted to execute an NDA and allow a higher bidder to conduct due diligence, demanding a signed Merger Agreement in days.[69]

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[66] A1127.

[67] POB 13-17; Op. 16. In this regard, Respondents contend that Hilltop was entitled to SWS's confidential information that Hilltop secretly and deceptively obtained pursuant to its confidentiality agreement. (RAB 12 n.42.) This is not true and would make no sense. Companies do not grant lenders who are stockholders and competitors the right to any confidential information they want to use for any purpose they choose, including to spring an unsolicited bid on an unprepared board. To be sure, the Credit Agreement explicitly limited Hilltop's use, ability and purpose for which it could share information obtained from SWS. A1449-A1550. Nor did Jeremy Ford's right to observe board or committee meetings give him a right to active participation in the management of SWS (POB 7-8), and the right to use information he obtained through his active participation in the management of SWS for the purposes of acquiring SWS, which is why he lied to management while conducting his due diligence.

[68] Op. 16.

[69] Op. 21.

Respondents also wrongly claim that Hilltop did not dictate the structure of the deal to its benefit.[70] Respondents ignore Hilltop's secret due diligence.[71] Respondents ignore that the Special Committee hired Hilltop's investment banker.[72] Respondents ignore that Hilltop dictated when it would exercise its warrants despite its refusal to waive the Merger Covenant at any price.[73] Respondents ignore that with stockholder approval of the Merger in jeopardy, the Special Committee was happy to extend the record date so Hilltop could exercise its warrants.[74] Respondents ignore Hilltop's internal pricing and strategy considerations – prepared months before any negotiation with the Special Committee took place.[75]

In these internal analyses, Hilltop targeted $7.63 per share, less than its stand-alone valuation for SWS:[76]

[70] RAB 58.

[71] POB 13-17.

[72] *Id*. 18.

[73] *Id*. 21.

[74] *Id*. 23-24. Respondents contest this. However, this was Sterling's deposition testimony (POB 24), and Hilltop's internal board presentations show that by the end of July 2014, the SEC had no further comments and it was Hilltop that moved to set the first record date. AR13.

[75] A1031-A1032.

[76] A1031.

Pricing Considerations – Price

	Dallas Price per Share				
	$7.00	$7.25	$7.50	$7.75	$8.00
Dallas Valuation	352,059	364,633	377,206	389,780	402,354
Price / Net Asset Value (MTM)	**0.87x**	**0.90x**	**0.93x**	**0.96x**	**0.99x**
Price / NAV w/ Change Control Costs	**0.92x**	**0.95x**	**0.98x**	**1.02x**	**1.05x**
Discount to Net Asset Value	(51,734)	(39,160)	(26,586)	(14,013)	(1,439)
After-Tax Change of Control Costs	22,099	22,099	22,099	22,099	22,099
Goodwill (Negative)	(29,634)	(17,061)	(4,487)	8,087	20,660
Premium to Market Price ($6.06 @ 1/9/14)	**16%**	**20%**	**24%**	**28%**	**32%**
Price / Standalone Case CY2014	**41.7x**	**43.2x**	**44.7x**	**46.2x**	**47.7x**
Price / Pro Forma Case CY2014	**12.6x**	**13.1x**	**13.5x**	**14.0x**	**14.4x**
SMU IRR - Standalone Case (50% Stock)	**14%**	**14%**	**13%**	**12%**	**11%**
SMU IRR - Pro Forma Case (50% Stock)	**31%**	**30%**	**29%**	**29%**	**28%**
SMU - Average IRR	**23%**	**22%**	**21%**	**20%**	**20%**

- Discount to NAV - important (and warranted) to price at discount to NAV, after change of control costs: **<$7.50**
- Premium to Market - important to offer recognizable premium to market: **>$7.25**
  - Dallas traded consistent with its 30 day average price of $6.11 (pre-announcement)
- Price / Earnings – to pay les than 14x forecasted 2014 Pro Forma earnings: **<$7.75**
- Tangible Book Value Accretive – to obtain greater than 14% accretive at 75% stock: **<$7.75**
- EPS Accretive – to obtain greater than 8.5% accretive at 75% stock: **<$7.75**
- IRR – to achieve Standalone + Pro Forma cases average IRR of >20%: **<$7.75**
- **Derives Average Price of $7.63**
- Note – this is Total Dallas valuation and includes OH warrant shares, though assumes no additional consideration to OH

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CONFIDENTIAL HTH00002001

Hilltop also targeted how much stock it wanted to pay as part of the deal – 73% to 87.5% of the Merger Consideration:[77]

[77] A1032.

Pricing Considerations – Stock vs. Cash

Price per Share	$7.50
Dallas Market Price (1/9/14)	$6.06

	Dallas % Stock				
	50%	63%	75%	88%	100%
Pro Forma Tangible Book Value	$10.38	$10.60	$10.80	$11.00	**$11.20**
Accretion (Dilution)	10%	13%	15%	17%	**19%**
Pro Forma EPS	**$1.70**	$1.67	$1.64	$1.62	$1.59
Accretion (Dilution)	**12%**	11%	9%	7%	5%
% Ownership - SMU	**93%**	92%	90%	89%	88%
% Ownership - GJF	**17%**	17%	16%	16%	16%
Remaining Excess Cash	162,498	200,113	237,728	275,344	**312,959**
SMU IRR - Standalone Case	**12.8%**	12.7%	12.4%	11.9%	10.8%
SMU IRR - Pro Forma Case	**29.4%**	28.6%	27.3%	25.3%	21.3%

- TBV Accretion - important and more certain than EPS accretion: **>50% stock**
- EPS Accretion and IRR – enhances SMU upside in future earnings and cost saves, though more risk: **<75% stock**
- Pro Forma Ownership – maintain SMU and GJF ownership (allow for 10% to Dallas) : **<75% stock**
- Pro Forma Excess Cash – maintain ability to make acquisitions (ensure >$150M but <$250M): **50% - 75% stock**
- **Derives Average % Stock of 73%, with maximum of 87.5%**
- Note – this is Total Dallas valuation and includes OH warrant shares, though assumes no additional stock or cash consideration to OH

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CONFIDENTIAL HTH00002002

That the Special Committee walked into Hilltop's desired outcome was not mere coincidence. The Special Committee as initially comprised was conflicted from the outset,[78] and was advised by a conflicted investment banker.[79] None of these relevant factors, nor any of Hilltop's internal pricing considerations, were considered by the trial court below.

[78] A2072-A2073.

[79] A50 at 60:18-64:5 (Sterling).

To the extent Respondents paint Stifel as some "kind of a spoiler,"[80] again, Respondents' only evidence is testimony at trial of its controlled witnesses. In contrast, Sterling's deposition testimony describing his last call with Stifel's CEO and CFO speaks volumes: "[W]e can't understand why you won't give us more time. We can't understand this artificial deadline, and we would be surprised -- I think their point was, we would be surprised if in your fiduciary duty with us having a number of 8.65 out, you could accept a deal for a lower price from somebody else while we've got a proposal at 8.65 out."[81] Stifel's CEO's contemporaneous written correspondence to the Special Committee and Sandler echo the same level of frustration with the Special Committee.[82] Further, the sincerity of Stifel's interest is

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[80] RAB 19 (quoting A81 at 138:12-18 (Miller)).

[81] B618 at 188:21-189:4 (Sterling Dep.).

[82] A2239 ("[W]e are perplexed by the sudden urgency when there appeared to be no urgency last week at the point where you deferred countersigning the NDA that would have given us access to your data room. Nevertheless, we will engage tomorrow as described above, but hope that you recognize that, in order to maximize the value to SWS shareholders, it may turn out that you and we conclude that it is best to announce a transaction a week from Monday."); AR1 ("I have personally been involved in over 20 acquisitions and believe that we can and will deliver a superior proposal, in a short timeframe, to the shareholders of your client if you can simply provide the due diligence materials which must be readily available considering your current circumstances.").

buttressed by the fact that it acquired Sterne Agee,[83] a competitor broker-dealer to SWS, within months of the close of the Merger.[84]

Nor was the Merger overwhelmingly approved by SWS's stockholders as Respondents suggest.[85] Only 47.8% of the non-insider shares voted in favor of the Merger.[86] And that is only after SWS materially mislead both its stockholders and proxy advisor services with respect to the process by which SWS was sold.[87]

The trial court's failure to consider these relevant factors was legal error, and it should be reversed.

B. External Markers of Value Confirm That the Unfair Process Affected the Transaction Price

Respondents ignore the legal issue Petitioners appeal and instead argue that the trial court did not abuse its discretion by failing to treat the deal price as a floor. That is not the question presented. Moreover, as the trial court did, Respondents

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[83] Sterne Agee was the broker-dealer that offered $7.50 per share cash for SWS at the time Hilltop and SWS entered into the Credit Agreement. Op. 10. Respondents claim that because Sterne Agee was not a bank-holding company at the time, it could not have acquired SWS. *See* Op. 11 (accepting Sterling's trial testimony). Hilltop was not a bank-holding company at the time either, yet that did not prevent Hilltop from actively seeking to acquire other bank-holding companies, and ultimately acquiring PlainsCapital. Op. 15.

[84] AR21-AR22.

[85] RAB 23.

[86] A3505-A3507; AR20.

[87] A3505-A3507.

ignore the external markers of value that confirm the unfair process not considered by the trial court affected the transaction price. While Respondents claim that "market evidence" justified the trial court's $6.38 per share valuation, the only evidence they point to is that no topping-bid emerged and that SWS's stock was trading slightly below that price prior to Hilltop's offer.[88]

Respondents do not dispute that the trial court gave no consideration to Hilltop's stand-alone valuation of SWS that was prepared contemporaneously to the Merger. Instead, Respondents justify the trial court's disregard of this relevant factor because the transaction was synergy-driven.[89] Respondents state that "Hilltop's internal rate of return ('IRR') analysis for an SWS deal confirmed that Hilltop projected to lose money at its offer price absent synergies."[90] But this is false. Hilltop prepared SWS's performance both on stand-alone and pro forma bases.[91] While Jeremy Ford testified at trial that "we thought the stand-alone value would be, you know, sub $5," on cross-examination he admitted that – on a stand-alone basis – Hilltop expected it would make a 14% return on a $7.00 per share purchase price, and a 12% return on a $7.75 per share purchase price:

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[88] RAB 60-61.

[89] *Id.* 12-13, 62.

[90] *Id.* 13 n.45.

[91] *Id.* 12.

Q. When I’m told about a rate of return, am I wrong to believe that that’s money that I’m going to be making on my investment? Isn’t that right, Mr. Ford?

A. That’s the – that’s the percentage return that you would make on your investment.

Q. That’s what I thought. So I guess am I right that what you’re telling me here is if I gave you $7, what I’d get back on the pro forma case for the internal rate of return would be $7 plus 31 cents [sic]; right?

A. No.

Q. I wouldn’t be making 31 percent on my $7 investment?

A. Well, you said $7 plus 31 cents.

Q. 31 percent. I’m sorry, Mr. Ford.

A. Oh, excuse me. You would be making 31 percent on the $7.

Q. Okay. Now, on $7, a 31 percent investment was worth your time; that was your testimony?

A. Yes.

Q. But a 14 percent return wasn’t. That was your testimony, too, wasn’t it, Mr. Ford?

A. Yes. That was my testimony, and it was not worth our time.

Q. That’s right. But this pricing consideration is still telling us that at $7, on a stand-alone case, Hilltop was still making 14 percent on its money; right?

A. That case says on a stand-alone basis we had a 14 percent IRR.

Q. And that's $7 per share. At 12 percent – you got 12 percent at $7.75; right?

A. That's what it says.

Q. On the stand-alone case.

A. Yes.[92]

* * *

Q. Okay. Without any cost savings, any synergies whatsoever, Hilltop estimated a 12 percent internal rate of return at $7.75; right?

A. That's what it says. Yes.

Q. Well, you prepared this, didn't you?

A. Yes.

Q. This was your analysis; right?

A. Yes.[93]

Respondents previously explained that "[t]o calculate IRR, an investor discounts to the present value the future cash flow of a potential investment using a range of discount rates. IRR can be thought of as the discount rate at which a target company's DCF valuation is equal to the cost of acquiring it, or the discount rate at

[92] A159 at 341:6-7, A160-A161 at 348:12-349:24 (Ford).

[93] A161 at 350:10-17 (Ford).

which an investment breaks even."[94] In other words, Hilltop's stand-alone IRR analysis for SWS is a DCF model flipped to show values at discount rates from 11 to 14%.[95] And as Petitioners argued in their Opening Brief, Hilltop's stand-alone IRR analysis revealed that contemporaneously to the transaction, Hilltop valued SWS on a stand-alone basis at $7.50 to $7.75 per share using discount rates of 12% to 13%, respectively.[96] As Petitioners also previously noted, Hilltop's stand-alone valuation of SWS incorporated $40.5 million in transaction costs.[97] The analysis is neither cited nor discussed in the Opinion.

Respondents also urge this Court to ignore the fact that the Special Committee meeting minutes prepared contemporaneous to the transaction explicitly stated that "the Special Committee concluded that Hilltop's offer of $7.00 per share undervalued the Company and was inadequate."[98] Respondents contend that consideration of the Special Committee's contemporaneous minutes as a relevant factor in determining the fair value of SWS "makes no sense."[99] Instead, Respondents say the credible and reliable evidence is Jeremy Ford's trial testimony

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[94] A3268-A3269.

[95] A1186; A3754 at 111:5-112:1.

[96] POB 52.

[97] *Id.*

[98] A2121.

[99] RAB 62.

that SWS was only worth $5 per share on a stand-alone basis, and Miller's trial testimony stating that the Special Committee's determination that $7.00 per share undervalued SWS was just a negotiation tactic.[100] Just as Jeremy Ford's trial testimony is contradicted by documents prepared contemporaneous to the transaction, so is Miller's. Indeed, what makes no sense is why internal minutes to the Special Committee would make such a statement as "a negotiation tactic."[101] Yet, that is exactly the position the trial court must have accepted.[102]

Respondents also scoff at Petitioners' reliance on SWS's $8.42 per share tangible-book-value.[103] Respondents claim that "the trial record demonstrated that SWS's tangible book value had no correlation with its fair value."[104] Yet, after accounting for transaction costs included in Hilltop's stand-alone valuation of SWS, tangible-book-value is approximately where you end up.[105] Moreover, Sandler and SWS management projected that SWS's tangible book value would increase, not only in the Base Case, but in the "Downside" case as well.[106] And, just about every

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[100] *Id.* 13, 62.

[101] *Id.* 62

[102] Op. 22.

[103] *See* A3167, A3306, A3327, A3377-A3378.

[104] RAB 61.

[105] $7.75 per share plus $0.80 per share value of transaction costs. POB 52.

[106] A2847; A2085.

single financial services transaction provided for in the record implies a transaction multiple of higher than 1x tangible book value.[107]

Respondents at least concede that "SWS tried to sell itself for its tangible book value,"[108] and no more, a point Petitioners have stressed.[109] Respondents contend that the lack of a topping-bid is relevant. The Special Committee, however, had "topping bids" from Esposito/Triumph of $8.00 and from Stifel for $8.65 per share before signing the Merger Agreement with Hilltop at $7.75 per share.[110] As to a post-signing topping bid, "[t]he pathway to success must be sufficiently realistic to warrant incurring the time and expense to become involved in a contested situation . . . ."[111] Here, the Special Committee was marketing SWS as being worth no more than a value below what Hilltop was able to block.[112] Moreover, Hilltop was an insider having "the best insight into the Company's value, or at least is perceived to

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[107] *See* A404; A570.

[108] RAB 61.

[109] A3490-A3491 ("Sandler O'Neill also told every potential bidder that SWS was worth no more than its tangible book value ('TBV'), which at the time was $8.15 per share, and that Hilltop could veto competing bids exceeding that value." (citing A2070; A43 at 30:1-32:22, 93:5-94:9 (Sterling)).

[110] POB 19-23 & n.90.

[111] *In re Appraisal of Dell Inc.,* 2016 WL 3186538, at *39 (Del. Ch. May 31, 2016). *Dell* focused on management buyouts, which is similar to this case because of Hilltop's investment, Merger Covenant and influence on and access to SWS information and management.

[112] POB 20 & n.91.

have an informational advantage," leading to a "winner's curse" that temper outside bids.[113] And Stifel understandably had moved on to acquire Sterne Agee.[114]

Hilltop also had a value advantage. After its investment in SWS, Hilltop strategically acquired other businesses that overlapped SWS both in operations and geography, making Hilltop a direct competitor of SWS.[115] Hilltop was not going to let all of the time, energy and money invested in SWS and the opportunity to eliminate a competitor to be compensated by a premium on the shares underlying its warrant, particularly with the prospect of realizing its projected pro forma IRRs on the transaction. Thus, any potential bidder in the market would know it would be relegated to a stalking horse only to drive up Hilltop's price while facing Hilltop's wrath in the process.

* * *

The trial court's opinion of fair value is unsupported by documents prepared by Hilltop and the Special Committee contemporaneously to the unfair process by which SWS was sold. Respondents present no basis in law or fact as to why the contemporaneous evidence of the unfair process should not have been considered

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[113] *Dell*, 2016 WL 3186538, at *42-43.

[114] *Supra* pp. 23-24.

[115] A3315-A3316; Op. 15.

under the statutory mandate of Section 262. The trial court's Opinion should be reversed.

SUMMARY OF ARGUMENT ON CROSS-APPEAL

1. Denied. (Respondents' Cross-Appeal Issue 1: Size Premium). The trial court appropriately exercised its discretion in placing weight on the size premium advocated by Petitioners (2.69%) to calculate SWS's cost of equity. The trial court made factual findings supported by the record that SWS's market capitalization as of the Merger Date was difficult to derive or unreliable. The trial court therefore found Clarke's method to selecting a size premium supported, and the methodology was conceded by Respondents to be generally considered acceptable in the financial community.

2. Denied. (Respondents' Cross-Appeal Issue 2: Equity Risk Premium). The trial court properly exercised its discretion by using a supply-side equity risk premium to calculate SWS's cost of equity. Respondents failed to present evidence at trial to overcome the overwhelming support in the valuation community for the supply-side equity risk premium.

3. Denied. (Respondents' Cross-Appeal Issue 3: Warrant Exercise). The trial court applied well-supported findings of fact to settled legal precedent in holding that the operative reality of SWS as of the date of the Merger included the exercise of warrants.

ARGUMENT ON CROSS-APPEAL

IV. THE TRIAL COURT DID NOT ABUSE ITS DISCRETION BY PLACING WEIGHT ON PETITIONERS' SIZE PREMIUM TO CALCULATE SWS'S COST OF EQUITY

A. Question Presented

Whether the trial court properly exercised its discretion in placing weight on Petitioners' size premium in calculating SWS's cost of equity.

B. Scope of Review

The standard of review is abuse of discretion.[116] This Court reviews non-legal issues challenged in appraisal valuations under an abuse of discretion standard. *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 217 (Del. 2010). A trial court abuses its discretion "only when either its factual findings do not have record support or its valuation is clearly wrong." *Id.* at 219. This Court will defer to the trial court's factual findings so long as they are supported by the record, "even if [this Court] might independently reach a different conclusion." *Id.*

C. Merits of Argument

The trial court properly exercised its discretion in placing weight on the size premium advocated by Petitioners in calculating SWS's cost of equity. To be sure, as argued above, the size premium advocated by Petitioners was the only size premium evidence presented at trial that reflected SWS's operative reality as of the

[116] RAB 27.

Merger Date.[117] Setting aside the legal point, however, the trial court's decision to use the size premium advocated by Petitioners is well supported by the record and not an abuse of discretion.

The trial court found SWS was "in some ways more analogous to a private company" because "it had a substantial amount of in the money warrants and significant influence by certain major creditors."[118] Respondents do not argue either of these factual findings were incorrect or unsupported by the record. To the contrary, the trial evidence was undisputed.[119] SWS had 17,391,304 shares subject to in-the-money warrants, which equaled over 34% of the total shares outstanding after exercise. There is no dispute as to Hilltop's influence as a result.

Respondents instead argue that the trial court was prohibited from considering that (a) SWS had an extraordinary number of in-the-money warrants outstanding as of January 2014, and (b) 87.5% of the shares underlying those warrants were actually exercised in September and October 2014 before the Merger, because size premium

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[117] *Supra* pp. 3-5.

[118] Op. 48-49.

[119] A210 at 545:16-546:2 (Clarke) ("Q. Okay. And why did you pick a different one than Dr. Ruback did? A. Well, I think that Dr. Ruback is in error here, because he is not -- you know, he has not -- he has not considered the very unusual capital structure of SWS. SWS is really sort of unique among public companies, at least that I've ever looked at. And this is because of the presence of the -- of the warrants outstanding, which, if exercised, would essentially increase SWS's number of shares by 50 percent.").

tables published by Duff & Phelps exclude warrants.[120] Delaware courts, however, reject the "rote application" of size premium tables. *See*, *e.g.*, *In re Orchard Enterprises, Inc.*, 2012 WL 2923305, at *22 (Del. Ch. July 18, 2012) (warning against the "rote application" of size premium deciles). Moreover, notwithstanding their own expert's testimony to the contrary, Respondents tried post-trial to show that SWS's capital structure was typical for a public company. It was not.

Respondents included documents outside the trial record in their post-trial briefs regarding one of Clarke's selected comparable companies that had issued convertible debt.[121] The capital structure of that company, however, was nothing like a 34% equity stake held by two holders in non-publicly traded warrants, like SWS. Indeed, Respondents abandoned the argument after Petitioners identified filings omitted by Respondents that showed the intended structure of convertible debt was to avoid the very type of equity dilution SWS stockholders were subject to by the warrants.[122] Nonetheless, Respondents continue to insist there is nothing unusual about SWS's capital structure.[123] But, both Ruback and Clarke testified to the contrary.[124] Respondents also ignore that warrants were actually exercised after

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[120] RAB 29-30.

[121] A3468 & n.269.

[122] A3534-A3535.

[123] RAB 32-33.

[124] A210 at 545:16-546:2 (Clarke); A3146 at 182:5-11 (Ruback Dep.).

Hilltop's public unsolicited offer, but months before the Merger. The trial court correctly found the uncontested trial evidence of SWS's unusual capital structure persuasive and recognized warrants had actually been exercised, and cannot be found to have abused its discretion in that regard.[125]

Since the trial court reasonably found SWS maintained an unusual capital structure for a public company, the trial court also could not have abused its discretion by placing weight on Clarke's size premium just because he considered an iterative approach as one data point.[126] Respondents conceded an iterative approach was appropriate where market capitalization is not easily derived or reliable.[127] Nor is the selection of an appropriate size premium for purposes of valuing a business so mechanical. *See Orchard,* 2012 WL 2923305, at *22. Even in *DFC Global*, the trial court departed from the size premium decile tables, because it was persuaded that the market capitalization of the subject company would have declined in the period between immediately prior to the announcement of the deal and its consummation. *In re Appraisal of DFC Global Corp.,* 2016 WL 3753123, at *14 (Del. Ch. July 8, 2016), *rev'd sub. nom on other grounds, DFC Global Corp.,* 2017 WL 3261190. Thus, to the extent Respondents are arguing "a simple exercise"

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[125] Op. 49.

[126] RAB 27.

[127] *See* Op. 48; A3621-A3622.

where a valuation expert has no leeway to account for the actual characteristics of the company or events at issue, that is not and has never been the law in Delaware.

In *Weinberger v. UOP, Inc.,* this Court held that "proof of value by any techniques or methods which are generally considered acceptable in the financial community" must be considered by the Court of Chancery. 457 A.2d 701, 713 (Del. 1983). Thus, under Delaware law, the appropriate valuation technique or method to account for the unique facts presented in this case is within the purview of the valuation expert. The iterative approach to determining size premium is generally accepted in the financial community.[128] Respondents have never suggested the contrary,[129] and as the trial court noted, the iterative approach is appropriate where the market capitalization of the subject company is not easily derived or reliable.[130] Indeed, the approach is described in Duff & Phelps,[131] which both experts relied upon. Nor is the fact that Petitioners' expert typically uses an iterative approach as a data point problematic.[132] Whether the trial court would or would not agree with the iterative approach in every instance Clarke has ever used it is pointless

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[128] A211 at 550:14-15 (Clarke) ("It is typically done in valuing companies.").

[129] *Cf.* A3467 (conceding that the iterative approach is used to value private companies).

[130] Op. 49.

[131] A366.

[132] RAB 29.

speculation outside the scope of appeal. All that matters is that the trial court placed weight on Clarke's size premium in this instance because it found SWS analogous to a private company and recognized that warrants were in fact exercised. Clarke took into account those company specific factors,[133] including the positive effect on SWS's stock price that would likely have occurred from the warrant exercise itself.[134] The trial court found these supported facts persuasive.

Accordingly, it was within the trial court's discretion to place weight on Clarke's size premium to calculate SWS's cost of equity. None of the trial court's factual findings are unsupported or clearly wrong and should be affirmed.

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133 Op. 48-49.

134 *Id.*

V. THE TRIAL COURT DID NOT ABUSE ITS DISCRETION BY USING A SUPPLY-SIDE EQUITY RISK PREMIUM TO CALCULATE SWS'S COST OF EQUITY

A. Question Presented

Whether the trial court properly exercised its discretion in using a supply-side equity risk premium in calculating SWS's cost of equity.

B. Scope of Review

Respondents do not state a standard of review for this issue on cross-appeal. Instead, Respondents state multiple standards of review generally.[135] Elsewhere, however, Respondents state that the application of the "ERP is a factual matter to be determined on the basis of the evidence presented."[136] The standard of review is therefore abuse of discretion.[137]

C. Merits of Argument

Respondents are wrong that the trial court abused its discretion by using a supply-side equity risk premium in calculating SWS's cost of equity.[138] Respondents contend that their expert "demonstrated that a recent survey of finance

[135] RAB 34.

[136] *Id.* 35.

[137] *Supra* pp. 33.

[138] Op. 45-46.

and valuation textbooks showed that historical ERP is now the preferred approach."[139] As Clarke explained in his rebuttal report:

> While Dr. Ruback suggests the survey is "recent," in reality it was originally published in 2009, and has been republished in 2010, 2011, 2013 and 2015. Also, while the title of the survey is "The Equity Premium in 150 Textbooks," the survey includes multiple editions of a number of the same textbooks including 7 editions of Brealey and Myers, and, among others, multiple editions of a number of textbooks written by Professor Damodaran. Notably, although the survey has been republished, its dataset has not been updated, and nearly all of the textbooks listed were published at least a decade ago, and many of them are much older than that, including the oldest published in 1979. It is also notable that publications such as Brealey and Myers has not looked to the Historical ERP since its 5th edition, published in 1996. Similarly, while the 2nd edition of Pratt's Cost of Capital published in 2002 looks to Historical ERP, the 3rd edition of Pratt & Grabowski's Cost of Capital published in 2008 does not. Thus, if anything, the survey that Dr. Ruback relies upon shows an evolution in thinking by leading authorities in the field of finance, which the Court of Chancery considered and evaluated back in 2010.[140]

Respondents never presented any rebuttal evidence to Clarke's opinion of the survey Ruback relied upon.

Respondents further contend that Ruback's "research supports the conclusion that participants in the M&A markets rely upon historical ERP in their decision-

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[139] RAB 36.

[140] A538.

making."[141] First, even if that were true, it would not make it an abuse of discretion for the trial court to use the supply-side rate that is well supported by the record and accepted in the academic community and Delaware courts. Second, Ruback testified that his most recent work on the topic was published in 1996, and was based on data from 1987.[142] Ruback further testified that he was unaware of any research in the past five years that supported his preferred use of the historical equity risk premium.[143] Ruback was unaware of any such research, despite the trial court's refusal to rely on his opinion on the issue in separate, but recent appraisal litigation. *See Merion Capital LP v. BMC Software, Inc.,* 2015 WL 6164771, at *12 (Del. Ch. Nov. 3, 2015).

In contrast, Petitioners proffered extensive expert evidence supporting the use of the supply-side equity risk premium.[144] Thus, the trial court's use of the supply-side equity risk premium is supported by the record, and cannot be clearly wrong, especially when Respondents' own expert used it in his report.[145] The trial court's

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[141] RAB 36.

[142] A293 at 769:12-24 (Ruback).

[143] *Id*. at 768:6-11 (Ruback).

[144] A535-A539.

[145] A438 ("I also report results using the supply-side ERP of 6.21% and the mid-point between the historical ERP and the supply-side ERP of approximately 6.61%.").

exercise of discretion in using the supply-side equity risk premium to calculate SWS's cost of equity should be affirmed.

VI. THE TRIAL COURT CORRECTLY HELD THAT THE OPERATIVE REALITY OF SWS AS OF THE MERGER DATE INCLUDED THE EXERCISE OF WARRANTS

A. Question Presented

Whether the trial court correctly held that the operative reality of SWS as of the Merger Date included the shares issued by SWS as a result of warrants exercised by Hilltop and Oak Hill prior to the vote on the Merger.

B. Scope of Review

Respondents again do not state which standard of review applies to this issue on cross-appeal.[146] By citing to multiple standards of review, Respondents suggest that this issue presents questions of fact and law. But, as explained below, regardless of the standard of review applied, the trial court should be affirmed.

C. Merits of Argument

1. The Trial Court Properly Exercised Its Discretion in Finding the Warrant Exercises Were Part of SWS's Operative Reality

It was undisputed that the warrant exercises were known at the time of the Merger Date, because they occurred months earlier. In September and October 2014, Hilltop and Oak Hill exercised warrants to acquire 15,217,391 shares of stock, which eliminated $87.5 million of debt under the Credit Agreement.[147] The trial record showed that:

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[146] RAB 50.

[147] A2682; A2720-A2721.

- The Merger Agreement provided for the warrants to be cancelled, not exercised, if and when the Merger closed;[148]
- The exercise of the warrants was not a condition of the Merger Agreement;[149]
- The exercise of the warrants was not contingent on the Merger closing and could not be undone if the Merger did not close;[150] and
- Hilltop and Oak Hill voted the shares received from the exercise of the warrants in favor of the Merger, but the vote did not guarantee the Merger would be approved.[151]

Thus, the exercise of the warrants was a known element of value as of the Merger Date and was not conditioned or contingent on the Merger.

Accordingly, the trial court properly held that the exercise of the warrants was part of SWS's operative reality at the time of the Merger:

> [U]nlike the facts in certain cases relied on by the Respondent, here the warrant exercise was not conditioned in any way on the merger: here those exercising the warrants simply made the independent decision to exercise in-the-money warrants before the record date to vote for the merger.[152]

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[148] A2911.

[149] Op. 37 & n.205.

[150] A2682; A2720-A2721; B1092-B1093 at 308:20-310:7 (Ruback Dep.).

[151] AR14-AR15; AR16; AR20; A174 at 404:2-7 (Ford).

[152] Op. 37 & n.205.

Respondents do not explain how these findings of fact were wrong, nor could they.

Respondents' reliance on *Gearreald v. Just Care, Inc*.[153] and *Cede & Co. v. JRC Acquisition Corp.*[154] is misplaced. Those cases show that the subject company's operative reality depends on the specific facts of each case.[155] Respondents claim *Gearreald* supports the use of a "hypothetical capital structure" rather than a company's actual capital structure for purposes of appraisal, but ignore the court's factual findings as to why it was appropriate there. In *Gearreald*, the debt payoff at issue was a condition to the merger agreement.[156] *Gearreald*, 2012 WL 1569818, at *8. Here, the warrant exercises were not. Respondents also point out that the court in *Gearreald* treated preferred stock as common stock. But again, that was a fact specific determination. *Gearreald* is clear that, on the facts of that case, the "preferred stock should be treated as common equity" because it was "treated as a common stock equivalent, not a dividend-paying debt instrument." *Id.* at *9. The court explicitly found that, "for appraisal purposes, the preferred stock should be treated as common equity because that was the true economic nature of the Company's preferred stock financing." *Id.* As a matter of finance, treating preferred

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[153] 2012 WL 1569818 (Del. Ch. Apr. 30, 2012).

[154] 2004 WL 286963 (Del. Ch. Feb. 10, 2004).

[155] RAB 52-54.

[156] Op. 38.

stock as "common stock equivalent" on an as-converted basis is proper under Section 262, particularly when the stock has weak dividend preferences as compared to the common. *See*, *e.g.*, *In re Appraisal of Metromedia Int'l Grp., Inc.*, 971 A.2d 893, 900 (Del. Ch. 2009); *Orchard*, 2012 WL 2923305, at *7-8, *aff'd sub nom. Orchard Enterprises, Inc. v. Merlin Partners LP*, 2013 WL 1282001 (Del. Mar. 28, 2013); *In re GoodCents Holdings, Inc.*, 2017 WL 2463665, at *6 (Del. Ch. June 7, 2017). Thus, contrary to Respondents' contention, the *Gearreald* court's use of a "theoretical capital structure"[157] did not exclude any "known elements of value." *Technicolor,* 684 A.2d at 299.

Factual findings were also outcome determinative in *JRC Acquisition*. The issue in *JRC Acquisition* was whether $55 million of debt incurred <u>*by the acquirer*</u> to finance its acquisition of the target company provided a reasonable basis to assume a higher level of debt in the target company's capital structure for purposes of valuing the target company in a statutory appraisal. *JRC Acquisition*, 2004 WL 286963, at *7-8; *see also Olson v. EV3, Inc.*, 2011 WL 704409, at *10 (Del. Ch. Feb. 21, 2011) ("Under this exception, debt incurred to finance a cash-out merger has been excluded as an element of value arising out of the accomplishment or expectation of the merger.") (citing *JRC Acquisition*, 2004 WL 286963, at *7 &

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[157] RAB 52.

n.71). The petitioner asked the court to account for debt incurred by the acquirer as if it was held by the target company prior to the merger – effectively asking the court to appraise the company on a *pro forma* basis rather than its operative reality at the time of the merger. Consistent with well-settled precedent, the court said no. *JRC Acquisition*, 2004 WL 286963, at *7. Had the court instead found evidence that the company had plans in place prior to the merger for additional debt and those plans were not conditional or contingent on the merger, the outcome would have been different. *See*, *e.g. ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 910 (Del. Ch. 1999).

Respondents also rely on *BMC Software*.[158] *BMC Software* did not concern a target company's capital structure, but the amount of the company's excess cash that should be considered in the appraisal. *BMC Software,* 2015 WL 6164771, at *10. Respondent there argued that $127 million in cash accumulated on its balance sheet in the last quarter leading up to the merger had to be excluded because it would have been spent on "tuck-in M&A activity" had the merger not taken place. *Id.* at *3 and *13. The court excluded the excess cash. Again, the question was factual and decided on the evidence presented. *Id.* at *13.

Here, the trial court properly exercised its discretion in finding that the exercise of warrants was a known element of value not conditioned or contingent on

[158] RAB 52-53.

the Merger and therefore part of the operative reality at SWS as of the Merger Date. The finding is supported by the record and therefore must be affirmed.

2. The Trial Court Correctly Applied Well-Settled Precedent in Holding that the Warrant Exercises Were Part of SWS's Operative Reality

Respondents also argue that the trial court erred in holding that the operative reality of SWS as of the Merger Date included the exercise of warrants by Hilltop and Oakhill because "but for" the Merger, the warrants would not have been exercised.[159] The argument stands on the very "but for" approach rejected by this Court in *Technicolor,* 684 A.2d at 299. Respondents embrace *Cede & Co. v. Technicolor, Inc.,* 1990 WL 161084, at *19-20 (Del. Ch. Oct. 19, 1990), which this Court reversed over twenty years ago. This Court explained then that "the 'but for' caveat that [the trial court] had superimposed upon this Court's holding in *Weinberger*" was "inconsistent with this Court's interpretation of the appraisal statute in *Weinberger*." *Technicolor,* 684 A.2d at 295-96.

The "'accomplishment or expectation' of the merger exception in Section 262 is very narrow, 'designed to eliminate use of *pro forma* data and projections of a speculative variety relating to the completion of a merger.'" *Id.* at 299 (quoting *Weinberger*, 457 A.2d at 713). The narrow exception does not include "known elements of value," even those which arise from an acquiror's action after a merger

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[159] RAB 50-54.

agreement is executed but before the merger closes. *Id.* As noted above, only elements of value that are "conditioned on the completion of the merger" so that they "cannot take effect unless the merger is completed" may be excluded. *Olson*, 2011 WL 704409, at *10; *Allenson v. Midway Airlines Corp.*, 789 A.2d 572, 585 (Del. Ch. 2011); *cf. ONTI,* 751 A.2d at 910.

As discussed above, it is undisputed that the warrant exercises were "known elements of value" as of the Merger Date not conditioned or contingent on the Merger. It was impermissible under Delaware law to exclude the value that arose to SWS from the warrant exercises. *Technicolor,* 684 A.2d at 299; *accord Cavalier Oil*, 564 A.2d at 1145.

None of *Gearreald*, *JRC Acquisition* or *BMC Software* excluded "known elements of value" not conditioned or contingent on the completion of the merger from the appraisal. Nor could any of these cases overrule *Technicolor*, and to the contrary, both *Gearreald* and *JRC Acquisition* consider and apply *Technicolor*.[160] With respect to the trial court's dictum concerning *BMC Software* and noting a difference between action taken by the company or some other party, Op. 38, the distinction is unsupported by Delaware law and would only invite mischief by those

[160] To the extent that *BMC Software* could be read as excluding a "known element of value" not contingent or conditioned on the merger from the appraisal, such a holding would be contrary to Delaware law. In this regard, it is notable that *Technicolor* is neither discussed nor cited in *BMC Software* on this point.

wielding control of the company. *Technicolor* itself involved the corporation's adoption and implementation of the Perelman plan prior to the merger date, which the court included as part of the company's operative reality as of the merger. It makes no difference under *Technicolor* whether the "known element of value" that was not contingent or conditioned on the completion of the merger involved corporate action, or action by some other party.

3. Equity Required the Warrant Exercises Be Part of SWS's Operating Reality

Finally, consistent with *Midway Airlines Corp.*, fairness also compelled inclusion of the warrant exercise as part of SWS's operative reality.[161] *See* 789 A.2d at 585 (citing *Technicolor* and explaining "economic fairness" dictates that where minority stockholders are subjected to the risks of pre-merger actions, they should also enjoy the rewards of those actions in an appraisal proceeding by including them as part of the operative reality). Hilltop and Oak Hill benefitted from owning and voting the 15,217,391 shares of stock obtained from the warrant exercises in favor of the Merger while SWS's minority stockholders, including the Petitioners, suffered substantial voting power dilution. Hilltop cannot dilute the minority and enjoy the benefit of voting millions of shares in favor of the self-interested Merger, and then

[161] *Id.*; Op. 38; A3360; A3518.

claim that any benefit to SWS and the minority from the warrant exercises must be excluded in the appraisal proceeding.

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The trial court correctly held that the operative reality of SWS as of the Merger Date included the shares issued as a result of warrants exercised by Hilltop and Oak Hill prior to the vote on the Merger. The decision should be affirmed.

CONCLUSION

For the reasons set forth herein and in Petitioners' Opening Brief, the trial court's $6.38 fair value determination should be reversed and remanded consistent with Petitioners' arguments on appeal, and Respondents' arguments on cross-appeal should be denied.

PRICKETT, JONES & ELLIOTT, P.A.

By: /s/ Marcus E. Montejo
Marcus E. Montejo (#4890)
Kevin H. Davenport (#5327)
Eric J. Juray (#5765)
Chaz L. Enerio (#6228)
1310 North King Street
Wilmington, Delaware 19801
(302) 888-6500

Attorneys for Petitioners-Below, Appellants/Cross-Appellees Merlin Partners, LP and AAMAF, LP

Dated: November 6, 2017

CERTIFICATE OF SERVICE

I, Marcus E. Montejo, do hereby certify on this 6th day of November, 2017, that I caused a copy of Appellants'/Cross-Appellees' Reply Brief on Appeal and Answering Brief on Cross-Appeal to be served via eFiling through File & Serve*Xpress* upon the following counsel of record:

Garrett B. Moritz
Eric D. Selden
Nicholas D. Mozal
Ross Aronstam & Moritz LLP
100 South West Street, Suite 400
Wilmington, Delaware 19801

Kurt M. Heyman
Patricia L. Enerio
Melissa N. Donimirski
Heyman Enerio Gattuso & Hirzel LLP
300 Delaware Avenue, Suite 200
Wilmington, Delaware 19801

/s/ Marcus E. Montejo
Marcus E. Montejo (DE Bar No. 4890)