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Transaction ID 61754000
Case No. 11204-VCG

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN RE APPRAISAL OF AOL INC.	) Cons. C.A. No. 11204-VCG

RESPONDENT'S MOTION FOR RECONSIDERATION

1. On February 23, the Court issued its post-trial opinion valuing AOL at $48.70 per share, an amount appreciably higher than AOL believed was warranted by compelling market evidence. But, recognizing the patience with which the Court had dealt with this case and the care that had gone into the Court's decision, AOL did not intend to disturb this judgment on a motion for reconsideration.[1]

2. Petitioners have moved to reopen the Court's decision. Relying solely on a DCF analysis, and taking no account of the substantial market evidence, petitioners now claim that the fair value of AOL is $51.98 per share, far above the amount anyone—any strategic buyer, any financial buyer, any stockholder—was ever prepared to pay for AOL's shares. Petitioners claim that the Court failed to accurately account for the Microsoft display deal and the effect of increasing AOL's perpetuity growth rate to 3.5%.

3. Under the guise of requesting that the Court correct these supposed "computational errors," Mot. ¶ 4, petitioners ask the Court to throw out its holding

[1] AOL does not waive any appeal rights by bringing this motion, nor does AOL waive its right to file an answer to petitioners' motion for reargument under Rule 59(f).

that Verizon paid more than fair value for AOL. Petitioners thus ask the Court, using a DCF model, to find that a public company was undervalued in an arm's-length transaction—precisely the outcome that the Supreme Court rejected in its ruling in *Dell, Inc.* v. *Magnetar Glob. Event Driven Master Fund Ltd.*, 2017 WL 6375829 (Del.).

4. In light of petitioners' motion for reargument, AOL also moves under Rule 59(f) for reconsideration, on two grounds:

(a) In holding that there was no evidence in the record of the value of the Microsoft display deal other than the $2.57 per share number derived from one of Dr. Cornell's DCF models, the Court overlooked record evidence, identified by AOL in its briefing, that the more realistic incremental valuation of the Microsoft display deal, if any, was $0.69 per share.

(b) The Court erred in selecting a 3.5% perpetual growth rate for AOL, when the uncontroverted record evidence showed that this implied an implausible growth rate for AOL's Platforms and Brands segments.

5. Correcting these errors, without any other changes to the Court's analysis, leads to a fair value of AOL of $45.54 per share—a valuation entirely in accord with the market evidence recently credited by the Supreme Court as essential to any valuation analysis under Section 262.

ARGUMENT

6. "A court may grant reargument or reconsideration when it appears that the court overlooked or misapprehended the factual or the legal principles governing the disposition of the motion." *Doft & Co.* v. *Travelocity.com Inc.*, 2004 WL 1366994, at *1 (Del. Ch.) (internal quotation marks omitted) (granting reconsideration in appraisal action). By filing their motion, petitioners agree that reargument on the issues AOL has identified is appropriate.

The Microsoft display deal

7. The Court ruled that the Microsoft display deal was part of AOL's operative reality as of the date of the merger. While reserving all rights as to any potential appeal, AOL does not challenge this ruling on this motion. But the Court then proceeded to value the Microsoft display deal at $2.57 per share—thus attributing over *$200 million* in equity value to it. The Court recognized that this "potentially overstat[ed]" the value of the deal because there was evidence that the effect of the deal was already incorporated into AOL's projections. Op. at 44. But the Court believed that the record evidence permitted no other outcome:

> The parties give me two choices with regard to the Display Deal: add the full value of the Display Deal as urged by the Petitioners, implicitly worth $2.57, or decline to add it to the LTP, as the Respondent recommends. I find that the Display Deal was, at least, partially accretive. . . . Because I lack the information necessary to cut a finer slice in this instance, I add the full $2.57 per share to my DCF analysis. In other words,

> the record gives me no basis that another value for the display deal is less arbitrary than $2.57 per share.

Op. at 42-43.

8. AOL respectfully submits that the trial record supplied "another value"—and a far more realistic "finer slice"—for the display deal. The trial record included the DCF model that *AOL itself* used to value the display deal when deciding whether to enter into it. In its post-trial answering brief, respondent described this model like this: "Under the median assumptions AOL applied to the discount rate and the length of the partnership [between AOL and Microsoft], the Microsoft display deal had a net present value of $58 million, or $0.70 per share." *See* Resp't's Ans. Post-Tr. Br. at 58 ("RAB") (Trans. ID 60731953) (citing JX2331 at tab "DCF").[2]

9. This valuation indicated by this evidence was far more reliable than the $2.57 per share value that the Court derived from Cornell's DCF model, for numerous reasons. The $2.57 per share valuation implied that AOL's shares (which, as Cornell conceded, traded in an efficient market) would have shot up by an astonishing *6%* upon the announcement of this deal.[3] But as AOL demonstrated at trial, AOL's stock price routinely went *down* when AOL announced

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[2] Respondent was slightly imprecise. Under the median deal assumptions—a 7-year term and a 15% discount rate—the value assigned by AOL was $58.9 million, which, divided by 85.1 million shares outstanding, equates to $0.69 per share.
[3] $2.57 is 6% of $42.59, AOL's pre-merger announcement stock price.

transactions, and AOL had never announced a transaction that had anything like the effect on AOL's stock price—or subsequent performance—that the Court's valuation, based on Cornell's model, would imply. RAB at 58; *see also* Resp't's Op. Post-Tr. Br. at 75 ("ROB") (Trans. ID 60586730) (reproducing Fischel demonstrative).

10. It is therefore remarkable that petitioners seek to revisit this holding. What is even more remarkable is that petitioners ask the Court to effectively *double* the value assigned to the Microsoft Display deal, as part of their effort to increase AOL's fair value, when the Court noted that $2.57 per share valuation already "potentially overstat[ed]" the deal's value. Op. at 44.[4] Petitioners arrive at this implausible valuation in part by asking the Court to assume that the cash flows from the Microsoft display deal would grow, forever, at a rate of 3.5% per year. Mot. ¶ 9; Cornell Aff. ¶ 5.

11. But the record evidence establishes that the *opposite* is true. AOL management, who were best placed to evaluate the deal, forecast that the cash

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[4] Petitioners' proposed valuation of $51.98 per share is $7.13 higher than Fischel's DCF valuation of $44.85 per share, on which it is based. Although petitioners do not quantify how much of this extra $7.13 should be assigned to the Microsoft display deal and how much should be assigned to the increase in perpetuity growth rate, the vast majority is due to the impossible value petitioners now assign to the Microsoft deal. *See* Op. at 48 n.222 (increase in perpetuity growth rate to 3.5% leads to $1.28 per share valuation increase); JX2255 Ex. N (Fischel Report) (increase in perpetuity growth rate to 3.5% leads to $1.26 per share valuation increase).

flows from the deal would *decline* after 2018. *See* JX2331 at tab "DCF." This reflected the reality of the transaction: as respondent noted in its briefing, "Microsoft's advertising business was declining, which was why Microsoft was leaving the business." ROB at 39. And not only would the display deal decline after 2018, it was forecast to end rather than continue in perpetuity: the deal had a 10-year term, but Microsoft and AOL had agreed that either of the parties could terminate the partnership after only five or seven years. *See* JX2331 at tab "DCF"; JX2008 at 32. Any assumption that the business would continue forever, growing at a steady rate, as in Cornell's model, is unfounded. On top of this, as the Court observed, the display deal was "risk[y]," Op. at 42, so AOL management modelled its cash flows using discount rates of between 11% and ***19%***—much higher than the discount rate of 9.5% used by Professor Fischel in his DCF. JX2331 at tab "DCF." Numbers for the display deal cannot simply be tacked on to a DCF model for the entire company.

12. Therefore, and contrary to petitioners' claims, the Court used the correct methodology in valuing the display deal: if any value is to be assigned to the deal, it must be valued as a separate, discrete add-on to AOL's business. AOL cited in its briefing the only reliable evidence of what this value might be: $0.69 per AOL share. *See* RAB at 58. If the Court wishes to ascribe value to the display deal, it should rely on this evidence and add $0.69 per share to Fischel's DCF valuation of $44.85 per share. This valuation, while generous given the risks of the

display deal and AOL's track record of acquisitions—to say nothing of how the deal actually worked out in the two years after signing, *see* ROB at 39—is the best evidence in the record of the value that should be assigned to the display deal. The $2.57 valuation is not the only valuation in the trial record, and is inferior to the alternative, grounded in both AOL's projections and the market evidence.

<u>The perpetuity growth rate</u>

13. The Court adjusted the perpetuity growth rate in Fischel's model from 3.25% to 3.5%. Op. at 47-48. But, under Fischel's model, AOL's Platforms and Brands were already forecast to grow much faster than the economy overall, forever—because the legacy Membership email business, by far AOL's most profitable business, was certain to continue to shrink. Increasing the perpetuity growth rate exacerbates this problem and, respondent submits, is unsupported by the evidence and inconsistent with Supreme Court precedent.

14. In the Court's words, AOL was a "classic" "tale of two companies": it had "small" Platforms and Brands segments, which while "rapidly growing" were still hardly profitable, and a "senescent" Membership segment—the legacy email business—which generated the vast majority of AOL's cash flows but was forecast to decline. *Id.* at 45. AOL produced optimistic projections for all of these segments until 2018. *Id.* at 47.

15. Unlike Cornell, Fischel appropriately declined to attempt to rewrite management's projections to extend them past 2018. *See id.*; *see, e.g.*, *DFC Glob.*

Corp. v. *Muirfield Value P'rs*, 172 A.3d 346, 380 (Del. 2017) (experts should be cautious in extending projection periods). Fischel did, however, apply a generous 3.25% growth rate to the entire company after 2018—*including* the declining Membership segment that produced all the company's cash. As AOL noted in its papers and at oral argument, an implication of applying a 3.25% perpetual growth rate to the entire company, when all parties conceded that the legacy email business was going to shrink, was that the Platforms business would grow at *7% forever*—well above long-term GDP growth rate. *See* RAB at 62. This implied, counterfactually, that it would eventually become larger than the entire economy.

16. At oral argument, the Court recognized that Fischel's model implied a very high perpetual growth rate for the Platforms and Brands segments: "Nothing could better illustrate . . . the false precision of relying on [a] DCF than . . . assuming one [segment] is going continue to grow forever at 7 percent, ***which we know won't happen***, or two [segments], and the other dying off to zero . . . ." Tr. of Post-Tr. Oral Arg. at 109 (emphasis added).

17. The Court's observations at oral argument were correct. Fischel's 3.25% perpetual growth rate was already extremely high; increasing it yet further would only create an implausible model. But in its opinion, the Court did not suggest reasoning for its decision to increase the perpetual growth rate to 3.5% or note the implications for the future of the Platforms and Brands businesses. Nor did the Court's analysis take account of the Supreme Court's ruling in *DFC*, where

the Chief Justice observed that the risk-free rate (here, 2.92%) might be the appropriate "ceiling" for a perpetual growth rate. Tr. of Post-Tr. Oral Arg. at 110; Resp't's Br. Discussing Supp. Auths. at 9 ("Resp't's *DFC* Br.") (Trans. ID 61101834); *DFC*, 172 A.3d at 359.

18. Respondent does not ask the Court to reduce Fischel's 3.25% perpetual growth rate to the risk-free rate. Respondent does, however, submit that the Court's decision to increase the perpetual growth rate to 3.5% should be reconsidered.

19. The source of the Court's error appears to be the "triangle" that petitioners used at trial and submitted in their papers, which purported to demonstrate the effects of Fischel's 3.25% perpetuity growth rate. . Op. at 46. Petitioners argued, and the Court appeared to accept that this "triangle" illustrated value "lost" in Fischel's model by applying a 3.25% perpetuity growth rate after the end of the projection period. But in words from *DFC* that could have been written for this case, the Chief Justice held:

> [I]f the record unambiguously supported the proposition that [AOL] was to continue a new spurt of growth past 2018, it would have been more appropriate to project out to a point where steady-state growth began. By doing that, *the appraiser would have to assess with discipline the next period after the projections end and also the potential that the period might be negative, as well as that another period of above-market growth might be followed by a terminal growth rate more like inflation than the risk-free rate*.

DFC, 172 A.3d at 380 (emphasis added). Chief Justice Strine continued: "Especially when, as here, the underlying projections assumed away important downside risks during the projection period, a consideration of downside scenarios, not just positive ones, must factor into this process . . . ." *Id.*

20. *DFC* put paid to petitioners' claim that Fischel's model "lost" value by stepping down from a high growth rate in the projection period to a 3.25% steady state growth rate. The high court specifically rejected the argument that there should be a presumption of a smooth decline from a period of above-market growth to a steady state. Rather, if petitioners wanted to press their "triangle" argument post-*DFC*, they had to put on actual proof of AOL's prospects after 2018. Petitioners put on none. (Indeed, AOL's performance in the quarter before closing the Verizon merger, and subsequently, was dire, as AOL showed.) Therefore, respondent respectfully requests that the Court revalue AOL using a 3.25% growth rate, which more than generously accounts for any possibility that AOL's Platforms and Brands segments might have continued above-market growth after 2018.

CONCLUSION

For the reasons above, respondent respectfully requests reconsideration of the Court's appraisal of the fair value of AOL at $48.70 per share, and requests that the Court enter judgment valuing AOL at $45.54 per share.

OF COUNSEL:

William Savitt
Ryan A. McLeod (No. 5038)
Andrew J.H. Cheung
Nicholas Walter
WACHTELL, LIPTON, ROSEN & KATZ
51 West 52nd Street
New York, NY 10019
(212) 403-1000

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5661338

POTTER ANDERSON & CORROON LLP

By: */s/ Kevin R. Shannon*
Kevin R. Shannon (No. 3137)
Berton W. Ashman, Jr. (No. 4681)
Christopher N. Kelly (No. 5717)
1313 N. Market Street
Hercules Plaza, 6th Floor
Wilmington, DE 19899-0951
(302) 984-6000

Attorneys for Respondent

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