"Fair Value" Determinations in Corporate "Freeze-Outs" and in Security and Exchange Act Suits: Weinberger, Other, and Better Methods

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"FAIR VALUE" DETERMINATION IN CORPORATE "FREEZE-OUTS," AND IN SECURITY AND EXCHANGE ACT SUITS: WEINBERGER, OTHER, AND BETTER METHODS

INTRODUCTION

Objective of Note

Federal and state courts have struggled with the task of establishing an adequate remedy for both minority shareholders in freeze-out situations and for plaintiffs in civil actions involving violations of the Security Acts. In both freeze-out and civil SEC violation cases the courts have tested the price at which the minority

1. See infra text accompanying notes 120-349, 485-572.
2. A major purpose of this note is to propose flexible guidelines which can assist in providing an adequate remedy in both state freeze-out actions and private civil actions involving violations of the Security and Exchange Act of 1934. 15 U.S.C. §§ 78a-78jj (1976). See also infra text accompanying notes 573-624.
3. For the purposes of this note, a minority shareholder is a shareholder who owns less than 50 percent of the equity in the company at issue.
4. Some jurisdictions have made the term freeze-out and the term squeeze-out synonymous:
   Elimination of a minority shareholder is commonly referred to as a 'freeze-out' or a 'squeeze-out.' It may be defined as the use of corporate control vested in the statutory majority of shareholders or the board of directors to eliminate minority shareholders from the enterprise or to reduce to relevant insignificance their voting power or claims on corporate assets.

7. The courts have tried to first determine whether the transaction was "fair." If the transaction was not found to be fair, the courts tried to determine the fair value of the minority shareholder's stock. See infra text accompanying notes 562-72, 577-604.
shareholder sold his stock against the stock's "fair value." The courts have proceeded on a case-by-case basis looking for the elusive fair value. Unfortunately, the case-by-case approach has provided few guidelines for future fair value determinations.

The concept of protecting the minority shareholder in freeze-out situations has recently undergone a substantial change in the Delaware courts. While the Delaware courts have changed the character of evidence allowed to prove fair value and have expanded the concept of fair value, they have not established guidelines to facilitate the planning capability of either the corporation, the majority shareholders, or the minority shareholders. On the other hand, the federal courts in actions under the Securities Acts have established some guidelines for testing the fairness of a transaction. However, the usefulness of these guidelines are limited.

This note develops potential judicial guidelines for determining "fair value." The guidelines proposed by this note are consistent with the new Delaware methods for determining fair value. The proposed guidelines use modern financial analysis and promotes the policies of both state and federal jurisdictions. Some policy concerns and objectives are illustrated by looking at the historical development of minority shareholder protection in freeze-out actions.

8. Defining "fair value" is one of the objectives of this note. The earlier decisions interchanged the terms "fair value," "intrinsic value," and "true value," as in Bell v. Kirby Lumber Corp., 395 A.2d 730 (Del. Ch. 1978), modified, 413 A.2d 137 (Del. 1980).

9. The note will illustrate the evolution of the concept of fair value from the earlier notions of intrinsic value to the concept of fair value suggested by this note. See infra text accompanying notes 573-623.

10. The "fair value" concept evolved through a seemingly structured analysis termed the "Delaware block" valuation method. See infra text accompanying notes 68-102. However, the final step of the Delaware block valuation procedure consisted of a subjective weighing process, which cast the entire analysis into a case-by-case analysis and provided few guidelines for either corporate or shareholder planning. See infra text accompanying notes 102-08.

11. In 1983, the Delaware Supreme Court eliminated the Delaware block valuation method, modifying the appraisal remedy. The modified appraisal remedy allows the use of modern financial analysis to determine fair value. Further, the entire concept of "fair value" has been expanded, making the modified appraisal more flexible. See infra text accompanying notes 238-349.

12. Id.

13. Id.

14. The modified appraisal, while more flexible, provides few guidelines. See infra text accompanying notes 333-49.

15. See infra text accompanying notes 562-72.

16. See infra text accompanying notes 562-72.

17. See infra text accompanying notes 54-349.
Historically, Delaware courts and the courts of many other jurisdictions used the appraisal remedy\(^{18}\) to protect the minority shareholders' interest.\(^{19}\) The purpose of the appraisal was to insure that the minority shareholder would receive a fair value for his stock.\(^{20}\) The structured procedure for conducting the appraisal was termed the "Delaware block" valuation method.\(^{21}\)

The traditional\(^{22}\) remedy of appraisal, which incorporated the Delaware block valuation method, was replaced by the Delaware Supreme Court with an expanded, more flexible appraisal remedy.\(^{23}\) The purpose of the appraisal remedy continues to be the determination of what constitutes fair value.\(^{24}\) But the Delaware Supreme Court subsequently expanded both the procedure used in finding fair value and the conceptual definition of fair value.\(^{25}\) The new remedy allows values derived from modern financial analysis to be admitted into evidence.\(^{26}\) The resulting values are then used to test the fairness of the proposed price\(^{27}\) advocated by the majority shareholder, corporation, on any potential acquirer.\(^{28}\) Further, the new remedy expands the restricted "going concern"\(^{29}\) concept by allowing the consideration of other possible values that might result from an arm's length negotiation.\(^{30}\) By this new test, Delaware has relaxed the struc-

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18. The appraisal remedy is a process of demanding a judicial determination of fair value for a dissenting shareholder.

The dissenting shareholder's appraisal remedy is essentially a statutory creation to enable shareholders who object to certain extraordinary matters to dissent and to require the corporation to buy their shares at the value immediately prior to the approval of such matter and thus to withdraw from the corporation. In different jurisdictions, the appraisal remedy often applies to sales of substantially all corporation assets other than in the regular course of business, mergers and consolidations, more rarely to certain amendments of the articles of incorporation or miscellaneous matters, but not to dissolution.


19. The appraisal remedy "was exacted to protect the minority interest, when the common law rule of unanimity was abolished." Gabhart v. Gabhart, 267 Ind. 370, 382, 370 N.E.2d 345, 353 (1977).

20. See infra notes 338, 339.

21. See infra text accompanying notes 54-119.

22. See infra text accompanying notes 54-119.

23. See infra text accompanying notes 238-349.

24. See infra text accompanying notes 333-49.

25. See infra text accompanying notes 333-49.


27. See infra text accompanying note 337.

28. See infra text accompanying note 337.

29. See infra text accompanying notes 343-49, 424-55.

30. See infra text accompanying notes 424-55.
tured Delaware block valuation procedure in favor of a more flexible and expanded remedy.

Scope of Note

First, the procedures used to apply the traditional Delaware block valuation method will be discussed.\(^{31}\) The traditional method of valuation used as the basis of the appraisal remedy was a structured approach with little flexibility.\(^{32}\) This made the appraisal remedy suitable only for limited applications.

As the courts attempted to apply the appraisal remedy to new situations, its limitations became apparent.\(^{33}\) The limitations of the appraisal remedy will be illustrated by examining its usefulness in determining the "fair value" of the natural resource companies' equity.\(^{34}\) The three cases examined in this note\(^ {35}\) illustrate the factors which led to the Delaware courts' change in the appraisal remedy.\(^ {36}\) In order to make the appraisal remedy more widely applicable, the Delaware Supreme Court expanded the remedy by making it more flexible.\(^ {37}\)

The flexibility of the appraisal remedy was enhanced by eliminating its highly structured approach\(^ {38}\) and by allowing the use of modern financial analysis to help test the fairness of the cash out price.\(^ {39}\) By looking at some of the more widely accepted valuation

\(^{31}\) The note examines the evolution in appraisals and fairness procedures with respect to natural resource companies where the majority shareholder dealt both fairly and unfairly with the minority shareholders. From a case analysis, this note proposes some flexible guidelines for determining fair value by first examining fair dealing. See infra text accompanying notes 573-624.

\(^{32}\) Under the traditional Delaware block approach, flexibility only existed in the weighing of the component analysis values; in this area, virtually no guidelines existed. See infra text accompanying notes 102-08. In addition, no flexibility existed with regard to what types of component analyses could be considered under the traditional Delaware block valuation.

\(^{33}\) See infra text accompanying notes 109-349.

\(^{34}\) See infra text accompanying notes 109-349.


\(^{36}\) See infra text accompanying notes 238-349.

\(^{37}\) Weinberger, 457 A.2d 701 (Del. 1983).

\(^{38}\) Id.

\(^{39}\) Id.
theories, this note points out arguments for and against the appropriateness of individual valuation theories. However, before any theory can be helpful in determining fair value, the current definition of fair value must be established.

The Delaware block method defined fair value as the minority shareholder's interest in a "going concern." The new appraisal method does not retreat from the requirement of a going concern; rather, it expands the going concern concept to include values that could result from arm's length negotiations. Four possible values are examined to delineate the range of possible values: the minority ownership value, the controlling interest value, the 100% ownership value, and the value to the acquirer. The note then examines the various methods of determining these values and the ultimate question of which value is the "fair value."

Federal jurisdictions have also tested the fairness of the price paid to a minority shareholder when a majority shareholder was found in violation of the Securities Acts. In testing the fairness of the price paid to the minority shareholder, some federal courts have adopted an approach which uses modern financial analysis. However, the inherent limitations in the underlying theory limit the analysis' applicability.

The fairness test proposed is based on the Delaware court's stated objective of "entire fairness." The amount determined to be the fair value will be an inverse function of the degree of unfair dealing found by the court. This variance in fair value will be limited

40. See infra text accompanying notes 350-423.
41. See infra text accompanying notes 350-484.
42. See infra text accompanying notes 424-55.
43. See infra note 108.
44. See infra text accompanying notes 424-55.
45. See infra text accompanying notes 424-55.
46. See infra text accompanying notes 485-572.
47. See supra note 5.
48. See infra text accompanying notes 562-72. See also Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 361 (2d Cir. 1979), citing, Mills v. Electric Auto Lite, 552 F.2d 1239 (7th Cir. 1977). The court used the "efficient market theory." For a discussion of the "efficient market hypothesis." See infra text accompanying notes 360-74.
49. See infra text accompanying notes 571-72.
50. For a definition of entire fairness, see infra notes 576 and accompanying text.
by the requirement that fair value should be a possible arm's length negotiated value.\textsuperscript{51} However, an arm's length price can vary from high to low, from the value to the acquirer,\textsuperscript{52} to the value of a minority interest in the going concern prior to the merger. The lowest possible arm's length value is the value of a minority interest, which was the value sought by the Delaware block method.\textsuperscript{53} The proposed guidelines provide a basis for determining fair value within the range of possible arm's length values for both federal Security Acts actions and state freeze-out actions in the jurisdictions that follow the Delaware lead of rejecting the traditional Delaware block valuation method.

\textbf{SECTION I—DEVELOPMENT AND USE OF THE DELAWARE BLOCK VALUATION METHOD}

Under common law, a unanimous shareholder vote was required to approve a major sale of corporate assets or a corporate merger.\textsuperscript{54} Since one shareholder could prevent a proposed asset sale or merger, many state legislatures felt that this was an unreasonable restraint on corporate activity.\textsuperscript{55} Legislatures, therefore, enacted various statutes allowing mergers with a less than unanimous consent of the shareholders.\textsuperscript{56} As a result of a sale of assets or a merger with a less than unanimous shareholder vote, a dissenting shareholder could be put into a precarious position.\textsuperscript{57} The shareholder was forced to either sell his stock or participate in the merger.\textsuperscript{58} Responding to allegations

\textsuperscript{51} Weinberger, 457 A.2d at 710 n.7; \textit{citing}, Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886 (Del. 1970) ("Particularly in a parent subsidiary context, a showing that the actions taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.")

Further, the \textit{Weinberger} court preferred arm's length dealing and required entire fairness when the majority shareholder was dealing with the minority shareholder. \textit{Weinberger}, 457 A.2d at 710, 711.

\textsuperscript{52} \textit{See infra} text accompanying notes 424-84.

\textsuperscript{53} \textit{See infra} note 108.

\textsuperscript{54} \textit{See note, Valuation of Dissenters' Stock Under Appraisal Statutes, 79 HARV. L. REV. 1453 (1966) (hereinafter cited as Appraisal Statutes).}


\textsuperscript{56} \textit{Id.}

\textsuperscript{57} \textit{Id.} at 487-89.

\textsuperscript{58} This result may be viewed as a private eminent domain action Universal City Studios v. Francis I. DuPont & Co., Inc., 343 A.2d 629 (Del. Ch. 1975) (The power of a majority stockholder to override minority dissenters and remit them to the cash remedy is analogous to the right of eminent domain.) \textit{See also Appraisal Statutes, supra note 54, at 1455.}
of abuse, the legislatures provided the dissenting shareholder some assurance of receiving a "fair value" for his stock.59

The protection provided was in the form of the appraisal remedy.60 The purpose of the appraisal was to determine the fair value of the dissenter's stock.61 If the stock was purchased at a price less than the determined fair value, the dissenting shareholder received the difference plus interest.62 Armed with the alternative of an appraisal remedy, the dissenting shareholder had the option of receiving a judicial valuation of his equity interest, if he felt the offered price did not represent his stocks' fair value.63 The valuation right granted by statute64 was designed to assure the dissenting shareholder receipt of the "intrinsic or fair value"65 for his interest. In the course of shareholder litigation, the Delaware courts developed a structured valuation method called the "Delaware block"66 which ultimately gained wide acceptance.67

**Valuation Using the Delaware Block Method**

The Delaware block valuation method was used in Delaware to determine the "fair value" of stock owned by minority shareholders until Weinberger v. Universal Oil Products (UOP).68 The Delaware block method consisted of three component values that were each weighted by the judge according to the attendant circumstances of the case.69

59. Stock is defined for the purposes of this note as the equity ownership in a corporation.

60. See supra note 18.

61. See infra notes 337-39 and accompanying text.


63. A determination of the value of corporate stock may be commenced by the surviving corporation or any stockholder who makes a timely demand for an appraisal. Kaye v. Pantone, Inc., 395 A.2d 369 (Del. Ch. 1978).

64. The Delaware appraisal rights statute does not grant appraisal in all circumstances. Del. Code Ann. tit. 8, § 262(b) (Supp. 1982). This statute specifies when an appraisal remedy is available. For instance, an appraisal is not available in Delaware resulting from a sale of assets or for shares which are traded on a national exchange, unless the facts fall under various exceptions such as a merger under Del. Code Ann. tit. 8, § 253 (1973).

65. See supra note 8.

66. In 1947, the state of Delaware was the first to use this method of valuation which consisted of weighing three valuation methods by the judge to fit the circumstances of the appraisal. In re General Realty & Utilities Corp., 29 Del. Ch. 480, 52 A.2d 6 (1947).

67. See Appraisal Statutes, supra note 54, at 1457.

68. 457 A.2d 701 (Del. 1983).

69. See supra note 66. The Delaware block method of valuation was used extensively until February 1983, when modified by Weinberger. See infra text accompanying notes 238-349.
The valuation analyses that comprised the Delaware block are usually labeled market value analysis,70 asset value analysis,71 and discounted earnings value analysis.72 While other factors may be considered,73 final determination of fair value was usually based on a weighted average of the values derived from the component analyses.74 The Delaware block method can be analyzed by first looking at its three component analyses followed by an examination of its weighting procedure.

**Examination of the Component Analyses**

The analytical component, market value, as used in the Delaware block method, is not necessarily the current market value,75 but could be a market value averaged over the time period immediately prior to such triggering actions as a major asset sale or a proposed merger.76 A few early appraisal statutes stated that the purpose of the appraisal was to determine market value; and, if a market value existed, it would be the "fair value."77 Some of these statutes were later amended by deleting the reference to market value and stating that the purpose of the appraisal was to determine "fair value" or "intrinsic value."78

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70. See infra text accompanying notes 75-85.
71. See infra text accompanying notes 86-92.
72. See infra text accompanying notes 93-101.
73. Depending on the facts of the case other factors may be considered such as: the firm's dividend yield, the firm's industry, the firm's standing in the industry, and a comparison of the firm's stock price to that of similar companies. The court in Universal City Studios, Inc. v. Francis I. DuPont, & Co., 312 A.2d 344 (Del. Ch. 1973), aff'd, 334 A.2d 216 (Del. 1975), considered other factors such as the firm's industry, but held that since dividends reflect the same value as nonretained earnings, they should not be considered separately.
74. See Appraisal Statutes, supra note 54, at 1468-71. See also infra text accompanying notes 102-08.
75. Depending on the court, the market value component could be the market price at the time of the merger or cash-out, as found by the lower court in Weinberger. Weinberger, 426 A.2d 1333, 1360 (Del. Ch. 1981). If no market value exists, a reconstructed market value can be considered, if it can be constructed. Chicago Corp. v. Munds, 20 Del. Ch. 142, 172 A.2d 452 (1953). Further, the court in Francis I. duPont & Co. v. Universal City Studios, Inc., 312 A.2d 344 (Del. Ch. 1973), aff'd, 334 A.2d 216 (Del. 1975) held that the market value, even a reconstructed market value, must be considered whenever available.
76. See Appraisal Statutes, supra note 54, at 1460, 1461.
77. See Squires, supra note 55, at 484 n.9.
78. Illinois dropped the requirement of market value when the state changed its 1919 Corporation Act in 1933. See Squires, note 55 at 424. See also supra notes 8, 9, 339.
In some jurisdictions, recent statutes state that if the stock is traded on a national exchange, the appraisal remedy is not available.79

Federal jurisdictions that make fair value determinations of publicly traded securities generally attribute at least some weight to the securities' market value.80 Jurisdictions using the Delaware block method of valuation also consider market value an important component of the weighted average determination of "fair value."81 The degree of significance placed on market value is determined by such factors as the state of the economy,82 the type of company,83 and how widely the company's stock is traded.84 Therefore, a jurisdiction using the Delaware block valuation method considers the stock's market value when it is available.85 Although market value is an important element, it is not the exclusive factor in the Delaware block method.86 Earnings value and asset value must also be considered when conducting a Delaware block valuation.

When considering the asset value component, the courts have been careful to distinguish the value of the company's assets as a going concern from their liquidation value.87 Even so, the asset value analysis generally consists of merely an appraisal of the firm's assets.88 Normally a firm that is ripe for a merger or asset sale owns assets that are either highly liquid or carried on the books at less than their market value.89 Therefore, the firm's asset value can be different from the firm's book value. Book value is based on acquisition cost less depreciation, and thus does not reflect the market value of the firm's assets.90 To determine the market value of the firm's assets, the

79. See supra note 64.
80. The federal courts have considered the market value to be almost conclusive proof of the value to the firm before the merger transaction. See Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 361 (2d Cir. 1979) (Although Tiger's asset value exceeded its market value, the market value was found to be the stock's fair value.); cf. Mills v. Electric Auto Lite Co., 552 F.2d 1239, 1247-48. (7th Cir. 1977) (The court primarily used the firm's market value to determine "fair value.") See also infra note 107.
81. See supra note 75.
82. Appraisal Statutes, supra note 54, at 1464.
83. Id. at 1463.
84. Id. at 1460.
85. See supra note 75, 107.
86. See supra note 73.
87. Appraisal Statutes, supra note 54, at 1457.
88. Id. at 1460.
90. Appraisal Statutes, supra note 54, at 1457.
appraiser or financial analyst must examine and evaluate each of the firm's major assets and liabilities.\textsuperscript{91} The analyst should then be able to explain any discrepancies between the firm's net book value and the market value of its assets.\textsuperscript{92}

The third component analysis of the Delaware block method is the discounted earnings analysis.\textsuperscript{93} The concept underlying this theory is that a company's value, as a going concern, is a function of its ability to generate earnings.\textsuperscript{94} The earnings benefit the shareholders through stock appreciation or increased dividends. This analysis projects a stream of future earnings and then discounts the earnings stream. The discount rate must reflect both the time value of money and the company's business risks.\textsuperscript{95} Therefore, the discounted earnings approach is a two step procedure usually starting with projected earnings.

The projected stream of earnings, as used in the Delaware block method, was normally the average earnings of a number of past years.\textsuperscript{96} However, some jurisdictions adjust past earnings before they are averaged.\textsuperscript{97} The adjustment reflects non-recurring items in either sales or expenses.\textsuperscript{98} After the projected stream of earnings is established, the appraiser or analyst must determine the proper discount rate.

\begin{itemize}
\item \textsuperscript{91} The differences between book value and asset market value might result from many other factors, such as: uncollectable accounts receivable carried on the books, long term securities tied into an interest rate which is different than the market rate, undeveloped patents and other trade secrets, depreciation taken on an asset which does not correspond to its value, etc. \textit{See Appraisal Statutes, supra} note 54, at 1457.
\item \textsuperscript{92} \textit{Id.} at 1457-60.
\item \textsuperscript{93} Some authors term the discounted earnings approach as an investment value. The analysis derives the firm's value from the firm's earnings capacity. \textit{Appraisal Statutes, supra} note 54, at 1464.
\item \textsuperscript{94} \textit{Id.}
\item \textsuperscript{95} The formula for making a projection is: $V = \Sigma E/(1 + r)^n$, where:
$\text{V} =$ The value of the firm.
$\text{E} =$ Projected annual earnings or dividends. (Under the Delaware block method, as used in Delaware, earnings ($E$) is equal to the average (mean) of earnings for five years immediately prior to the triggering action.)
(Note: The difference in a value obtained by using earnings rather than dividends would be compensated for by a different discount rate r.)
$n =$ The number of periods. (usually one year or fraction thereof.)
$r =$ The discount rate reflecting the time value of money and the risk of the firm. \textit{Appraisal Statutes, supra} note 54, at 1464-68.
\item \textsuperscript{96} \textit{Id.}
\item \textsuperscript{97} The court, in Application of Delaware Racing Assn., 42 Del. Ch. 406, 421-22, 213 A.2d 203, 212 (Del. 1965), did not use the year suggested by the appraiser, 1958, when computing the five year earnings average, because the court felt the earnings during (1958) were abnormally high.
\item \textsuperscript{98} \textit{Id.}
\end{itemize}
In order to find the appropriate discount rate, analysts have generally used earnings multipliers designated as price/earnings ratios. The appropriate price/earnings ratio is determined by comparing the price/earnings ratios of other similarly situated publicly traded companies. Once the price/earnings ratio is determined, it is then multiplied by the firm's average earnings. The product is equal to the earnings value of the firm. The analyst, and ultimately the court, then weights the three values derived from the component analyses to determine the "fair value" of the minority shareholders' stock interest.

The Weighting Procedure

The process used to find fair value from the component analyses is termed weighting. The weighting process is accomplished by multiplying each value derived from the component analyses by a percentage, termed weights. The sum of all three percentages must equal 100%. Therefore, if the court decides to give the discounted earning value a 50% weight and the asset value a 30% weight, the market value would receive a 20% weight. The decision to assign

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<th>COMPONENT ANALYSES</th>
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<td>50</td>
</tr>
<tr>
<td>Net asset value</td>
<td>300</td>
<td>50%</td>
<td>150</td>
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"Fair Value" $225

99. See infra note 101. The price/earnings ratio is no more than an imprecise approximation of the capitalization rate.

100. For example, in Swanton v. State Guaranty Corp., 42 Del. Ch. 477, 481, 215 A.2d 242, 246 (1965), the price/earnings ratio was determined by use of an industrial analysis conducted by Professor Dewing and contained in his text, THE FINANCIAL POLICIES OF CORPORATIONS (5th ed. 1926). The price/earnings ratio was then adjusted upward to reflect a strong real estate market together with the company's policy of buying real estate and holding for a return in the form of capital appreciation. Swanton, at 244.


102. Appraisal Statutes, supra note 54, at 1468.

103. It is possible to weight a value by a factor of zero. The court in Application of Delaware Racing Assn., 42 Del. Ch. 406, 423-24, 213 A.2d 203, 213 (Del. 1965), found a 10 percent weight to dividends which amounted to 10 percent of zero. The court in Delaware Racing cited Adams v. R.C. Williams, 39 Del. Ch. 61, 158 A.2d 797 (1960), where the court found a zero value for earnings and ordered a reappraisal. Delaware Racing, 213 A.2d at 213, Adams, 39 Del. Ch. at 71, 158 A.2d at 803. The reappraisal resulted in the appraiser giving a 40 percent weight to the zero earnings value, which was later affirmed by the Chancellor in an unreported opinion. Delaware Racing, 213 A.2d at 213.

104. For example, assume the values illustrated by the chart below resulted from the component analyses. Further, assume the court decided to give both discounted earnings and market value a 25 percent weight and asset value a 50 percent weight. The result would be illustrated by the chart below.
the various percentages is not made pursuant to definite guidelines.

The court examines each component analysis and decides its degree of applicability according to the attendant circumstances. While the courts have on occasion allowed a certain component to be given a weight of zero percent, they required consideration of all three analyses. In Tri-Continental v. Battye, the Delaware Supreme Court required consideration of all relevant factors to determine the fair value of the minority shareholders' stock. Delaware courts have interpreted the Tri-Continental requirement to mean that basing a fair value determination on only one component analysis is improper. Further, the Delaware courts have pointed out that, when using the Delaware block, the fair value must be the value of the business as a going concern. In sum, the Delaware block valuation method was highly structured in terms of which component analysis must be considered, but guidelines did not exist for the final weighting process.

Application of the "Delaware Block"

Due to the arbitrary weighting process, the structured Delaware block valuation method provided less than satisfactory results when valuing natural resource companies such as timber, paper, or oil companies. Natural resource companies generally have high levels of undervalued assets. Their assets in the form of natural resources

105. See supra note 103.
106. 31 Del. Ch. 523, 74 A.2d 71 (Del. 1950).
107. In Tri-Continental the court stated that since an actual market value did not exist, the reconstruction of a market value was permissible but not necessary. Tri-Continental, 74 A.2d at 74. Further, the Delaware Supreme Court stated, "courts must take into consideration all factors." Tri-Continental, 74 A.2d at 72. In Application of Delaware Racing Assn, 42 Del. Ch. 406, 419, 213 A.2d 203, 211 (Del. 1965), the court stated that even if an actual market value of the shares did not exist, a reconstructed market value must be given consideration if a reconstructed market value is ascertainable. Id. Further, the court in Delaware Racing stating that while market value is an important element, it must not be the sole consideration. Id. Liquidation value also cannot be the sole factor used to determine fair value. In re General Realty & Utilities Corp., 29 Del. Ch. at 497, 52 A.2d at 14 (1947) (The Delaware court noted that the appraisal should not be comprised of only one factor:); Chicago & Corp. v. Munds, 20 Del. 142, 155, 172 A. 452, 457 (1931) (Neither market value nor net asset value can be the sole factor in establishing value within the statutes).
108. The "going concern" requirement is required by the Tri-Continental holding. The concept of value under the appraisal statute is that "the stockholder is entitled to be paid for that which has been taken from him, viz., his proportionate interest in a going concern." Tri-Continental, 74 A.2d at 72. The going concern requirement has been interpreted to mean that asset or liquidation value alone can not be the sole determinant of fair value. See infra note 146.
109. See infra text accompanying notes 120-349.
110. In the three cases cited infra note 112, which pertained to natural resource
have market values higher than the values carried on the companies' books. The Delaware block's "going concern" concept, which required consideration of all three component analyses, led to the argument that asset value in natural resource companies did not receive the proper weight.111

Three cases illustrate the valuation problem of the Delaware block method both with regard to natural resource companies and to breaches of fiduciary duty.112 In Bell v. Kirby Lumber Corp.,113 fair value was determined by using an appraisal remedy based on the Delaware block valuation method.114 The plaintiff, however, argued that asset value was not given adequate weight.115 In Lynch v. Vickers Energy Corp.,116 a breach of fiduciary duty case, the court held that an appraisal remedy, using the Delaware block valuation method was inadequate to establish satisfactory damages.117 Finally, in Weinburger v. UOP Inc.,118 another case involving a breach of fiduciary duty, the court eliminated the Delaware block valuation analysis and held that a new appraisal concept should be adopted; one that will provide minority shareholders with an adequate remedy.119

Kirby Exemplifies The Weakness Of The Delaware Block Analysis

In Kirby, minority shareholders were cashed out120 by the 95% owner, Santa Fe Industries, Inc.121 Contemplating the acquisition of

companies, the plaintiffs argued that more weight should be given to the net asset value, because the net asset value was more reflective of the value of a natural resource company and was considerable above the offered price. See infra text accompanying notes 120-349.

111. Id.


113. 413 A.2d 137 (Del. 1980).

114. Id. at 146.

115. Id. at 142.


117. Id.

118. 457 A.2d 701 (Del. 1983).

119. Id.

120. Cash-out is a term used to signify that the minority shareholders were forced to sell their stock to the majority shareholder for cash, as in Kirby, 413 A.2d at 139.

121. Kirby's 5 percent minority shareholders' interest consisted of 25,000 shares. Kirby, 413 A.2d at 139.
Kirby's minority shareholders' stock under Delaware's short form merger statute, Santa Fe commissioned both an appraisal of Kirby's assets and a market value opinion of Kirby's stock. The asset appraisal valued Kirby's assets at $320,000,000 ($640.00 per share). The market value opinion of Kirby's stock was $125.00 per share. Based on this data, Santa Fe offered the minority shareholders $150.00 per share. Owners of 5,000 of the 25,000 minority shares dissented and made a formal demand for a stock appraisal. For this reason, the court appointed an appraiser.

The appraiser, using the Delaware block valuation method, determined that the minority shareholders' stock was worth $254.00 per share. The appraiser determined that the asset value was $456.00 per share and the earnings value was $120.00 per share. The appraiser then assigned a 40% weight to the asset value ($456.00) and 60% weight to the earnings value ($120.00), resulting in the overall "fair value" of $254.00. Both Santa Fe and the Kirby minority shareholders objected to the value found by the court-appointed appraiser.

122. Id.
124. The Morgan Stanley company was commissioned to perform a stock value opinion. Mr. W. Davis was commissioned to conduct an asset appraisal. However, seven months later, immediately prior to the merger a second asset appraisal was commissioned. Kirby, 413 A.2d at 139.
125. The second asset appraisal subsequently found Kirby's asset value was $227,754,000 or $456.00 per share. Id. at 147.
126. Id. at 149.
127. Id. at 139.
128. The dissenters, stockholders who did not think the offered price was adequate, demanded an appraisal under Del. Code Ann. tit. 8, § 262 (1973). Kirby, 413 A.2d at 139. The court did not deal with the fiduciary aspect because it already had been litigated in federal court. Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977). The court held that the fair value, determined by an appraisal remedy, was adequate. Damages, such as rescissory damages, were not appropriate. The court looked to the entire fairness of the merger. Kirby, 413 A.2d at 140.
129. Kirby, 413 A.2d at 139.
130. Id. at 140.
131. The appraiser used the value derived from the second asset appraisal, which valued Kirby's net assets at $277,754,000 or $456.00 per share. Id. at 147.
132. Id. at 140.
133. ASSET VALUE
    | WEIGHT | VALUE |
    | 40%    | X     | $254.40 |
    | 60%    | X     | $120.00 | 72.00 |
    |        |       | FAIR VALUE |
134. Id. at 139.

https://scholar.valpo.edu/vulr/vol19/iss2/6
The minority shareholders argued that the parent corporation owed a fiduciary duty of entire fairness to the minority shareholders. Therefore, damages should have been awarded in the amount the shareholders would have received based on an arm's length transaction. Santa Fe argued that such a stock valuation would be based on the sale or the liquidation of the assets, rather than the traditional "going concern" standard. However, the shareholders argued that the only dispute concerned the relative weights placed on the asset and earnings values. Therefore, the minority shareholders contended that their value was consistent with the concept of the Delaware block and its "going concern" requirement.

The Delaware Supreme Court held that Santa Fe, with a 95% ownership, had virtual control over the Kirby company's operations. At Santa Fe's option, it could liquidate the company and give the shareholders $670.00 per share, the company's net asset value. Alternatively, Santa Fe could cash out the minority shareholders at the pre-merger going concern value. Further, the court held that because there was no market price for the stock, the relevant factor to establish the market value was a $3.00 per share dividend, which would result in a low market value as a going concern, thus making the Kirby company ripe for a cash out. The court held that fair value should be based on the traditional "going concern" concept and rejected the minority shareholders' argument that fair value should approximate the company's asset value.

135. For a definition of entire fairness, see infra notes 576 and accompanying text.
136. Id. at 140. See infra note 576.
137. The result of an arm's length transaction would be closer to the market value of the assets. Kirby, 413 A.2d at 140.
138. The defendant argued that the "going concern" requirement was established in Tri-Continental and that damages based on an arm's length value would be an unwarranted extension of the appraisal remedy. Id.
139. The plaintiff argued that asset value should be given a 90 percent weight and earnings value a 10 percent weight. Id. at 141.
140. Id.
141. Id. at 140.
142. Id.
143. The court rejected the minority shareholders' claim that this was in effect a private eminent domain action. The plaintiff argued that a cash-out under the short form merger statute should be viewed as a forced sale at a distressed price. Id.
144. The only market for Kirby's stock was a tender offer for $65 per share and occasional sales at $85 to $95 per share. Id. at 141.
145. Id.
146. The court in Kirby quoted Tri-Continental emphasizing that the stock should be valued as a "going concern" and that "intrinsic" or "true value" can not be determined by the exclusive acceptance of only liquidation value. Id. at 141.
The minority shareholders in *Kirby* then conformed their arguments to the traditional standards of the Delaware block. They argued that the asset value should have been given more weight.\(^{147}\) Secondly, they contended that the five year average earnings figure used to compute the earnings value did not represent the potential future earnings because of recent pre-merger changes in Kirby company's product lines and marketing strategy.\(^{148}\) On the other hand, Santa Fe argued that earnings should be given more weight to adjust for lack of marketability of Kirby's stock.\(^{149}\)

The court observed that there was no rule of thumb for assigning weights to the component analyses.\(^{150}\) While acknowledging that asset values can be increased in some instances, the court noted that the lack of stock marketability in this case offset any reason to increase the asset value's weight.\(^{151}\) Although the court recognized the appraiser's concern that a large spread between asset values and earnings value could result in a bargain for Santa Fe, the court did not inquire into the problem.\(^{152}\) Rather, the court found that the appraiser's assigned weights adequately compensated for any disparity.\(^{153}\)

The Delaware Supreme Court, affirming the lower court's finding, found that the weight the appraiser assigned to the asset level was satisfactory.\(^{154}\) Even though Kirby's main asset, its timberland, was appreciating in value, was saleable on the open market, and was capable of generating cash,\(^{155}\) the lower court had found that future earnings potential was adequately accounted for through the calculated earnings value.\(^{156}\) Therefore, based on a concern that earnings value would be given too much weight, the lower court excluded any asset

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147. The plaintiff argued that because Kirby was a natural resource company, asset value must be given additional weight. *Id.* at 142.

148. The minority shareholder argued that an earnings value based on a five year average is inappropriate because growth and appreciation are not adequately considered. This is true especially, because Kirby's investors looked to capital appreciation of their stock, rather than dividend income. *Id.* at 144.

149. *Id.* at 145.

150. *Id.* at 143.

151. *Id.* at 146.

152. *Id.* at 145.

153. *Id.* at 145-56.

154. *Id.* at 146.

155. The court acknowledged that: "The investing and trading public . . . give consideration to corporate assets only insofar as they disclose a capability of generating earnings. . . ." *Id.* at 144 (Gibbons v. Schenley Ind., Inc., 339 A.2d 460 (Del. Ch. 1975).

156. Based on a five year average earnings. *Kirby*, 413 A.2d at 145.
value that was based on an earnings analysis.\textsuperscript{157} Further, the Morgan Stanley stock value opinion commissioned by Santa Fe reinforced the notion that the earnings potential had been adequately considered.\textsuperscript{158} Finally, the lower court examined the Davies' asset appraisal,\textsuperscript{159} which was also commissioned by Santa Fe but supported the minority shareholders' position. The lower court found that the Davies' asset appraisal could not be used because it determined Kirby's asset value on a "going concern"\textsuperscript{160} basis and not on the basis of a "willing seller/willing buyer"\textsuperscript{161} which is the proper method for determining a liquidation price.\textsuperscript{162}

The Kirby court strictly adhered to the traditional "going concern" concept,\textsuperscript{163} and thus to the historical constraints of the Delaware block valuation.\textsuperscript{164} The court refused to allow asset value to predominate in the determination of "fair value," primarily because of the court's definition of the "going concern" requirement.\textsuperscript{165} In establishing a stream of earnings for the discounted earnings approach, the court used the traditional standard of examining the five year average earnings rather than looking to prospective earnings.\textsuperscript{166} This adherence to the Delaware block structure provided what appeared to be a realistic "fair value," because it fell between the differing values which the parties requested.\textsuperscript{167} However, the strained application of the appraisal remedy based on the Delaware block, as used

\begin{itemize}
  \item \textsuperscript{157} Id. at 144.
  \item \textsuperscript{158} The Morgan Stanley opinion compared historical earnings trends and price/earnings ratios with similar companies. The Morgan Stanley opinion then selected a 15.2 multiplier and applied it to average earnings. The court agreed with this concept and termed the report as an "orderly and logical deductive process in accordance with approved methodology." Id. at 147.
  \item \textsuperscript{159} See supra note 124.
  \item \textsuperscript{160} The Court, while requiring the overall "fair value" to be based on a "going concern" value, held that asset value should be based on the liquidation value of the assets. Kirby, 413 A.2d at 141, 148.
  \item \textsuperscript{161} The term "willing buyer/willing seller" was meant to indicate an asset liquidation standard, but the Davies asset appraisal used a going concern standard to determine asset value. Using the Delaware block method, the going concern standard is proper for the final determination of fair value, but it is not proper for finding the net asset value. Id. at 147-48.
  \item \textsuperscript{162} Id.
  \item \textsuperscript{163} See supra note 108.
  \item \textsuperscript{164} Kirby, 413 A.2d at 147-48.
  \item \textsuperscript{165} See supra note 108.
  \item \textsuperscript{166} Kirby, 413 A.2d at 147.
  \item \textsuperscript{167} Kirby company had made offers of $150 per share. Id. at 149. The minority shareholders desired a value of approximately $600 per share, which was a little less than the asset value of $670.00 per share. Id. The court appraisal using the traditional standards found a fair value to be $254.00. Id. at 140.
\end{itemize}
in *Kirby*, provided an inadequate remedy in *Lynch v. Vickers Energy Corp.*,168 where the court found a breach of fiduciary duty.

**The Inadequacy of The Delaware Block Valuation Method Under Lynch**

When the Delaware block was used in *Lynch*, the method resulted in a “fair value” that was less than the purchase price.169 The Delaware Supreme Court in *Lynch* found that the minority shareholders, who were damaged by a breach of fiduciary duty,170 should not be limited to the Delaware block valuation method in proving damages.171 Therefore, the court held that the plaintiff could be awarded a different form of damages.172

The controversy in *Lynch* resulted from a purchase of the minority shareholders’ stock by the majority shareholder, Vickers Energy Corporation (Vickers), a wholly owned subsidiary of Esmark Company.173 Through a tender offer of $12.00 per share, Vickers was able to acquire a substantial portion of TransOcean Oil, Inc. (TransOcean).174 However, after the transaction, the minority shareholders discovered that Vickers had failed to disclose certain facts about the tender offer.175 In the complaint, the plaintiff176 alleged that

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169. *Lynch*, 402 A.2d at 12. The purchase price was $12.00 per share, the “fair value” of the minority shareholders’ stock was found to be $11.85.

170. The breach of fiduciary duty resulted from nondisclosures to the minority shareholders. See infra note 175.


172. The Delaware Supreme Court allowed damages to be in the form of the monetary equivalent to rescission, with the objective of putting the parties in the position they were in before the transaction. *Id.* at 501.

173. *Id.* at 499.


175. The nondisclosures consisted of the following:
   a. An asset appraisal by the company valuing the assets at $250,800,000 was omitted. The company in its September, 1974 offer, stated the value of the assets to be approximately $200,000,000. *Lynch*, 351 A.2d at 574.
   b. Esmark had authorized purchases of the TransOcean stock for a price up to $15.00 per share. *Id.* at 575.

The Delaware Supreme Court found item (a) and (b) to be critical factors. *Lynch*, 383 A.2d at 280; and 429 A.2d at 499.

176. The plaintiff represented herself and the minority shareholders similarly
Vickers had breached its fiduciary duty as a result of the nondisclosures. The Delaware Chancery court rejected the plaintiff's claim and found for the defendant.

Reversing the chancery court's decision, the Delaware Supreme Court found that Vickers had breached its fiduciary duty owed to the minority shareholders. Although the supreme court resolved the liability issue, it remanded the damages issue. On remand, the chancery court examined three alternative remedies. The plaintiff argued that she should have been able to choose the alternative remedy that gave her and the members of her class the greatest recovery. In contrast, Vickers argued that the plaintiff did not suffer any injury resulting from a material omission in the proxy statement and therefore was not entitled to recovery. The chancery court, after examining the three possible remedies, found that though the defendant had breached its fiduciary duty, the breach did not cause injury to the plaintiff.

The chancery court noted that the only fiduciary duty breached was the duty of complete candor. When dealing with the minority shareholders, the majority shareholders owe a duty of "entire fairness" to the minority shareholders. Since the Delaware Supreme Court had already decided that the information withheld from the minority shareholders might have affected their individual valuation of TransOcean's stock, the chancery court was only to determine an adequate remedy to be accorded the plaintiff. To determine the appropriate


177. The chancery court did not find a breach of fiduciary duty, *Lynch*, 351 A.2d at 575-76, but the supreme court reversed the chancellor's finding that a reasonable man could use the information not disclosed to value the stock, and found that Esmark, controlling the majority, had a fiduciary duty to disclose this information to the minority shareholders. *Lynch*, 383 A.2d at 281.


180. *Id.*


182. *Id.* at 7.

183. *Id.*

184. Further the chancery court did not find fraud or intentional misrepresentation. *Id.* at 10.

185. *Id.* at 13.

186. "Vickers as the majority shareholder of TransOcean, owed a fiduciary duty to the plaintiff, which required complete candor." *Lynch*, 383 A.2d at 279.


188. *Id.* at 9.
remedy, the chancery court examined Poole v. N.V. Deli Maatchappi,\textsuperscript{189} a case involving a greater degree of unfairness than in Lynch.\textsuperscript{190}

In Poole, the court found that the defendant had made fraudulent misrepresentations upon which the plaintiffs had relied and sold their stock at an inadequate price.\textsuperscript{191} The Lynch chancery court noted that even in Poole, where fraudulent misrepresentation occurred, the court looked to the “going concern” standard and applied the structured Delaware block valuation method in determining the “intrinsic” or “fair value” of the stock.\textsuperscript{192} Therefore, the Lynch chancery court deduced that if the Delaware block was an adequate remedy in a case involving fraud, it was also adequate in a case involving mere breach of a fiduciary duty.\textsuperscript{193}

The plaintiff in Lynch then conformed his argument to the context of the traditional appraisal remedy.\textsuperscript{194} He argued that the oil industry was an asset-wasting industry whose value should be based primarily on the value of its major assets, generally oil reserves.\textsuperscript{195} The chancery court held that the facts in Lynch were analogous to the facts in Kirby, which also involved a natural resource company.\textsuperscript{196} The Kirby court applied the appraisal remedy based on the Delaware block analysis.\textsuperscript{197} Although in Kirby the asset value was an important element in finding the fair value, the Lynch chancery court held that in applying the Delaware block valuation, asset value cannot be the sole determinant of fair value.\textsuperscript{198}

After applying the Delaware block method of appraisal, the chancery court determined that the “fair value” was less than the offered price of $12.00 per share.\textsuperscript{199} In deriving the fair value, the chancery court based the asset value component on an asset appraisal

\textsuperscript{189} Poole v. N.V. Maatchappi, 43 Del. Ch. 283, 224 A.2d 260 (Del. 1966).
\textsuperscript{190} Lynch, 402 A.2d at 10.
\textsuperscript{191} Id.
\textsuperscript{192} The Poole court would not allow “fair value” to be determined exclusively by the company’s net asset value. The court required a Delaware block weighting of market value, earnings value, and asset value. Lynch, 402 A.2d at 9.
\textsuperscript{193} Id. at 10.
\textsuperscript{194} Id.
\textsuperscript{195} Id. An asset wasting industry is one which consumes or sells its non-replenishable resources, primarily minerals.
\textsuperscript{196} Id.
\textsuperscript{197} Kirby, 413 A.2d at 146.
\textsuperscript{198} Lynch, 402 A.2d at 11, 12.
\textsuperscript{199} Id. at 12.
"FAIR VALUE" DETERMINATION

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report\textsuperscript{200} commissioned by the defendant.\textsuperscript{201} The market value component was based on TransOcean's stock market price two days before the offer.\textsuperscript{202} The earnings value component was based on the traditional five year average earnings, which was then multiplied by 17.4, the figure found to be the appropriate earnings multiplier.\textsuperscript{203} The court then weighed the values derived from the component analyses.\textsuperscript{204}

In determining the proper weight for the asset value component, the Lynch court considered the Kirby court's analysis.\textsuperscript{205} Because both Kirby Lumber Company and TransOcean were natural resource companies, the Lynch court applied the same 40% weight to asset value that was applied by the Kirby court. Market value was also given a 40% weight and earning value was given a 20% weight.\textsuperscript{206} The resultant fair value was found to be $11.85 per share, a value less than the $12.00 per share offered.\textsuperscript{207} Therefore, the lower court found the plaintiff was not damaged by the defendant's omission of material factors.\textsuperscript{208} Since the plaintiff could not show any out-of-pocket loss,\textsuperscript{209} the chancery court examined the alternative remedy of rescission.

The chancery court held that even if the plaintiffs were entitled to equitable rescission, which would amount to a return of their stock, they would have to pay the defendant, Vickers, $12.00 per share plus reasonable interest of 13.1% or a total price per share of $19.64.\textsuperscript{210} However, the market value of Vickers' stock as of the 1978 judgment

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<th>WEIGHTS</th>
<th>RESULTS</th>
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<tr>
<td>Asset Value</td>
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<td>40%</td>
<td>$ 7.00</td>
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<tr>
<td>Market Value</td>
<td>9.48</td>
<td>40%</td>
<td>3.80</td>
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<tr>
<td>Earnings Value</td>
<td>5.25</td>
<td>20%</td>
<td>1.05</td>
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Fair Value = $11.85

\textsuperscript{200} Id. at 8.
\textsuperscript{201} This report was one of the items not disclosed to the minority shareholders.
\textsuperscript{202} Id. at 11.
\textsuperscript{203} Id. at 12.
\textsuperscript{204} Id. at 12.
\textsuperscript{205} Id. at 10.
\textsuperscript{206} See supra note 204.
\textsuperscript{207} Lynch, 429 A.2d at 499.
\textsuperscript{208} The court in Lynch held that the plaintiffs were not damaged by the conduct of the defendant. Lynch, 402 A.2d at 13.
\textsuperscript{209} The Lynch court quoted Poole, "Plaintiffs seek to recover the difference between the actual value of the stock and the price paid, known as the 'out-of-pocket' measure of damages. . . ." Poole, 224 A.2d at 262, cited in Lynch, 429 A.2d at 500.
\textsuperscript{210} Lynch, 402 A.2d at 12. Further, the court found that a "prudent investor" can get 13.1 percent on his investment. Id. at 12.
date was approximately $14.31, which was below the $19.64 per share level. Consequently, the chancery court found that the plaintiff and members of her class would not benefit from an award of rescissory damages, and thus they were not damaged as a result of any omission made in the tender offer circular.

Lynch's Second Appeal to the Delaware Supreme Court

The plaintiff appealed for a second time to the Delaware Supreme Court. The supreme court, after considering the issue of damages, reversed the chancery court's decision. The court first examined the applicability of the appraisal as propounded by the court in Poole. Distinguishing Poole, the supreme court noted that the court in Poole applied the Delaware block appraisal, which the plaintiffs had specifically requested. However, the plaintiff in Lynch did not ask for the same appraisal formula that was applied in Poole.

In determining whether the appraisal remedy was adequate, the supreme court found that greater weight should be given to TransOcean's asset value and less weight to TransOcean's market value. The Lynch supreme court recognized that TransOcean was a natural resource company whose major asset, oil reserves, was in high demand and scarce supply. Further, Vickers' dominion, control, and announced plan to acquire 100% of TransOcean, had adversely influenced the price of TransOcean's stock. Thus, the court held that TransOcean's stock price should not have been given a 40% weight in determining TransOcean's intrinsic value. Consequently, in Lynch, the supreme court found the structured Delaware block appraisal

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<tr>
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<tr>
<td>EARNINGS VALUE</td>
<td>13.41</td>
<td>20%</td>
<td>2.68</td>
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"Fair Value" $14.36

This is a chart representation of the data used to determine market value. Id. at 13. (NOTE $.06 DISCREPANCY IN THE COURT'S CALCULATION)
remedy did not adequately compensate the plaintiff for her loss.\footnote{221} Further, the court held that the statutory limitation of appraisal does not apply in cases of breach of fiduciary duty.\footnote{222} Instead, the court found other remedies such as rescission, or its monetary equivalent, were applicable in such cases.\footnote{223}

The state supreme court did not order actual rescission because of the lapse of time since the transaction had occurred,\footnote{224} but stated that the monetary equivalent of rescission should be awarded.\footnote{225} Since the purpose of rescission is to place the parties where they were before the transaction,\footnote{226} the monetary equivalent to rescission equals the gain in value Vickers received as a result of acquiring and holding TransOcean's stock.\footnote{227} Therefore, the supreme court held that the plaintiffs were entitled to receive from the defendant the equivalent value of TransOcean's stock as of the time of the judgment, less the $12.00 per share already received plus fair interest.\footnote{228} The supreme court then established broad guidelines for determining the monetary equivalent of rescission.\footnote{229}

\footnote{221} Id. at 507.
\footnote{222} In finding breach of fiduciary duty, the Delaware Supreme Court did not require an actual intent to deceive when one party has an advantageous bargaining position with respect to the other party. Id. at 503. However, in Poole, breach of fiduciary duty was neither alleged or found. Id. at 501. A strange result since fraud should also be a breach of a fiduciary duty.
\footnote{223} Id. at 501.
\footnote{224} The supreme court stated that rescission would be preferable if at an earlier stage, but was not possible at this late date because of the corporate changes that had taken place in Esmark. Id.
\footnote{225} Id.
\footnote{226} Id.
\footnote{227} Id. at 501, 502.
\footnote{228} The rescissory damages should be measured at the time of the judgment. Id. at 503. The defendant is entitled to a credit equaling the $12.00 already paid plus the interest equivalent to what they could have “safely earned” by use of the $12.00. The supreme court overruled the court of chancery, which allowed a 13.1\% rate. The supreme court stated that a 7\% rate would be more fair. The intent is not to reward the wrongdoer. Id. at 506.
\footnote{229} The supreme court stated the stock should not be valued at less than $15.00 per share or more than $41.40 per share. The lower limit was established by the undisclosed information that Vickers was willing to buy TransOcean's stock from anyone for $15.00 per share in September, 1974. The supreme court reasoned that an arm's length transaction with the minority shareholders should not have resulted in a price less than $15.00 per share. In addition, the supreme court set the high limit on the basis that $41.40 per share is the most value the plaintiff ever alleged Trans-Ocean's stock was worth. Id. at 505.
In conclusion, the supreme court held that if the majority shareholder breaches its fiduciary duty when dealing with the minority shareholders for the purchase of their stock, the minority shareholders are entitled to rescission or its monetary equivalent.\textsuperscript{230} Although the appraisal remedy was appropriate in Kirby,\textsuperscript{231} the concept of fairness requires rescission or its monetary equivalent when the court finds a breach of fiduciary duty.\textsuperscript{232} Therefore, the use of the structured Delaware block method to determine fair value did not provide adequate relief to the minority shareholders, in this instance.\textsuperscript{233}

After Lynch, the traditional Delaware block method of valuation still existed for standard appraisals of dissenting shareholders' equity, as in Kirby. However, the traditional appraisal remedy, which uses the Delaware block method, was found inadequate in cases involving a breach of fiduciary duty.\textsuperscript{234} The Delaware Supreme Court's dissatisfaction with the Delaware block appraisal method reached its peak in 1983, when it eliminated the traditional Delaware block valuation method.\textsuperscript{235} In Weinberger v. UOP, Inc.,\textsuperscript{236} the Delaware Supreme Court made the valuation process more flexible, appropriate, and justifiable.\textsuperscript{237}

The New Appraisal Remedy Adopted In Weinberger

The controversy in Weinberger involved both the value of a natural resource company's stock and a breach of fiduciary duty.\textsuperscript{238} Therefore, the facts in Weinberger are analogous to both Kirby and to Lynch.\textsuperscript{239} In 1975, Signal Companies, Inc. ("Signal"), the defendant, was looking for additional investments because it had just sold a wholly owned oil subsidiary for $420,000,000 in cash.\textsuperscript{240} After examin-
ing Universal Oil Products ("UOP"), Signal began friendly negotiations in 1975 with the hope of acquiring the controlling interest in UOP.241

The negotiations began with Signal offering $19.00 per share and UOP asking $25.00 per share. Arm's length bargaining resulted in a price of $21.00. Pursuant to the final agreement, a tender offer for a limited number of shares242 was made to obtain UOP's controlling interest. Because more than the desired number of outstanding shares were offered,243 Signal became the majority shareholder, owning 50.5% ownership of UOP's stock.244

After becoming the majority shareholder, Signal made board appointments.245 Signal initially appointed only six of the thirteen directors.246 However, when the president and chief executive officer retired in 1975, Signal appointed a replacement, Mr. Crawford, giving Signal control of the board.247 Simultaneously, Signal, still with excess cash, was searching unsuccessfully for additional investments.248

After researching the market for other possible acquisitions, Signal decided its best investment opportunity was to purchase the balance of UOP's stock.249 Therefore, in February, 1978, Signal decided to explore the feasibility of this course of action.250 Pursuant to this decision, Signal's management ordered a feasibility study to be performed by two of Signal's vice presidents.251 That study indicated that a purchase price of up to $24.00 per share would provide an acceptable return for Signal.252

Based on the information derived from the feasibility study, Signal's management decided to offer UOP's minority shareholders

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241. The purpose of the negotiations was to purchase both issued and unissued stock, giving Signal 50.5% ownership. Id. at 1336.
242. Signal only needed 5,800,000 shares to obtain the desired 50.5% controlling interest. The negotiated agreement to buy 1,500,000 unissued shares at $21.00 per share was contingent upon a successful tender offer of 4,300,000 issued shares at $21.00 per share. Weinberger, 457 A.2d at 704.
243. The number of outstanding shares tendered to Signal totaled 7,800,000, representing 78.2% of the total outstanding shares. Weinberger, 426 A.2d at 1336.
244. Weinberger, 457 A.2d at 704.
245. Id.
246. Id.
247. Id. at 705.
248. Id.
249. Id.
250. Id.
251. Id.
252. Id.
$20 to $21 per share for their stock. Signal then contacted Crawford and made the proposal. While Crawford did suggest some modification with respect to the employee benefits, he did not object to the offered price. Later Crawford suggested that in order to convince the minority board members to vote in favor of the cash out, Signal should offer $21.00 per share, which was still within the proposed range and was the price of the over subscribed tender offer. Consequently, Crawford and Signal’s management both thought the $21.00 per share price was fair, and would be approved by the minority board members.

Signal’s management, believing UOP’s minority shareholders would accept their offer, authorized negotiations with UOP’s directors, and on February 28, 1978, issued a press release. The press release announced that negotiations were to begin for the purchase by Signal of UOP’s 49.5% minority ownership. At that time, UOP’s stock was selling for $14.50 per share. Two days later, on March 2, 1978, Signal issued another press release stating that its offering price was in the range of $20 to $21 per share. In order to validate the fairness of Signal’s offer, Crawford started negotiating with an investment banking firm to provide a fairness opinion.

Crawford retained Lehman Brothers, an investment banking firm, to do the fairness study. Crawford chose this firm for three stated reasons. First, Lehman Brothers had been UOP’s investment banker for years. Second, Mr. Glanville, a partner in Lehman Brothers, was also a director of UOP. Third, Crawford thought time was of the essence and realized that Glanville’s present knowledge of UOP’s operations would expedite the analysis. After negotiating the price

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253. Id.
254. Id.
255. Id.
256. More than the desired amount of stock was tendered. Id. at 706. See also supra notes 242, 243.
257. Id. at 705, 706.
258. Id. at 705. See also supra notes 242, 243.
259. Id. at 706.
260. Id.
261. Id.
262. Id.
263. Id.
264. Id.
265. Id.
266. Mr. Crawford was told by Signal’s management that time was of an essence.

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https://scholar.valpo.edu/vulr/vol19/iss2/6
for the fairness opinion, Glanville accepted the assignment. Crawford and Glanville then discussed the value of UOP's stock.267

During the same discussions, Glanville indicated that $20 to $21 per share for UOP's stock was a fair value because it represented a 50% premium over the market price.268 Believing time was of the essence, Lehman Brothers used three analysts who completed the fairness opinion in only three days.269 By analyzing public information and interviewing Crawford, Lehman Brothers' team concluded that either $20.00 or $21.00 per share was a fair price.270 Although it became apparent that the opinion was not needed as urgently as anticipated, Lehman Brothers performed no further analysis.271 The results of the fairness opinion were given to the board members who represented the minority shareholders.272 However, Signal never disclosed the hasty manner in which the study was completed.273

Based on the information provided, the UOP board members who were not affiliated with Signal voted to accept the offered price of $21.00 per share.274 However, the non-affiliated board members voted without knowledge of either the manner in which the fairness opinion was conducted, or the existence of the prior study conducted by Signal's management, which indicated that $24.00 per share was a fair price and was still profitable for Signal.275 The plaintiff, representing all the minority shareholders who did not exchange their stock for the merger price, attacked the validity of the merger seeking to either set the merger aside or to be compensated monetarily.276 The chancery court found for the defendant, Signal; the plaintiff appealed.277

The Delaware Supreme Court reversed.278 The supreme court found that Signal had breached its fiduciary duty by not disclosing to the non-Signal board members either the manner in which Lehman

267. Id.
268. Id.
269. Id.
270. Id. at 707.
271. A board meeting was convened on March 6, 1978, but the merger was not submitted to UOP's shareholders until their annual meeting May 26, 1978. Id. at 707, 708.
272. Id.
273. Id. at 708.
274. Id. at 707.
275. Id. at 707-09.
276. Weinberger, 426 A.2d at 1335.
277. Weinberger, 457 A.2d at 703.
278. Id. at 715.
Brothers' fairness opinion was performed or the prior study indicating that $24 per share was still a fair price.\textsuperscript{279} The first study, performed internally by Signal's management, indicated that Signal should purchase the remaining stock of UOP for a price between $21 and $24 per share.\textsuperscript{280} The analysis indicated that Signal was projecting a return on investment of 15.7% if the stock was purchased for $21 per share and a 15.5% return if purchased for $24 per share.\textsuperscript{281} The difference between $21 and $24 per share amounted to a $17,000,000 impact on the minority shareholders.\textsuperscript{282} The Delaware Supreme Court indicated that because the .2% difference in the rate of return on investment was very small in relationship to the aggregate difference of $17,000,000, the information should have been given to the non-Signal board members.\textsuperscript{283} Therefore, the directors affiliated with Signal, who owed a fiduciary responsibility to the minority directors, breached this duty by not disclosing the earlier study which indicated that $24 per share would be a fair price.\textsuperscript{284}

The Delaware Supreme Court in \textit{Weinberger} held that the directors affiliated with Signal and UOP had both dual capacities and dual responsibilities,\textsuperscript{285} and thus should have treated the minority shareholders in a fair manner.\textsuperscript{286} Further, the court held that the concept of fairness should be viewed as involving two components: "fair dealing and fair price."\textsuperscript{287} The Signal affiliated directors had access to inside information which they did not disclose to the minority directors.\textsuperscript{288} Neither the study that was prepared for the exclusive use of Signal's directors, nor the circumstances surrounding Lehman Brothers' fairness analysis was disclosed to UOP's minority directors.\textsuperscript{289} Therefore, the majority directors were not "dealing fairly" with the minority directors.\textsuperscript{290}

\textsuperscript{279} "Given these particulars and the Delaware law on the subject, the record does not establish that this transaction satisfies any reasonable concept of fair dealing . . . ." \textit{Id.} at 712.

\textsuperscript{280} \textit{Id.} at 709.

\textsuperscript{281} \textit{Id.}

\textsuperscript{282} \textit{Id.}

\textsuperscript{283} \textit{Id.} at 712.

\textsuperscript{284} \textit{Id.}

\textsuperscript{285} \textit{Id.} at 710.

\textsuperscript{286} "When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." \textit{Id.}

\textsuperscript{287} \textit{Id.} at 711.

\textsuperscript{288} The inside information refers to the in-house study conducted by Signal's management. \textit{Id.}

\textsuperscript{289} \textit{Id.} at 712.

\textsuperscript{290} \textit{See supra} note 279.
The second component of the "fairness" standard is fair price.\(^{291}\) Price fairness relates to the "fair value" of UOP's stock.\(^{292}\) In determining the "fair value," the supreme court found that the chancery court had erroneously used an analysis, propounded by the defendant's analyst, which applied the concepts of the traditional Delaware block valuation method.\(^{293}\) The market value component was determined by looking at the five year market performance of UOP's stock.\(^{294}\) During the five calendar year period from 1974 through 1978, the highest price at which UOP's stock was traded was $18.75 per share in 1974.\(^{295}\) The average market price was slightly less than $14.00 per share.\(^{296}\) Finally, the current closing market price on February 28, 1978, was $14.50 per share.\(^{297}\) Therefore, based on any criteria, the market value was less than the $21.00 per share offering price.

After analyzing the market value of the stock, the defendant's analyst examined the firm's earnings value.\(^{298}\) Looking at this component, the analyst noted that, due to the "nature of UOP's business," its earnings were both erratic and unpredictable.\(^{299}\) The analyst determined the appropriate earnings multiplier by examining comparable companies.\(^{300}\) The resulting range of values, from $14.31 per share to $16.39 per share, was substantially below the $21.00 per share offering price.\(^{301}\)

Signal's analyst then turned to the asset value component.\(^{302}\) Although the analysis of the asset value resulted in the highest value, the value was still less than the offering price of $21.00.\(^{303}\) The analyst

\(^{291}\) Id. at 711.

\(^{292}\) The Delaware Supreme Court stated that fair price includes "... all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." Id.

\(^{293}\) Id. at 712.

\(^{294}\) Weinberger, 426 A.2d at 1364.

\(^{295}\) Id.

\(^{296}\) Id. at 1365.

\(^{297}\) Id.

\(^{298}\) Id.

\(^{299}\) Further, UOP's dividend policy was erratic with the 1978 first quarter dividend equal to the 1970 level. Id. However, it should be noted that accepted economic theory views diversification as a stabilizing force on earnings.

\(^{300}\) The analyst selected comparable companies and found their earnings values were between 6.5 and 7.0 times that of UOP's 1977 earnings per share and between 80% to 85% of UOP's 1977 book value. Id.

\(^{301}\) Id.

\(^{302}\) Id.

\(^{303}\) "The net asset value or book value was $19.86 at year-end, 1977, and $20.69 as of the end of the first quarter of 1978." Id.
equated asset value with book value and concluded that the asset value should be given very little weight because Signal was acquiring UOP as a going concern with no intention of liquidation.\footnote{304}

Finally, Signal's analyst departed from the traditional Delaware block analysis by examining the premium paid over the market price of comparable acquisition transactions.\footnote{305} In examining the premium paid over the market price of comparable firms, the analyst again concluded that the offered price was fair.\footnote{306} The chancery court held that this type of analysis proffered by the defendant's analyst was more in line with the traditional Delaware block method than the analysis propounded by the plaintiff's analyst.\footnote{307}

The plaintiff argued that at the time of the merger UOP's stock had a fair value of $26.00 per share.\footnote{308} His expert, Mr. Bodenstein, used two techniques to prove the stock's value.\footnote{309} First, he compared the premium paid over market price in ten other tender-offer merger combinations of similar size.\footnote{310} Secondly, he computed the fair value for UOP's stock based on a discounted cash flow approach.\footnote{311} Both analyses were based on the principle that fair value equals the value derived from owning 100% of an ongoing company.\footnote{312} The 100% owner would be free from constraint\footnote{313} and could do with the company as he pleased.\footnote{314} The 100% owner could maximize his wealth by changing the company's dividend policy, its investments, its overall risk, or even by liquidating its assets.\footnote{315} Neither of Bodenstein's analytical methods conformed to the established principles of the Delaware block valuation.\footnote{316}

\footnote{304} Id.
\footnote{305} Id.
\footnote{306} He found that the median premium was 41% and the average (mean) premium was 48%. Comparing the market price of $14.50 (on February 28, 1978) and the offered price of $21.00, the resulting 44.8% premium was deemed a fair premium to pay for the acquisition of UOP's minority interest. Id.
\footnote{307} Weinberger, 457 A.2d at 712, 713.
\footnote{308} Id.
\footnote{309} Id.
\footnote{310} Id.
\footnote{311} Id.
\footnote{312} Weinberger, 426 A.2d at 1359.
\footnote{313} See infra text accompanying notes 449-51, 473-75.
\footnote{314} Id.
\footnote{315} Id.
\footnote{316} As seen in Kirby and prior cases, the objective of the Delaware block valuation method is to determine fair value based on a "going concern" prior to the merger. See supra text accompanying notes 120-67.
"FAIR VALUE" DETERMINATION

The plaintiff's first approach determined that based on the premium in ten comparable transactions, the premium paid for UOP's stock should have been between 70% and 80%, with the median at 74%.317 By applying these percentages to UOP's stock price on February 28, 1978, he concluded that the fair value of UOP's stock should have been in the range of $25.65 to $27.30 per share.318 The discounted cash flow analysis also resulted in comparable values.

Bodenstein's discounted cash flow analysis determined the fair value to be between $25.21 and $30.59 per share.319 The basic concept of this approach equates fair value to the sum of the net present values of cash generated from operations and from excess liquidity.320 The first step in this method is to determine the excess liquidity and discount the excess liquidity to present value.321

In order to perform this first step, the company's assets were examined and any excess liquidity was assumed to be drained or reinvested in efficient investments.322 The resultant cash flows from the elimination of the excess liquidity, or the return from the new, more efficient investments, was then discounted to present value.323 Next, the cash flow from operations was determined and then discounted to its net present value.324 The fair market value was the sum of the cash flows' net present values.325 This figure, however, was not an exact calculation due to the imprecise determination of both the cash flows and the discount rate.326

The chancellor rejected both the cash flow determination and the determination of the discount rate.327 The court noted that a small change in the discount rate would make a large difference in the resulting value.328 Further, the lower court held that neither the concept that the fair value is equal to the value of 100% ownership nor

317. Weinberger, 426 A.2d at 1357.
318. Id.
319. Id. at 1358.
320. Excess liquidity as defined by Mr. Bodenstein is "the working capital that is not required to generate the earnings of the business from its operation." Id. at 1357.
321. Id.
322. Part of the excess liquidity hypothesized to be drained was the value of the unused timberlands. The analyst hypothesized that the timberland was sold and considered the funds generated cash. Id. at 1358.
323. Id.
324. Id.
325. Id.
326. Id. at 1358, 1359.
327. Id.
328. Id. at 1359.
the concept that the fair value is equal to projected discounted cash flows was the established law in Delaware.\textsuperscript{329}

The chancellor, abiding by precedent, ruled that the proper method in valuations was the "Delaware Block" method which had been accepted since 1947.\textsuperscript{330} Therefore, since the defendant's analysis was both logical and more closely resembled the concepts of the Delaware block method, the chancellor relied on the defendant's analysis and rejected the plaintiff's analysis.\textsuperscript{331} However, the Delaware Supreme Court reversed and remanded to the chancery court.\textsuperscript{332}

The Delaware Supreme Court ruled that the "Delaware Block" method was outdated and that the time had come for the acceptance of modern valuing techniques using accepted financial theories.\textsuperscript{333} The supreme court held that, with the narrow exception that an increase in value resulting solely from the contemplation of a merger cannot be considered in determining fair value,\textsuperscript{334} all other "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered."\textsuperscript{335} Further, a fair price requires consideration of all relevant variables.\textsuperscript{336} The court noted that the new valuation concept would be more widely used and flexible, as well as reflective of the intent of the Delaware corporation statutes.\textsuperscript{337}

The Weinberger court held that a more liberal approach to valuing minority interest must be taken so as to reflect the spirit of Delaware's statutory provisions regulating corporations.\textsuperscript{338} The

\textsuperscript{329} The chancellor wrote, "I do not find this approach to correspond with either logic or the existing law." \textit{Id.} at 1360.
\textsuperscript{330} \textit{Weinberger}, 457 A.2d at 712.
\textsuperscript{331} \textit{Id.}
\textsuperscript{332} \textit{Id.} at 715.
\textsuperscript{333} \textit{Id.} at 712, 713.
\textsuperscript{334} \textit{Id.} at 713.
\textsuperscript{335} \textit{Id.}
\textsuperscript{336} \textit{Id.}
\textsuperscript{337} The following quote illustrates Delaware's concern for fairness and flexibility, but is void of guidelines: "In view of the fairness test which has long been applicable...[T]he expanded appraisal remedy [is] now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate..." \textit{Id.} at 715. "[T]he Chancellor's discretion, the monetary award, if any, should be in the format of monetary damages, based upon entire fairness standards, i.e., fair dealing and fair price." \textit{Id.} at 714.
\textsuperscript{338} After 1981, the term "fair value" was repeatedly emphasized in 8 Del. Code § 262. "Clearly, there is a legislative intent to fully compensate the shareholders for whatever their loss may be, subject only to the narrow limitation that one cannot
The legislative history of sections 262(f) and 262(h) of the Delaware Code place increased emphasis on determining the "fair value" of the minority shareholders' interest.339 The legislative intent is to "fully compensate shareholders for whatever their loss may be, subject to the narrow limitation that one cannot take speculative effects of the merger into account."340 Therefore, the court found that the analysis of the type offered by the plaintiff's analyst must be considered in determining fair value.341 Declaring that the determination of fair value using the structured Delaware block method is no longer the law in Delaware,342 the court stated that more flexible techniques must be used to determine fair value.

The Delaware Supreme Court, by allowing more flexible determinations of fair value, held that damages based on complete monetary rescission were probably not necessary in Weinberger.343 But, the court did not preclude consideration of "elements" of rescissory damages if the chancellor determined that they were appropriate.344 Although the supreme court found a breach of fiduciary duty as it had in Lynch, the court found that the expanded concept of fair value determination makes appraisal an adequate remedy.345 On remand, the plaintiff would be able to test the fairness of the $21.00 offer by considering all of the relevant factors.346 No longer are the plaintiff's arguments constrained by the Delaware block valuation method.347 In summary, the appraisal remedy, as expounded in Weinberger, expanded both the use of modern financial analysis348 to determine "fair value" and the
concept of "going concern" to include consideration of the value of
100% company ownership.\textsuperscript{349}

SECTION II—VALUATION THEORIES

The \textit{Weinberger} court allowed the use of modern financial analysis
to determine the "fair value" of a minority shareholder interest in
freeze-out situations.\textsuperscript{350} This section will explore some modern valuation
 techniques that are relevant to finding the "fair value" of minority
shareholder interests. This note then examines the range of possible
arm's length values where the "fair value" of minority interests might
lie.\textsuperscript{351} The determination of various "values" is a function of economic
theory.

As "positive" micro-economic theory purports,\textsuperscript{352} one purpose of
financial theory is to find the relationships and relative effects of real
world variables.\textsuperscript{353} One such relationship is the effect of dividend policy,
earnings, cash flow, information, and numerous other factors on the
market price of stock.\textsuperscript{354} If the world consisted of only two variables,
the process would be merely to change one variable and observe the
impact on the other. However, in order to determine these relative
relationships in a world with many variables, it is necessary to hold
constant some variables, while other variables are being tested.\textsuperscript{355} One
method of accomplishing this makes use of several assumptions.

Financial theory is based on assumptions that are necessary both
in its development and operation.\textsuperscript{356} As the various theories were
developed, they have increased in sophistication by incorporating more
variables.\textsuperscript{357} However, as a model becomes more complex, its ability

\textsuperscript{349} \textit{Id.} at 714.
\textsuperscript{350} See \textit{supra} note 348.
\textsuperscript{351} See \textit{infra} text accompanying notes 424-84.
\textsuperscript{352} For a good discussion of law and economics see: \textit{Strasser, Bard, and Arthur,
(1982). The article describes the concepts of positive and normative economics. [hereinafter cited as Strasser].}
\textsuperscript{353} \textit{J. Mao, Quantitative Analysis of Financial Decisions} 12 (1969)
[hereinafter cited as Mao]. Variables may be classified in two broad categories: exogenous
variables, those given by the decision maker; and endogenous variables, whose value
is determined by the model.
\textsuperscript{354} Smidt, \textit{A New Look at the Random Walk Hypothesis, 3 The Journal of
\textsuperscript{355} \textit{Strasser, supra} note 352, at 576.
\textsuperscript{356} \textit{Id.}
\textsuperscript{357} The complexity of a mathematical model is limited, among other things,
by the number of variables, given the number of equations. C. \textit{Frank Jr., Statistics
and Econometrics} 317 (1971) (hereinafter cited as Frank).
to portray the relationships between its component variables becomes weakened because of the effects of the interdependence of the variables. This lessens the model's usefulness in predicting the changes in its variables. Therefore, in order to be useful, every economic or financial model must retain a degree of simplicity. No single model or theory can be used to explain all real world variable relationships. Consequently, every financial theory and resultant model used to predict the reaction of a number of variables by varying others must contain certain assumptions, which hold some of the variables at a constant level. In short, even with respect to the widely accepted efficient market hypothesis, assumptions are necessary.

Efficient Market Approach

The efficient market hypothesis' main postulate is that given an array of complex assumptions, the market price of a security is equal to, or nearly equal to, its intrinsic value. The market price might not reflect the intrinsic value, but the price does reflect all past events and available information. Therefore, if the efficient market hypothesis is valid, a security's market price will at least be a good

358. Strasser, supra note 352, at 576.
360. Professor Fama divided the efficient market hypothesis into three operational categories. The divisions were based on the amount of information investors use to evaluate the value of a security. These categories are:
(a) Weak form efficiency: For this, the lowest level of the efficient market hypothesis, to be valid the hypothesis assumes that most investors utilize historical price and financial data to value the securities. Therefore, no investor can make excess returns by using historical data.
(b) Semi-strong efficiency: This level requires the assumption that investors use all publicly available financial information to value securities. Therefore, no investor can make excess profits by using any publicly available information.
(c) Strong form efficiency: This form requires that investors know all information, both public and inside, which they use to value security prices. Therefore, an investor cannot make excess returns even using inside information.
Fama's theory as in most empirical studies, does not contend that the strong form efficiency describes the real world. The strong form is merely an extreme yardstick to measure the degree of efficiency that might exist in a capital market. Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 THE JOURNAL OF FINANCE No. 2, 383 (May 1970) [hereinafter cited as Fama 1970].
However considerable empirical support does exist for both the weak and semi-strong form of the efficient market hypothesis. Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 TEX. L. REV. 1, 3 n.9 (1978).
361. Fama (1965), supra note 359, at 56.
estimate of its intrinsic value. Further, the market price will vary randomly around this intrinsic value.

Professor Fama developed the "random walks" hypothesis; a theory that attempts to explain random movements of stock prices. The random movement around the intrinsic value of the stock results from the market participants' different notions of the stock's intrinsic value. Due to the large number of market participants over-valuing and under-valuing the stock, their bidding will cause the stock's price to vary around its intrinsic value. However, to reach this conclusion certain assumptions are necessary.

First, the primary premise in the random walk theory is that the stock market is efficient. An efficient market exists when a large number of rational profit maximizers with free access to information concerning both the firm and outside factors attempt to predict the future market values of the firm's stock. Contained in this definition are four assumptions:

362. Id. at 59.
363. Id. at 56.
364. Id. at 56-59.
365. Id. at 56.
366. Id.
367. There are assumptions required in various degrees for each level of the efficient market hypothesis. However, as the assumptions are relaxed, the market, by definition, will be less efficient. Varying degrees of market efficiency can be illustrated by first allowing all investors access to all relevant information about the company, both public and inside information. Each investor, assuming he is economically rational, will form similar notions of risks and returns. Since risk is still present even if all investors calculated identical risk parameters, they still might lose money by purchasing the firm's security.

The analysis does not require seeing into the future. For the efficient market hypothesis to be valid, it only requires that the investors have access to information. The information must be relevant to determining the potential returns and the firm's risk. While a few investors might value the firm extremely high or low, the bidding for the purchase of the securities will cause the securities price to vary around its intrinsic value. Further, most securities are held by institutional investors who, with the same information available, will probably reach similar notions of risks and returns.

If investors perceived only slight variances in risks and returns from an investment, each investor's expected value of the firm would be similar. However, the investors' perceived values would show more variance, if their perception of the investment's risks and returns were different. This might be the result of allowing some investors complete access to relevant information, while withholding information from other investors.

The investor with access to more relevant information could make better judgments as to the firm's potential returns and risk than the investors without such information. Therefore, as the information is released to the other investors, they also will perceive similar risks and returns, reflecting their notions of the firm's value.
1. Market participants are rational profit maximizers. 368
2. Market participants are numerous. 369
3. The market participants have perfect or near perfect knowledge. 370
4. Market competition will both instantaneously cause new information to be known and affect the intrinsic value of the stock, which is reflected in this market price. 371 In summary, the implication of the efficient market theory is that the stock prices are the best estimators of the intrinsic value of the stock. If the “random walk” theory 372 is valid and the market is efficient, the market price of a stock is a good estimate of its intrinsic value. 373 However, if information not available to the market participants was not discounted by the market, the stock’s price might not be a good estimate of the stock’s intrinsic value. 374

Discounted Cash Flow—Investment Opportunities Approach

The efficient market hypothesis, at least in its weak and semi-strong form, 375 is generally accepted by the financial community. 376


Further, empirical analysis shows that above average “gross returns” can be made with the use of information not available to the general market. However, while gross returns can be increased with additional information, the cost of the information offsets the increase. Therefore, the empirical results are consistent with both the weak and the semi-strong efficient market hypothesis. See Cornell and Roll, Strategies for Pairwise Competition in Markets and Organizations, THE BELL JOURNAL OF ECONOMICS 201-13 (Spr. 1981) (Shows that the individual using costly information will out perform the market, but only in terms of gross returns.)

368. This is the traditional assumption of economic analysis. Strasser, supra note 352, at 581-85.
369. See supra note 367.
370. Id.
372. Fama (1965), supra note 359, at 58.
373. This is consistent with all three levels of the efficient market hypothesis.
374. See supra note 367.
375. See supra notes 359, 360.
376. The efficient market hypothesis was considered bizarre by many in 1960, “but by 1970, it was generally accepted by academicians and by many financial institutions.” J. Lorie and R. Brealey, MODERN DEVELOPMENTS IN INVESTMENT MANAGEMENT 101 (1972).
However, even among analysts who accept the efficient market model, its application is limited to situations where a public market price is available. Therefore, in the case of closely held companies or in situations where the efficient market model is not applicable, the analyst might use the discounted cash flow method of firm valuation.

The discounted cash flow method is another alternative to valuing a firm or asset as a going concern. The model consists of the summation of cash flows projected over a period of time discounted back to present value. The model's major premise is that the value of a firm is derived from its ability to generate a return to the investor over a period of time. The cash flows can be in the form of either dividends, earnings, or net cash flows. These cash flows are pro-

377. The efficient market method would not be applicable where there is a disparity of information. If an analyst were trying to determine the value of a firm to someone with undisclosed inside information, he must look somewhere other than the security's market price. Since the stock market price would not reflect the unknown information, the stock market price would not reflect the value to the insider. The same lack of information occurs with respect to closely held companies, only on a broader scale.

In the case of privately held firms, the discounted cash flow basis can be viewed as an approximation of the market value. The analysis requires the investor to calculate the potential return generated by the firm as well as the risks of the returns materializing. See supra note 367.

378. See supra note 377.

379. This type of analysis is theoretically performed by a large number of investors with respect to publicly held companies. Their resultant values determine the market price of the security. Fama (1965), supra note 359.

380. Investors making investment decisions concerning the acquisition of business assets undergo the same type of analysis. The economic value of an asset is based on its ability to generate a return. Even jurisdictions using the Delaware block valuation method, valued leased property on the basis of the lease payments. Sporborg v. City Speciality Stores, 35 Del. Ch. 560, 123 A.2d 121 (1956).

However, the Delaware court in Francis I. duPont & Co. v. Universal City Studios, Inc., 312 A.2d 344, 352 (Del. Ch. 1973), citing Poole, did not allow the market value of fully amortized films to be determined by discounting the film's projected income. See also infra note 383.

381. Mathematically the model is the same as the discounted earnings approach used in the traditional analysis. The major difference between the Delaware block concept of discounted earning value is not the theory; the difference is in determining the component parts. Mao, supra note 353, at 464-93.

382. This was one of the approaches used by the plaintiff in Weinberger. See supra text accompanying notes 319-26.

383. Early cash flow methods valued the firm using either dividends or net earnings. The dividend model's premise is that the investor's perception of the firm's value is a result of the firm's ability to pay dividends. The investor perceives a current income stream, rather than capital appreciation as the primary way to realize income. This argument is countered by the analysts who advocate the net earnings method.
jected over the life of the investment. At the termination of the investor's holding period, the firm's market value is the summation

The net earning advocates point out that capital appreciation is a significant portion of an investor's expected return. As a result of the income tax structure, dividends are not necessarily the optimum method of maximizing shareholder's wealth. The firm's earnings are first taxed on the corporate level. Then the dividends are again taxed as ordinary income to the investor. However, if the investor obtains his income by selling a portion of his stock, he incurs some transaction costs, but he might be able to receive a reduced income tax rate through capital gains. Further, by allowing the corporation to retain earnings, the net earnings can be reinvested and compounded with payment of only one income tax. The significance of retained earnings reinvestment becomes more pronounced as the investor's tax rate becomes larger.

Most investors in public markets are financial institutions, banks, trust companies, insurance companies, etc., thus their marginal tax is forty-six percent. For example, if the corporation has a pre-tax earnings of $100 and a marginal tax rate of forty-six percent, the after-tax balance left for reinvestment or the payment of dividends is $54. If the corporation can receive 10 percent on its investments, the $54 investment would return $5.40 in the first period, which if retained would increase the value of the firm. Now if the $54 is paid to a stockholder also with a 50 percent marginal tax rate only $26.00 is left for reinvestment by the stockholder. Therefore, for the stockholder to receive a return equal to $5.40, he must have investment opportunities returning 21 percent. An investment returning 21 percent will probably have considerably more risk than one returning 10 percent.

Even if the investor has better investment opportunities than the company, he can maximize his return by selling his stock to reinvest in the more profitable endeavors. With proper tax planning, the investor would benefit from capital gains, resulting in reinvestment of a larger gross amount. This line of argument supports the theory that investors value a firm by analyzing the firm's expected net earnings, rather than the firm's dividend payout. See Bhattacharya, Imperfect Information, Dividend Policy and 'The Bird in the Hand' Fallacy, BELL JOURNAL OF ECONOMICS 259-70 (Spring 1979). Bhattacharya developed a model, which explains why, in spite of the tax disadvantage, firms pay dividends. The reason for a dividend payout is the favorable signaling effect investors perceive.

However, the net-earnings analysis is not without problems. Net earnings are the result of accounting conventions, which not only can be changed but also might contain non-cash charges. Cash flow analysis considers changes in accounting conventions that have no effect on the firm's disposable cash. By changing accounting conventions, such as the method of inventory accounting or the rate of depreciation, reported net earnings may be changed. Unless the tax records are also changed, there would be no real change to disposable cash.

Two empirical studies show that investors are not misled by changes in accounting conventions. These studies indicate that discounting net cash flows are appropriate. Therefore, cash flow analysis is merely the normalizing of net earnings for changes in accounting conventions that do not affect disposable cash. Kaplan and Roll, Investor Evaluation of Accounting Information: Some Empirical Evidence, JOURNAL OF BUSINESS 225-57 (April 1972). Kaplan and Roll examined two types of accounting changes which increased earnings per share, but had no effect on cash flows. The results indicated that investors look beyond the effect on earnings per share to the effect on cash flows.

The life of the investment is not the same as the investor's holding period. Rather, the investment life refers to the period of time the investment generates cash, which could be longer than the investor's holding period.
of the remaining discounted cash flows, the value at which the investor could then dispose of his investment.\textsuperscript{385} To initiate the cash flow analysis, projecting the cash flows is required.

Cash flow projections may be based on historical data.\textsuperscript{386} But a better way to project cash flows is by means of the investment opportunities approach, which examines the firm's capacity to generate cash.\textsuperscript{387} Using this approach, the projected cash flows should be derived from three sources: first, the current cash flows generated by the firm's present investments;\textsuperscript{388} second, the cash flows generated from the firm's expected present and future investment opportunities;\textsuperscript{389} third, in the case of excess liquidity, excess cash can be considered the same as generated cash.\textsuperscript{390} The cash flows are then discounted by an interest rate reflecting both the time value of money (risk free rate), and the risk related to the firm's ability to generate the projected stream of cash flows.\textsuperscript{391}

The risk free portion of the discount rate is similar to the price

\begin{itemize}
  \item Mathematically, the cash flow model is similar to the earnings model. The equation would be: $V = \sum CF_n/(1 + r)^n$
  \item $V =$ Value of company.
  \item $n =$ number of periods.
  \item $r =$ discount rate reflecting: (1) time of value money, (2) uncertainty related to the projected cash flows.
  \item $CF =$ projected cash flows.

If the investor sold at the end of year (period) #2, the value of the firm at the time of sale would be equal to the projected stream of cash flows starting with the next period, i.e. year #3.

\textsuperscript{386} The Delaware block method generally used an average of the firm's preceding five years earnings to determine the projected earnings used in the discounted earnings approach. Delaware Racing, 213 A.2d at 212. Lynch, 402 A.2d at 12. See also supra note 97.

\textsuperscript{387} The firm's record of past cash generations might be indicative of future performance, but this should not be assumed without examination. The analyst should explain the basis for the past and expected future cash flows. Questions to be considered are: What projects and factors allowed the firm to generate its past cash flow? Are the same projects continuing to generate these cash flows, or will the existing projects require a substantial increase in capital reinvestment to maintain past levels of cash flows? Are new or different cash-generating projects being planned? This type of analysis, together with a statistical analysis of the past record adjusted for future expectations, should provide a more realistic approximation of the firm's future performance.

\textsuperscript{388} Id.

\textsuperscript{389} Id.

\textsuperscript{390} Id.

\textsuperscript{391} The plaintiff in Weinberger used the excess cash as an element of his cash flow projection. This is not inconsistent when finding the value of 100 percent owner-
a consumer demands to forgo current consumption. By foregoing present consumption he is entitled to increased consumption in the future. The price of foregoing current consumption has been referred to as the risk free rate or time value of money. This risk free rate might be approximated by the rate of short term government securities. The portion reflecting the firm’s business risk is more difficult to estimate.

The second portion of the discount rate must reflect the firm’s business risk. When the portion of the discount rate reflecting the firm’s business risk is added to the first portion, the risk free rate, the sum equals the firm’s cost of equity capital. The cost of equity capital. The 100 percent owner could drain off any excess liquidity to maximize his wealth.

The discount rate, which is the sum of the risk free rate and the rate reflecting the firm’s risk is equal to the company’s cost of equity. The cost of equity is the return a reasonable investor would expect to receive for investing in a venture given its risk. Mao, supra note 353, at 466. See also infra note 356.

392. Even in a world of certainty, a person would rather receive money today than a promise to receive the money in the future. Therefore, money received today is more valuable than money received at a later date.


394. Id. at 116.

395. Even United States government securities, which have virtually no default risk, are susceptible to interest rate risk. For instance, hypothesize an investor who purchases U.S. government bonds paying 10 percent. But before maturity the effective yield on similar bonds increases. The investor will not be able to sell his bonds unless he discounts their price to the extent that the purchaser will receive the new higher market yield. Therefore, although default risk is minimal, the interest rate risk can be substantial with long-term securities. So to approximate the risk free rate, the yield of very short-term government securities such as 90-day treasury bills should be used.

396. The concept of total firm risk is generally subdivided into two categories; systematic and unsystematic risk. Systematic risk is the risk of the market. If an investor held and equal investment in every market security, his return would fluctuate as the market return fluctuates. This fluctuation of return is caused by systematic risk. However, a single firm or an investor who holds less than a full market portfolio will also experience unsystematic risk. Unsystematic risk reflects the particular characteristics of the firm.

A firm’s unsystematic risk reflects on the firm’s ability to generate revenues and to control expenditures. The level of unsystematic risk is, among other things, a function of the firm’s efficiency and its level of fixed expenses, both operational and financial. Unsystematic risk can be reduced by diversification. An investor who owns a equal share of all market securities only encounters systematic risk. He does not encounter unsystematic risk. Therefore, the more securities held by an investor, the less unsystematic risk he will encounter. But systematic risk will still remain. For a good discussion of systematic risk see Copeland, supra note 393, at 191-94.

397. Id.
can also be viewed as the rate an investor requires for an equity investment in the firm, given the firm's level of risk.\textsuperscript{398} Assuming investors are risk adverse, if the investor felt firm A was more risky than firm B, he would require a greater return from firm A to compensate him for accepting the additional risk.\textsuperscript{399}

The following factors are generally believed to result in an increase or decrease in the perception of the firm's business risk.\textsuperscript{400} The investor views the volatility of the firm's cash flows as an indicator of the firm's business risk level.\textsuperscript{401} That is, an investor will require a chance for a higher return if more uncertainty is associated with the return. Therefore, a firm that has highly volatile cash flows must show more potential for gain to maintain its value than a firm with stable cash flows.\textsuperscript{402} Anything that affects the variance of the firm's earnings will be detrimental to the firm's value, unless the increase is associated with a proportional increase in the firm's expected return.\textsuperscript{403}

The firm's debt level is one such factor that can increase the volatility of the firm's earnings without decreasing the firm's value.\textsuperscript{404} Increased debt level has the effect of increasing the fixed costs of the firm. As fixed expenses are increased, whether from operations or from financing requirements, the firm's cash flows become more volatile given a change in sales volume.\textsuperscript{405} However, within limits, the

\textsuperscript{398} See supra notes 391, 396.

\textsuperscript{399} Most economic analysis assumes investors are risk adverse. The risk adverse investor prefers certainty and will pay for certain investments by accepting lower expected returns. The magnitude of an investor's risk adverse trait will vary, and can best be measured by utility theory. For example, an investor might have more disutility from losing $3.00, than positive utility from gaining or winning $5.00 in a game of coin toss. Therefore, to induce him to buy a chance to win, to play the game, the prize must be increased or the possible loss decreased. Copeland, supra note 393, at 84-92.

\textsuperscript{400} See supra note 396.

\textsuperscript{401} Empirical evidence indicates that increasing the dividend payout might act as a favorable signal to stockholders and investors about the firm's risk. See Ross, "The Determination of Financial Structure" The Incentive Signaling Approach, BELL JOURNAL OF ECONOMICS 23-40 (Spring 1977) (hereinafter cited as Ross).

\textsuperscript{402} Id.

\textsuperscript{403} Although debt increases the firm's risk by increasing the level of the firm's fixed cost, the market views an increase in debt as a positive signal. Assuming the firm is not close to cash insolvency, the market generally perceives that the increase in risk from an increase in the debt level is offset by the potential increase in cash flows. However, an adverse signal regarding the firm's risk might result from increasing both debt levels and dividend levels. See Ross, supra note 401.

\textsuperscript{404} Id.

\textsuperscript{405} Id.
increase in risk is offset by a perceived increase in investment opportunities. Therefore, an increase in the firm's debt level can result in an increase in the firm's value. The problem then is that given the firm's debt structure, past earnings performance, and future investment expectations, the financial analyst must develop both projected cash flows and an appropriate discount rate.

The analyst has at least a few analytical methods at his disposal. First, the analyst might use the firm's past performances along with annual reports and projections to predict the future cash flows. While most empirical evidence now shows that past cash flows alone are not good indicators of future cash flows, historical data might indicate the firm's risk performance. Unless the firm has recently changed its risk parameters, the appropriate discount rate may be determined from the historical data.

Second, the projections derived directly from the firm's plans, if available, might provide a good basis for projecting future cash flows. They will at least indicate the cash flows the firm is planning to generate. Further, the projections would indicate the type of investments contemplated by the firm, which would indicate the investment's risk, and therefore the firm's risk.

The accuracy of the cash flow projection is accounted for in the discount rate. To determine the appropriate discount rate, the analyst might examine other firms with similar product lines, similar investments, or similar volatility of earnings. Therefore, industrial classification or pseudo-industrial classification can provide forms with similar risk parameters that could be used to determine the appropriate discount rate. Once the projected cash flows are established and the appropriate discount rate is determined, the result

406. Id.
407. For a good example see Copeland, supra note 393, at 526-31.
408. Id.
410. Id.
411. Id.
412. See supra note 391.
413. See Elton, supra note 409.
414. See Elton, supra note 409.
is the value of the company under the discounted cash flow method.\textsuperscript{415} The tangible asset analysis is a valuation approach less theoretical than the discounted cash flow analysis.

**Tangible Asset Analysis**

The concept of tangible asset analysis states that the firm's value is equal to the sum of its net tangible asset values.\textsuperscript{416} Tangible asset analysis can be divided into two categories: (1) tangible book value\textsuperscript{417} and (2) liquidation value.\textsuperscript{418} Tangible book value is almost universally found to be a totally inappropriate method of valuing a firm.\textsuperscript{419} Assets on the firm's books may be drastically over or under stated.\textsuperscript{420} The market value of assets such as patents, natural resources, real estate, and physical assets, are especially susceptible to wide divergence from the book value. Even if an asset's market value is accurately portrayed by its book value, book value never includes the cost of disposal.

Liquidation value, or net asset market value, examines each major asset and determines what it can be sold for on the market. Therefore, the asset value analysis is equivalent to the sum of the net market values of the firm's liabilities and assets.\textsuperscript{421} If large blocks of land or assets exist, the disposal cost must be factored into the analysis. The major drawbacks to this type of analysis are its expense and time consumption.\textsuperscript{422} However, net asset value can accurately portray the minimum "fair value" of 100 percent ownership in a "going concern."\textsuperscript{423}

\textsuperscript{415} After the elements of the model are determined, the final step is the mathematical calculation. \textit{See supra} note 385.

\textsuperscript{416} Net tangible asset value is the net of the tangible assets' market value, less liabilities. Intangible assets such as goodwill are not included in the calculation.

\textsuperscript{417} Book value is the value of the assets as shown on the company's books.

\textsuperscript{418} Liquidation or market value is the value that net assets have on the open market, i.e. the price a willing buyer and a willing seller under no compulsion to buy or sell would pay for the assets.

\textsuperscript{419} Investors value assets by looking to the cash flows which the assets are capable of producing, not the book value, which results from a variety of accounting principles. \textit{See supra} note 155.

\textsuperscript{420} Because book value is typically on a cost basis, it is related to the length of time the asset has been held, which might not be relevant to the asset's market value. This is true because depreciation or appreciation schedules are generally unrealistic.

\textsuperscript{421} Once the component values and liabilities are found, the process becomes merely arithmetic balancing.

\textsuperscript{422} Appraisals of assets such as land, equipment, and inventory are both time consuming and expensive.

\textsuperscript{423} \textit{See infra} text accompanying notes 473-75.
SECTION III—EXPANDED FAIR VALUE CONCEPT

In order to decide which valuation theory is most useful with respect to a given set of facts, the question of what is "fair value" must first be considered. Is fair value the value to a minority shareholder before the merger; the "going concern" concept of the Delaware block as in Kirby? Or, is fair value the value of 100 percent ownership in the company, as the plaintiff argued in Weinberger? The Delaware Supreme Court in Lynch resorted to a remedy other than appraisal. The bounds of the rescissory remedy used in Lynch are greater than the traditional "going concern" constraints of the Delaware block.

Although the Delaware Supreme Court in Lynch chose rescissory damages, the later Weinberger decision, also involving a breach of fiduciary duty, did not use the rescissory damages approach. Rather, the Weinberger court looked to a middle ground in the form of an expanded valuation remedy, which contains elements of rescissory damages. Therefore, in expanding the appraisal remedy, the Delaware Supreme Court not only allowed the use of modern valuation techniques, but also expanded the traditional definition of "going concern" value to encompass consideration of the value of 100 percent ownership. This section will first examine the possible arm's length "going concern values," which after Weinberger may now be considered in freeze-out "fair value" determinations. This section will then examine some methods used to determine the various possible arm's length values, using the types of financial analyses previously discussed.

The Range Of Possible Arms Length Values

As previously detailed, the Weinberger decision not only expanded the appraisal remedy to include modern valuation techniques, but also expanded the concept of "going concern" value. The Delaware Supreme Court in Weinberger placed the burden of proving fairness on the party breaching the fiduciary duty, because the majority's directors were not dealing with the minority directors at arm's length.

424. The Delaware Supreme Court in Lynch resorted to rescissory damages. See supra text accompanying notes 214-37.
425. Id.
426. See supra text accompanying notes 333-49.
427. See supra text accompanying notes 238-349.
428. See infra text accompanying notes 430-55.
429. See infra text accompanying notes 456-84.
430. See supra text accompanying notes 333-49.
431. Weinberger, 457 A.2d at 703.
The court's holding arguably expands the fair value concept, where breach of fiduciary duty is found, from the narrow "going concern" value, the value of the minority ownership, to any value in the range of possible arm's length values supportable by modern financial analysis. The plaintiff in *Weinberger* argued that the fair value should be the value based on 100 percent company ownership. The Delaware Supreme Court held that the plaintiff could test the fairness of the offered price against the value representing 100 percent company ownership.

Under the *Weinberger* analysis, the fair value could equal the value to a 100 percent owner in cases where a breach of fiduciary duty is found. However, the 100 percent ownership value is but one value which could result from an arm's length acquisition of a minority shareholder interest. Therefore, an examination of the possible values resulting from an arm's length transaction is appropriate. To facilitate this analysis, four levels of value, spanning the range of possible arm's length values, will be considered. Ranging from a low value to a high value, the four values considered are: (1) the value of a minority interest, (2) the value of a controlling interest, (3) the value of a 100 percent owner, and (4) the value to an acquirer.

Value Of A Minority Interest (The Lowest Value Considered)

The value of a minority ownership interest in a company is the lowest value on the spectrum of possible arms length values considered. The minority owner's value is derived from his proportional share in the cash flows, which might result from both dividends

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432. Id. at 712-15.
435. Conceivably, an infinite number of possible arm's length values can result between the value limits of each party. However, the maximum arm's length value would be the value to the buyer. Likewise, the lowest arm's length value would be the value to the seller.
436. Since this note is concerned only with the purchase of the stock from the minority shareholders, the value to the minority shareholder, who is the seller, is the lowest possible arm's length negotiated value.
437. This note will illustrate that the value of the controlling interest is higher than the value of a minority interest.
438. The value of 100 percent ownership was the value argued for by the plaintiff in *Weinberger*. This section will point out where the value to a 100 percent owner lies on the spectrum of arm's length values.
439. Due to the possibility of synergy, the value to the acquirer, or buyer, is the highest possible arm's length negotiated value.
440. The value of a minority interest in a going concern was the objective of the Delaware block valuation method. See supra note 108.
and value appreciation of the company.\textsuperscript{441} However, the minority owner is at the mercy of management's ability and policies.\textsuperscript{442} On occasion the minority owner will not agree with management's policies or efficiency, in which case his most viable alternative is to sell his stock.\textsuperscript{443} However, the market in which he sells his stock, will be aware of the firm's level of management efficiency.\textsuperscript{444} Therefore, the arm's length value of a minority interest will reflect the potential buyer's limited control over both management's decision making ability and management's level of efficiency. Further, the value of the minority's equity is the lowest possible arm's length transaction value, because the minority owner does not have any control over the company other than his ability to organize other investors in order to achieve a controlling block.

Value of Controlling Interest

The value of the controlling interest is greater than the value of a minority owner, because of the controlling interest's power to change management. While the minority owner generally must accept management's decisions, the controlling interest can force management to change undesired policies, or can simply change management.\textsuperscript{445} The value of control is derived from the potential of improving management efficiency, thus increasing the value of the company. However, the controlling interest still has limits.

The controlling shareholder, through his directors, owes certain fiduciary responsibilities to the minority shareholders.\textsuperscript{446} For example,

\begin{itemize}
\item \textsuperscript{441} See supra text accompanying notes 375-415.
\item \textsuperscript{442} H. Henn, Law of Corporations 95 (2d ed. 1970) (hereinafter cited as Henn).
\item \textsuperscript{443} Although this area is beyond the scope of this note, the writer recognizes that special veto provisions, giving the minority shareholder more authority, exist in corporations. However, the general rule in public corporations is that of majority shareholder rule. \textit{Id.} at 338-405, 525.
\item \textsuperscript{444} Unless a new investor in the same security has additional stock, or control of additional stock, his voting, and therefore control over the corporation, is on the same level as the previous shareholder. \textit{Id.}
\item \textsuperscript{445} The controlling interest is limited in a number of ways. These include, for example, when meetings can be called, certain fiduciary duties, etc. However, for the purpose of this note, it is sufficient to point out that the controlling interest has the authority to effectuate a management change, which makes his ownership interest more valuable than a minority shareholder's interest. For limits on control see Henn, supra note 442.
\item \textsuperscript{446} Lynch, 402 A.2d at 7 (Directors representing the controlling shareholder failed to disclose material facts concerning a tender offer); Weinberger, 457 A.2d at 703 (The majority shareholder was cashing out the minority shareholders, but failed to disclose relevant information to the directors representing the minority shareholders).
\end{itemize}
the controlling shareholder cannot expropriate funds and assets from the company for his own interest. If the controlling shareholder has investments in other companies, he must be careful not to divert business or otherwise take advantage of his dual position with both companies at the expense of the minority owners. Consequently, the controlling owner, while having more power and value than the minority owner, is not free to exercise unlimited discretion as is the 100 percent owner.

**Value of 100 Percent Owner**

Absent any restriction from debt covenants, the 100 percent owner is free to do with a company as he pleases. If the 100 percent owner owns more than one economic entity, he does not have to be concerned with a conflict of interest with respect to any minority ownership. The 100 percent owner has complete and ultimate control of the company. He can liquidate the company, pay dividends, pass through tax savings, retain the earnings sheltered by a lower corporate tax, maximize his wealth, or give the company away. The value of 100 percent company ownership is therefore greater than the value of the controlling interest. Although the value of 100 percent ownership is greater than the value of controlling interest, the highest possible value might be the value to the acquirer.

*Value to the Acquirer*

A particular shareholder might have a special use for 100 percent ownership of a company which both enhances the value of his present firm, or economic entity, and the value of the acquired firm.

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447. *Id.*
449. The 100 percent owner does not owe a fiduciary duty to any other equity member. However, he may owe some duties to debt holders via loan covenants.
450. *Id.*
451. How much more valuable 100 percent ownership is than controlling interest depends upon the individual attributes of the parties. The value of the controlling interest and 100 percent ownership could be very close if the shareholder would not greatly benefit from 100 percent ownership. See *infra* note 453.
452. This increase in value could be the result of factors such as:
   1. Economies of scale in management, operations, accounting, etc,
   2. Monopolistic profits, either vertical or horizontal,
   3. Replacement of inefficient management,
   4. Tax considerations,
   5. Undervalued company—asymmetrical information,
   6. Reduction of unsystematic risk through diversification.

Copeland, *supra* note 393, at 561-69.
The increase in value to both entities is commonly referred to as synergy. As a result of synergy, the value of a firm can be more than the value to a 100 percent owner. For example, assume the value of firm A is equal to $100, and the value of firm B is equal to $50. If the firms merge to form firm C, its value without synergy will be $150. However, if the resulting value of firm C is equal to $200, the transaction resulted in the creation of synergy equal to $50. The preceding example could result if, for instance, firms A and B were the only two firms in a particular industry. Therefore, by merging into one firm, C, they will enjoy monopoly profits, which will increase C's value in excess of the individual values of the component firms, A and B. The value of firm B is only $50 to any firm in another industry, but due to the possibility of monopoly profits, firm A considers the value of firm B greater than $50. Consequently to a particular acquiring company, the value of a company might be greater than the value to a 100 percent owner due to the effect of synergy.


The Cox article examines Mills v. Electric Auto-Lite. See infra text accompanying notes 485-572. More specifically, the article considers the application of Brudney and Chirelstein's valuation of the minority stock's "fair value" in Mills. The article states that synergy is found in most mergers, but more often in conglomerate mergers rather than horizontal or vertical mergers. Cox notes that there are many more reasons why intra-industry mergers should result in a synergy value. These reasons include the following: economies of scale, operating efficiency, market expansion, monopolistic power, administrative and managerial efficiencies, and complementing operations in areas such as technology, marketing, and research.

Cox notes that there is a major source of synergy in conglomerate mergers called financial synergy which includes: "instantaneous synergy," "latent debt capacity," "defensive diversification," or "bargain purchase."

1. "Instantaneous synergy" Cox defines as an increase in the conglomerate's earnings per share, accompanied by an increase in the conglomerate's "price-earnings" ratio.
2. "Latent debt capacity" Cox defines as an increase in the conglomerate's debt capacity resulting from merging with a firm that has a lower debt to equity ratio.
3. "Defensive diversification" is defined as the stabilizing of the conglomerate's earnings fluctuations, which generally are considered an indicator of the conglomerate's risk. The more volatile the conglomerate's earnings the more risk, therefore, the more return it must provide to maintain or increase its price. Such diversification not only increases income but also reduces risk.
4. "Bargain purchase" is defined as buying the firm for less than what it is worth. Cox discounts this theory. He assumes the market is efficient with perfect information and adequate breadth. Therefore, any "bargain" would probably be bid out of existence.

The final aspect to his article restates the finding in Mills, which holds that the proper procedure to find fair value is to first find the synergy value, and then
In sum, the spectrum of possible values that can result from arm's length negotiations between companies contemplating a merger range from the low value, the value of a minority interest, to the high value, the value to the acquiring firm. The analyst and the lawyer must know how to determine these four values through the use of the financial valuation techniques previously discussed.

SECTION IV—DETERMINING POSSIBLE VALUES RESULTING FROM ARM'S LENGTH NEGOTIATIONS

Determining The Value Of A Minority Interest

The value to a minority shareholder reflects both the minority shareholder's right to a proportional share in the firm's present and expected future profits and the minority shareholder's lack of control over the decisions of management. In the case of publicly traded companies, this value is directly reflected in each company's market price. Most economists would apply the efficient market hypothesis in this case. The efficient market hypothesis states that given the information available to the minority shareholder, the market price reflects the risks and returns of minority ownership. However, the market price might not reflect undisclosed information relevant to the firm's future expected profits.

If a court found that management owed a duty to disclose this relevant information, a discounted cash flow approach could be used to establish the value of the information. The value of the information would then be added to the market price to establish the value of the minority ownership. To determine the components of the discounted cash flow analysis, the best source would be the actual plans of management. However, if the actual plans are not available, the

divide it between the interests on a proportional basis. He considers this to be a "fair allocation," but states that the proportional division of the synergy value may depend in part on why the synergy came about.

454. See supra note 435.
455. See supra text accompanying notes 350-425.
456. See supra notes 443-45.
457. See supra text accompanying notes 360-74.
458. See supra text accompanying notes 360-74.
459. See supra text accompanying notes 360-74.
460. See supra note 367.
461. See supra text accompanying notes 375-415.
462. In effect the market price is adjusted as if the information were disclosed.
463. The plaintiff in Weinberger used UOP's five year business plan to project cash flows. Weinberger, 426 A.2d at 1362.
Determination of investment a management approach through value minimal disclosure.

The analyst could look to similar projects or product lines implemented by other companies. The comparison to other firms which implemented similar projects would also determine the appropriate discount rate. Therefore, with both components, the expected cash flows and the discount rate, the value of the undisclosed information can be determined.

By multiplying the value of the undisclosed information by the percentage of equity owned by the minority shareholder, the proportional distribution is determined. The minority owner is entitled to a proportional interest in the return of the net expected cash flows adjusted for the project's risk. After the proportional value of the undisclosed information is determined, it should be added to the market price. The result is an approximation of the market value of the minority shareholder's interest after the undisclosed information becomes public. Moreover, this adjusted value should be the minimum value in an arm's length negotiation. As stated above the value of a minority interest reflects the minority shareholders' lack of control over management. Of course, if a shareholder can control management, the value of his stock would be enhanced.

Determining The Value Of Controlling Interest

The value of the controlling interest is difficult to quantify through financial analysis. For instance, if the investment opportunities approach was used, an analysis of all the company's possible investment opportunities would be required. Since the controlling interest can change both the direction of investments and the level of risk, a cash flow analysis would have to consider virtually every known investment opportunity.

However, for the situations examined in this note, the problem

464. Elton, supra note 409, at 78.
465. Id.
466. This step is necessary to give the minority shareholder his proportional share of the value of the undisclosed information. See supra note 367.
467. Net expected cash flows equals the projected returns minus the projected cash invested and minus projected expenses to be encountered.
468. See supra note 367. Also this assumes the market has not already discounted the undisclosed information.
469. See supra text accompanying notes 440-44.
470. Since the owner of the controlling interest can change the direction of the company, the analysis would have to relate to how he proposes to change the company. The projected risks and returns relating to such a change, or a comparison of the industry, would be appropriate. See Elton supra note 409, at 78.
of valuing the controlling interest through financial analysis does not arise. This note considers only instances where the controlling interest is already purchased by the majority shareholder. Therefore, an approximation of controlling interest value might be the actual cost to the majority shareholder.\footnote{471}{Brudney and Chirelstein, \textit{Fair Shares in Corporate Mergers and Takeovers}, 88 Harv. L. Rev. 297 (Dec. 1974) (hereinafter cited as Brudney).} However, for the purposes of this note it is enough to point out the relative value of the controlling interest. The value of the controlling interest is greater than the value of a minority interest, but less than the value of 100 percent ownership.\footnote{472}{See supra text accompanying notes 445-48.}

\textit{Determining The Value Of 100 Percent Ownership}

The value of 100 percent ownership depends on the efficiency of the 100 percent owner or his management, but at a minimum it is the net market value of the firm's assets.\footnote{473}{The 100 percent owner can increase management efficiency or simply sell the company's assets. The market values of the assets are based on their ability to generate cash. Therefore by selling the assets, the 100 percent owner is accepting the general efficiency of the market's management.} If the 100 percent owner or his management is highly efficient, the market price of the company's equity would be more than the net market value of the firm's assets.\footnote{474}{If the 100 percent owner can increase the management of his firm to a level greater than the market efficiency, the market value of his company as a "going concern" will be greater than the market value of the firm's net asset value.} However, the 100 percent owner might manage the company's assets less efficiently than other firms. In this case, the market value of his 100 percent interest becomes the net market value of the firm's assets.\footnote{475}{See supra note 473. Also the assets might have an operating synergy; thus the market value of the assets would be greater if they are sold as a block, rather than individually.} Consequently, without evaluating the efficiency of management, the minimum value of a 100 percent ownership is the net market value of the firm's assets less its liabilities. Further, the value of 100 percent ownership is the maximum value resulting solely from the attributes of the firm. Any value above the value of the 100 percent ownership results from the expected synergistic value to the acquirer.

\textit{Determining The Value To The Acquirer}

Since the value to the acquirer is the result of expected synergy, its dollar amount is a function of the factors causing the synergy.\footnote{476}{See supra notes 452, 453.}
The value of the expected synergy can be approximated by looking to the reason for the acquisition. Usually the determination of the value to the acquirer is not necessary, unless the court perceives "fair value" as including the complete benefit of the bargain.

In summary, the Delaware Supreme Court in Weinberger opened up a range of possible values for consideration as the fair value. The Weinberger court held that, where a breach of fiduciary duty was found, the plaintiff would be allowed to test the fairness of the offered price against the 100 percent ownership value. Further, at the discretion of the chancellor, the court could consider elements of rescissory damages. Delaware has recognized that arm's length negotiations could result in a value equivalent to the value of a 100 percent owner. Consequently, the Delaware Supreme Court does not preclude the use of the value to a 100 percent owner in determining "fair value." State freeze-out actions are not the only situations which require finding "fair value." The issue of finding "fair value" has also been an essential element of civil actions involving violations of the Securities and Exchange Act of 1934.

SECTION V — THE LIMITED FEDERAL APPROACH USED TO DETERMINE "FAIR VALUE"

The issue of fair value determination has also arisen in cases involving proxy statement nondisclosures which constitute violations of the Securities and Exchange Act of 1934. Like state courts, the federal courts have had problems in fleshing out the elusive "fair

477. See supra text accompanying notes 452, 453.
478. See supra notes 337-39.
479. See supra text accompanying notes 238-349.
480. Weinberger, 457 A.2d at 714.
481. Id.
482. Id.
483. While the court does not define fair value as the value of 100 percent ownership, the court certainly does not preclude fair value from equaling the value of 100 percent ownership.
484. See infra text accompanying notes 485-572.
485. Securities Exchange Act of 1934 [hereinafter cited as "the 1934 Act"]. This section of the note will deal with section 14(a) (and the Rule promulgated thereunder): (a) It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted
value” concept. Some circuits have adopted the “efficient market” approach of valuation analysis. The Seventh Circuit Court of Appeals has used the efficient market hypothesis as a starting point for the fair value analysis; the resultant fair value was based in part on a sharing of the synergy. The analysis in Mills v. Electric Auto-Lite Co. is a good example of this approach.

Auto-Lite was a diversified company engaged primarily in the sale of auto parts. Mercenthaler, which primarily produced typesetting equipment, began purchasing Auto-Lite’s stock in 1957. By March of 1962, Mercenthaler owned 54.2 percent of Auto-Lite, and thus was able to obtain control of Auto-Lite’s board of directors. In early 1963, Mercenthaler attempted to merge Mercenthaler and Auto-Lite into a new company named Eltra Corporation. On May 28, 1963, Auto-Lite’s board of directors, controlled by Mercenthaler, voted to accept the proposed merger. Proxy statements including a proxy statement were sent the next day to Auto-Lite’s shareholders. An additional thirteen percent vote from Auto-Lite’s minority shareholders

security) registered pursuant to section 781 of this title.


Rule 14a-9 promulgated thereunder.

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.


487. We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. Mills, 552 F.2d at 1247. See also supra note 486.

488. Mills, 352 F.2d at 1249.


490. Mills, 552 F.2d at 1240.

491. Id.

492. Id.

493. Id.

494. Id.

495. Id.
was necessary in order to obtain the required two-thirds vote.\textsuperscript{496} The merger was approved on June 27, 1963.\textsuperscript{497} As a result, the minority shareholders of Auto-Lite instituted a class action suit challenging the corporate merger.\textsuperscript{498}

The plaintiffs filed suit in district court on June 26, 1963, alleging that the proxy statement did not disclose that Auto-Lite’s board of directors was controlled by Mergenthaler.\textsuperscript{499} Therefore, they argued the proxy statement was in violation of section 14(a) of the 1934 Act.\textsuperscript{500} The minority shareholders requested that the merger be set aside. The district court found for the plaintiffs, but the appellate court reversed on the issue of causation.\textsuperscript{501}

The United States Supreme Court reversed, stating that the plaintiffs had made a sufficient showing of causation by proving that the necessary proxies had been obtained by means of material misrepresentations.\textsuperscript{502} Further, the Supreme Court stated that the lower court was not required to set aside the merger, but could look to other remedies, such as monetary relief.\textsuperscript{503} The Supreme Court suggested two possible methods of determining potential monetary relief.\textsuperscript{504} First, the minority shareholders might be compensated for a reduction in their stock’s earnings potential as a result of the merger.\textsuperscript{505} However, if the plaintiffs could not show such a reduction in earnings potential, an award could be based on the “fairness” of the merger terms at the time of the merger.\textsuperscript{506} The district court, on remand, decided not to rescind the merger, rather it applied the second method of determining damages, as suggested by the Supreme Court.\textsuperscript{507}

\textsuperscript{496} Id.
\textsuperscript{497} Id.
\textsuperscript{498} Id.
\textsuperscript{499} Id.
\textsuperscript{500} See supra note 485.
\textsuperscript{501} 
\textsuperscript{502} 
\textsuperscript{503} 
\textsuperscript{504} 
\textsuperscript{505} 
\textsuperscript{506} 
\textsuperscript{507} 

\textsuperscript{501} Mills, 403 F.2d 429 (7th Cir. 1968).
\textsuperscript{502} Mills, 396 U.S. 375 (1970).
\textsuperscript{503} The Supreme Court then stated that since, “the misleading aspect of the solicitation did not relate to terms of the merger, monetary relief might be afforded to the shareholders only if the merger resulted in a reduction of the earnings potential of their holdings.” However, if this decrease in earnings potential could not be determined, because of the commingling of assets, a “fairness” approach might be used. The fairness approach envisioned an award based on the “fairness” of the merger terms at the time of the merger. Further, the Supreme Court noted that the two methods illustrated for determining monetary relief were not to be considered exclusive. Mills 396 U.S. at 388-89.
\textsuperscript{504} Mills, 396 U.S. at 389.
\textsuperscript{505} Id.
\textsuperscript{506} Id.
\textsuperscript{507} Mills, 552 F.2d at 1243.
The district court determined the merger terms were unfair and awarded damages of $1,233,918.35 plus interest. Both parties appealed.

No Reduction In Earnings Potential

On the second appeal, the primary issue was to determine what damages, if any, could be awarded as a result of the proxy nondisclosure. The appellate court examined both suggested methods of determining monetary damages. First, as to whether the plaintiff was entitled to compensation for a loss in potential earnings power, the appellate court compared Auto-Lite’s dividend policy with the dividend policy of the newly formed firm. The analysis began by looking at the exchange ratio of the merger offer. For every one share of Auto-Lite stock, the minority shareholder was to receive 1.88 “preferred” shares of Eltra’s stock, the new company.

After examining the exchange ratio, the amount of dividends was calculated. At the time of the merger, Auto-Lite was paying a dividend of $2.40 per share and Mergenthaler was paying $1 per share. Under the merger agreement Eltra was to pay dividends of $1 per share for common stock and $1.40 per share for preferred stock. The appellate court determined that the proposed dividends to Auto-Lite’s minority shareholders would increase by $.23 per share from $2.40 per share to $2.63 per share. Eltra’s preferred stock was more valuable than Auto-Lite’s common stock, because the stock paid higher dividends, was more secure, and was convertible into common shares. Therefore, the appellate court concluded that the earnings potential of Auto-Lite’s minority shareholders’ stock was enhanced, rather than weakened, by the merger.

508. Id. at 1244 n.4.
509. Id. at 1241.
510. Part of this major issue is choosing the proper method of determining fairness of merger terms when the solicitor of the merger both controls the board and fails to disclose such control.
511. Mills, 552 F.2d at 1242-50.
512. Note the assumption that the company’s value is reflective of the company’s dividend policy.
513. Mills, 552 F.2d at 1241.
514. Id. at 1242.
515. Id.
516. Id.
517. Id.
518. Calculated by the following: (1.88 X $1.40 = $2.63) Id.
519. Id.
520. Id.
Next the appellate court looked at the subsequent performance of Eltra's stock and determined that Auto-Lite's shareholders received more than a fair price for their stock in Auto-Lite.\textsuperscript{521} Eltra's preferred stock was being sold in the month following the merger for $31.06.\textsuperscript{522} Eltra's common stock sold for $25.25 during the same period.\textsuperscript{523} Due to the 1.88 exchange ratio afforded Auto-Lite's minority shareholders, they received a cash equivalent of $58.39 per share.\textsuperscript{524} Because Mergenthaler's stock was exchanged at a 1 to 1 ratio, Auto-Lite's minority shareholders received 2.31 times the value of Mergenthaler's stock.\textsuperscript{525}

Finally, with respect to proving a reduction of potential earnings, Auto-Lite's minority shareholders alleged that Eltra appropriated liquid assets from the old divisions belonging to Auto-Lite and shifted the liquid assets to other divisions.\textsuperscript{526} The appellate court pointed out that after the merger the divisions became one economic entity.\textsuperscript{527} Therefore, Eltra's management was merely increasing the efficiency of the company by transferring assets to where they would be most productive.\textsuperscript{528} This action would benefit both Auto-Lite's minority shareholders and Mergenthaler's shareholders.\textsuperscript{529} Auto-Lite's minority shareholders then noted that post merger operations of the division associated with Auto-Lite produced almost 5 times more profit than the divisions associated with Mergenthaler.\textsuperscript{530} The minority shareholders contended that this disparity in profitability proved that the price paid for Auto-Lite, which was 2.31 times Mergenthaler's stock value, was inadequate.\textsuperscript{531}

However, the appellate court noted that use of post-merger performance assumes the divisions operated independently from each other.\textsuperscript{532} Therefore, the profits could have resulted from the input of Mergenthaler's talent, economies of scale, or quality of management.\textsuperscript{533}

\begin{itemize}
  \item 521. \textit{Id.}
  \item 522. \textit{Id.}
  \item 523. \textit{Id.}
  \item 524. Calculated by the following: ($1.88 \times 31.06 = 58.39) \textit{Id.}
  \item 525. Calculated by the following: ($58.39 \div 25.25 = 2.31) \textit{Id.}
  \item 526. \textit{Id.}
  \item 527. \textit{Id.}
  \item 528. \textit{Id.}
  \item 529. \textit{Id.}
  \item 530. \textit{Id. at 1243.}
  \item 531. \textit{Id.}
  \item 532. \textit{Id.}
  \item 533. \textit{Id.}
\end{itemize}
Since the assets were commingled, post-merger performance could not be indicative of the fairness of the merger.\textsuperscript{534} 

Even without the commingling of assets, the appellate court held that post-merger evidence could at best create only a rebuttable inference of unfairness.\textsuperscript{535} It was impossible to know whether the increase of earnings of one partner to a merger was predictable at the time of the merger.\textsuperscript{536} The court found that the plaintiff did not prove that the defendant should have known Auto-Lite's business would become more profitable than the rest of the company.

\textit{No Justifiable Damages Based On Unfairness}

After finding no reduction in earnings potential, the court reviewed the fairness question.\textsuperscript{537} The appellate court first looked to the analysis of the district court.\textsuperscript{538} The district court based its damages on the assessment of fairness at the time of the merger.\textsuperscript{539} Five factors were considered: (1) The market value of the companies' stock; (2) The companies' earnings; (3) The companies' asset book value; (4) The dividends paid by each company; (5) Other qualitative factors.\textsuperscript{540}

The district court found that earnings and book values demonstrated that the merger was unfair.\textsuperscript{541} The court determined that a fair exchange ratio would be 2.35 shares of Eltra's stock for each share of Auto-lite's stock.\textsuperscript{542} The district court further found that Auto-Lite's minority shareholders actually received an equivalent of 2.25 shares of Eltra common stock for each share of Auto-Lite stock.\textsuperscript{543} Therefore, the court awarded damages of $1,233,918.35 based on the .10 difference.\textsuperscript{544} Further, the district court found that market value was unreliable and discounted the importance of dividend policy.\textsuperscript{545}

\begin{itemize}
\item \textsuperscript{534} \textit{Id.}
\item \textsuperscript{535} \textit{Id.} at 1244.
\item \textsuperscript{536} \textit{Id.}
\item \textsuperscript{537} \textit{Id.}
\item \textsuperscript{538} \textit{Id.}
\item \textsuperscript{539} \textit{Id.}
\item \textsuperscript{540} \textit{Id.}
\item \textsuperscript{541} \textit{Id.}
\item \textsuperscript{542} \textit{Id.}
\item \textsuperscript{543} This calculation of a 2.25 exchange ratio is incorrect. \textit{Id.} at 1244 n.6.
\item \textsuperscript{544} \textit{Id.} at 1244.
\item \textsuperscript{545} The district court discounted the significance of the comparative market values of Auto-Lite and Mergenthaler, because in the preceding five years there were purchases of Auto-Lite's stock by both Auto-Lite and Mergenthaler and purchases of Mergenthaler's stock by American Manufacturing Co. The appellate court dismissed
\end{itemize}

\url{https://scholar.valpo.edu/vulr/vol19/iss2/6}
The appellate court held that the market price nearest to the merger was reliable and reflected the value of the companies.\textsuperscript{546} However, to account for any short term price fluctuations, an average price for a period of six months prior to the merger date was used.\textsuperscript{547} The court found the ratio between the average stock prices was 2.1 and was fairly stable over a two year period.\textsuperscript{548}

The appellate court then compared the before merger stock prices and the effective exchange ratio. The 2.1\textsuperscript{546} ratio of premerger stock prices was compared to the 2.31\textsuperscript{550} ratio calculated from the ultimate price\textsuperscript{551} of Eltra’s preferred stock times the 1.88 exchange ratio given to Auto-Lite’s minority shareholders divided by the price of Eltra’s

the assessment of unreliability due to the small nature of the purchases in question when compared to the total stock sales of either company. \textit{Id.} at 1245. Further, a greater number of purchases of Auto-Lite took place during the last three years prior to the merger, which if affecting the stock price at all would tend to inflate the price. \textit{Id.} 546. We hold that when market value is available and reliable, other factors should not be utilized in determining whether the terms of a merger were fair. Although criteria such as earnings and book value are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise’s worth. In this case thousands of shares of Auto-Lite and Mergenthaler were traded on the New York Stock Exchange during the first part of 1963 by outside investors who had access to their full gamut of financial information about both corporations, including earnings and book value. If we were to independently assess criteria other than market value in our effort to determine whether the merger terms were fair, we would be substituting our abstract judgment for that of the market. Aside from the problems that would arise in deciding how much weight to give each criterion, such a method would be economically unsound.

\textit{Id.} at 1247-48.

The plaintiff argued that Mergenthaler used its control over Auto-Lite to force it to pay high dividends, thus depressing its price, i.e., draining Auto-Lite’s capital while raising the price of Mergenthaler by giving Mergenthaler funds in the form if dividends?. The appellate court stated that increased dividends should have made Auto-Lite’s stock more attractive. \textit{Id.} at 1247.

Because of this dividend policy and a change in the industry, Auto-Lite minority shareholders claimed that only during the period between 1958 and 1960 did the market value reflect an accurate value. The appellate court found this argument unacceptable. The market value in 1961 reflected the uncertainty of Auto-Lite’s future and continued to do so until the merger. \textit{Id.}

547. \textit{Id.} at 1246.

548. \textit{Id.} at 1246 n.10.

549. See supra note 525.


551. Mills, 552 F.2d at 1246.
common stock. Since the ratio comparison assumes that the value of the ultimate company, Eltra, was merely the sum of the two companies' values, it did not take into account synergy. However, the appellate court held that fair value should include an element of the synergy created by the merger.

**Effect Of Synergy On Fair Value**

The appellate court accepted and applied the analysis propounded by Professor Brudney and Chirelstein, which requires consideration of synergy in finding fair value. Therefore, the court found that ratio analysis alone might lead to incorrect results. Professors Brudney and Chirelstein argued that the minority shareholder should be compensated for not only the market value of his stock, but also a portion of the increase in the value of the ultimate company resulting from the synergy created by the merger. The proportion the minority shareholder should receive is directly related to their proportional share of ownership.

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552. *Id.*
553. *Id.* at 1248. See also *supra* notes 449, 450 and text accompanying notes. Since the ratio's incorporated post merger values, the values already accounted for any synergy resulting from the merger. In short, the post merger values represent the value of a minority equity interest of the post merger concern. Since the *Mills* Court chose a value greater than that based on the post merger market prices, the court was defining "fair value" as a value larger than the value of a minority interest in the post merger firm.
554. *Mills*, 552 F.2d at 1248.
556. *Id.*
557. *Id.*
558. The appellate court applied Professors Brudney and Chirelstein's approach through the following calculations:

**GIVEN:** (AT THE TIME OF THE MERGER)
1. 532,550 share of Auto-Lite were held by the minority shareholders;
2. 2,698,822 shares of Mergenthaler were outstanding;
3. During the first part of 1963 Auto-Lite's average per share price was $52.25;
4. During the first part of 1963 Mergenthaler's average per share price = $24.875;
5. POST MERGER VALUES (one month after merger) Eltra's common = $25.25; Eltra's preferred stock = $58.39 (to Auto-Lite's minority shareholder based on the 1.88 exchange ratio).

**CALCULATIONS:**
1. 532,550 X 52.25 = $27,825,737 (PREMERGER VALUE OF Auto-Lite)
2. 2,698,822 X 24.875 = $67,133,197 (PREMERGER VALUE OF Mergenthaler)
3. SUMMATION (1. + 2.) = $94,958,934 (POST MERGER VALUE, NO SYNERGY)
4. The minority shareholder owns 29.3 percent of Eltra

https://scholar.valpo.edu/vulr/vol19/iss2/6
Applying the Brudney and Chirelstein approach, the appellate court found that the minority shareholders received more than a fair price for their stock.\textsuperscript{559} Auto-Lite’s minority shareholders received in excess of the proportion of synergy they were entitled to receive.\textsuperscript{560} Therefore, the minority shareholders could not show damages as a result of the “unfair” merger terms.\textsuperscript{561}

**Summary Of The Approach Adopted By The Court In Mills**

The approach adopted in *Mills* defines “fair value” as the market value of the minority shareholder’s stock plus a proportional share of any synergy that may result from the merger.\textsuperscript{562} It follows that the value sought is greater than the minority value, but less than the value to the acquirer.\textsuperscript{563} In determining the fair value, the federal approach begins by using the efficient market hypothesis.\textsuperscript{564} The efficient market hypothesis states that the traded price is equal to the minority value of the firm.\textsuperscript{565} This federal approach then examines the synergy\textsuperscript{566} which might have resulted from the transaction.\textsuperscript{567}

**ACTUAL POST MERGER VALUE**

\begin{align*}
1. & \quad 532,550 \times 58.39 = \$31,095,594 \\
2. & \quad 2,698,822 \times 25.25 = \$68,145,255 \\
3. & \quad \text{SUMMATION (1. + 2.)} = \$99,240,894 (\text{POST MERGER VALUE WITH SYNERGY}) \\
\end{align*}

SYNERGY = \$99,240,894 – \$94,958,934 = \$4,281,915 \times 29.3\% = \$27,825,737 = \$29,080,338. $29,080,338 is equivalent to 1,151,696.5 shares of Eltra at \$25.25 per share or a 2.16 ratio.

The Auto-Lite minority shareholders actually received \$31,095,594 which is \$2,015,256 more than \$29,080,338. The court held that 2.16 shares of Eltra common per share of Auto-Lite would have been fair, when in fact the minority shareholder received an equivalent of 2.31 of Eltra’s common.

\textsuperscript{559} *Id.* at 1249.
\textsuperscript{560} *Id.*
\textsuperscript{561} *Id.*
\textsuperscript{562} *Mills*, 552 F.2d at 1248.
\textsuperscript{563} The *Mills* court used the efficient market hypothesis to establish the market value of the stocks. By definition, this value objective is the value of a minority interest in a going concern prior to the merger or transaction. The court further added a portion of the synergy that resulted from the merger. Because the market price should already reflect synergy, the court might be using the concept of synergy to reflect an objective value greater than the value of the minority shareholder, which would be the market price. However, only a proportional amount of the synergy was awarded to the minority shareholders; thus the resultant value must be less than the value to the acquirer. The value to the acquirer would include all the synergy value.

\textsuperscript{564} See *supra* notes 487, 546.
\textsuperscript{565} See *supra* text accompanying notes 360-74.
\textsuperscript{566} See *supra* note 453.
\textsuperscript{567} *Mills*, 552 F.2d at 1248.
If synergy did result, the fair value should be based on a proportional split of the synergy between the majority shareholder and the minority shareholders. Consequently, if the price paid for the minority shareholder's stock is less than the stock price plus his proportional share of the synergy, he will be able to prove damages. If, on the other hand, as in Mills, the stock is acquired by the majority shareholder at a price in excess of the market price plus the minority shareholder's proportional share of the synergy, the minority shareholder will not be able to show damages. Therefore, the Mills court established certain guidelines for finding damages based on the value of a minority shareholder's interest, plus a proportional share of any synergy created by the transaction.

Although Mills established a concept of fair value, the guidelines established in finding fair value have limited usefulness. The analysis used in Mills requires a market value hindsight approach where two publicly traded companies merge using an exchange of stock to form a third, publicly traded company. In a cash out transaction or in a situation where the resulting companies are no longer publicly traded, the Mills analysis would not be useful. However, as in most areas of the law, legal guidelines eliminating uncertainty and providing fair notice even in limited areas are desirable. This note suggests a methodology to establish guidelines in determining "fair value" that are both more flexible and have more applications. The proposed guidelines can be used in both SEC violations and state freeze-out actions.

SECTION VI—A NEW APPROACH TO AN OLD PROBLEM: DETERMINING "FAIR VALUE"

The proposed guidelines utilize the modern valuation principles previously discussed, which are allowed in Delaware freeze-out actions subsequent to Weinberger and are used in civil actions under the federal securities laws. The proposed objective of the valuation is to determine fair value within the spectrum of possible arm's length values. The analytical guidelines link the concept of fairness in deal-

568. See Brudney supra note 555.
569. Mills, 552 F.2d at 1248.
570. Id. at 1249.
571. Id.
573. See supra text accompanying notes 350-423.
574. See supra text accompanying notes 238-349, 485-572.
575. See supra text accompanying notes 424-84.
ing with the dissenting or minority shareholder to the concept of finding a fair value. Utilizing the proposed guidelines, the degree of unfair dealing determines the level of fair value to the minority shareholder. Therefore, the proposed analysis starts with a fairness determination in dealing with the minority shareholder.

**Step 1: Determining The Degree Of Fair Dealing**

The determination of fair dealing is currently the necessary first step in both state freeze-out actions as well as actions under the 1934 Securities Act. In federal courts, to sustain an action alleging a violation of section 10(b) under the 1934 Act, the plaintiff must allege a high level of culpability or unfair dealing in the form of reckless or intentional misrepresentation. In the private civil actions such

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576. This is consistent with the entire fairness concept propounded by the Delaware Supreme Court in *Weinberger*. "However, the test of fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness." *Weinberger*, 457 A.2d at 711.

577. Securities and Exchange Act of 1934 § 10(b); 15 U.S.C. § 78j (1976). It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
(b) To use or employ, in connection with the purchase or sale, of any security registered on a national securities exchange, or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, promulgated thereunder:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
(a) To employ any device, scheme, or artifice to defraud,
(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. 240.10b-5.

578. The United States Supreme Court reversed the Court of Appeals for the Seventh Circuit, holding that to maintain a civil cause of action under the SEC Rule 10b-5, the plaintiff must allege a scienter, or an "intent to deceive, manipulate or
as Mills which involved violations of section 14(a) of the 1934 Act, the
required culpable conduct is merely the negligent preparation of
a proxy statement which contains material misrepresentations or
omissions.\textsuperscript{579} Therefore, in order to determine whether the standards
of culpability required under section 10(b) and section 14(a) have been
met, the court must inquire into the defendant's level of unfair
dealing.\textsuperscript{580}

In actions involving violations of the anti-fraud provisions of the
1934 Act, section 10(b) and Securities Exchange Commission Rule 10b-5
promulgated thereunder, the court must first determine whether the
defendant had the requisite scienter.\textsuperscript{581} It then must find either a
misrepresentation or omission of a material fact with respect to the
purchase or sale of a security.\textsuperscript{582} The United States Supreme Court
in Santa Fe Industries v. Green,\textsuperscript{583} an action brought under Rule 10b-5,
held that the plaintiff must allege more than breach of fiduciary duty;\textsuperscript{584}
he must allege that the defendant possessed the scienter required
under Ernst & Ernst v. Hochfelder.\textsuperscript{585} Although the fundamental pur-
pose of the Securities and Exchange Act of 1934 is "to substitute a
cases have held that reckless conduct by the defendant might be enough to sustain
a civil cause of action. However, Ernst holds that more than mere negligence must
be found to sustain a 10b-5 cause of action. Ernst, 425 U.S. at 201. See also infra note 579.

\textsuperscript{579} The issue of culpability with respect to civil actions under SEC 14(a) has
not yet been decided by the United States Supreme Court. However, courts, such as
Mills, have allowed actions involving misleading statements or omissions which might
have resulted from mere negligence. See supra note 485, and text accompanying notes
485-572.

\textsuperscript{580} See supra note 578.

\textsuperscript{581} Id.

\textsuperscript{582} The plaintiffs met the requirement that they purchased, or in this case
sold, their stock relying on the information disclosed. Superintendent of Insurance v.
Banker's Life & Cas. Co., 404 U.S. 6, 12-13 (1971), but the nondisclosure was found
to be immaterial. Santa Fe Industries v. Green, 430 U.S. 462, 476 (1977), on remand,
562 F.2d 4 (2d Cir. 1977).

\textsuperscript{583} 430 U.S. 462 (1977), on remand, 562 F.2d 4 (2d Cir. 1977).

\textsuperscript{584} Santa Fe, 430 U.S. at 473-74. The facts in Santa Fe are the same as the
facts in Kirby. See text accompanying notes 485-563. The plaintiff brought a federal
cause of action against Santa Fe for violation of section 10(b) of the 1934 Act. However,
the court did not find either "deceptive or manipulative" conduct by the plaintiff.
Although the plaintiffs alleged a breach of fiduciary duty, they did not allege any
deception, misrepresentation or material nondisclosure. Santa Fe, 430 U.S. at 476. See
also supra note 578.

\textsuperscript{585} 425 U.S. 185 (1976). To maintain a 10b-5 cause of action the plaintiff must
allege deceptive or manipulative conduct on the part of the defendant. Santa Fe, 430
U.S. at 473-74. See also supra note 578.
philosophy of full disclosure for the philosophy of caveat emptor, \ldots\)\textsuperscript{586} The court requires more than unfair fiduciary conduct before a cause of action can be maintained under the anti-fraud provisions of the 1934 Act.\textsuperscript{587}

Therefore, the first step in a federal action under section 14(a) or 10(b) of the 1934 Act is to determine whether the defendant was negligent in misrepresenting or omitting a material fact for section 14(a), or whether the defendant had the requisite scienter for section 10(b). Either finding requires the court to determine what level of unfair dealing, if any, was conducted by the defendant, and what, if any, remedy is adequate. State freeze-out cause of actions also require a determination regarding fair dealing.\textsuperscript{588}

In state freeze-out actions, unlike federal civil actions under the 1934 Act, the courts must consider all levels of fairness.\textsuperscript{589} The Weinberger court mandated an examination of the degree of fair dealing in order to determine whether the plaintiff is merely dissatisfied with the price offered, or whether a breach of fiduciary duty occurred, or whether an intentional misrepresentation occurred.\textsuperscript{590} When directors with dual responsibilities deal with the minority shareholders, the Weinberger decision dictates a two part fairness analysis which explicitly examines first "fair dealing" and then "fair value."\textsuperscript{591}

The Weinberger court noted that the directors affiliated with the majority shareholder, Signal, possessed dual responsibilities.\textsuperscript{592} The directors owed a fiduciary duty of complete candor, or entire fairness, to both parties. The directors' dual function precluded arm's length dealings with the minority shareholders.\textsuperscript{593} Therefore, when dealing


\textsuperscript{587} The Supreme Court has repeatedly stated that "once full and fair disclosure has occurred, the fairness of the terms of the transaction is at most a tangential concern of the statute." Santa Fe, 430 U.S. at 478. Cf, Mills v. Electric Auto-Lite Co., 396 U.S. 375, 381-85 (1970). See also supra note 578.

\textsuperscript{588} See supra note 576.

\textsuperscript{589} A shareholder may be able to demand an appraisal without alleging any unfair dealing. His appraisal right might be granted by statute. See e.g., DEL. CODE ANN. tit. 8, § 262 (1981).

\textsuperscript{590} See supra note 576.

\textsuperscript{591} Id.

\textsuperscript{592} Weinberger, 457 A.2d at 710.

\textsuperscript{593} The court in dictum suggested that arm's length negotiations might have been possible if UOP would have appointed an independent committee comprised of its outside directors to negotiate with Signal's directors. Id. at 709 n.7.
with the minority shareholders the directors, representing the majority shareholder, have a primary obligation of "fair dealing." The court further noted that an arm's length negotiated price was the objective of such "fair dealing." In both Weinberger and Lynch, the court found the majority did not deal fairly with the minority shareholders. In both cases the majority shareholder was in breach of its fiduciary duty. Thus, both courts at least considered damages beyond those available from the traditional appraisal concept. In Lynch, the court found rescissory damages were the appropriate remedy while in Weinberger the court left the application of rescissory damages to the discretion of the chancellor on remand.

Unlike Lynch and Weinberger, the courts in the earlier Kirby and Santa Fe cases did not find any major unfair dealing between the majority shareholder and the minority shareholders. Therefore, the application of a traditional appraisal remedy was deemed adequate to assure the minority shareholders would receive the premerger value of a proportional interest in the going concern. This value, the lowest on the spectrum of possible arm's length values, was the objective of the traditional appraisal remedy. In summary, while earlier Delaware cases, such as Kirby, recognized a fiduciary duty of entire fairness by the majority shareholder, the Weinberger court, in a situation where unfair dealing was found, expanded the fairness concept to a two step analysis which requires an examination of both "fair dealing" and "fair value."

Step 2: Link Fair Dealing With Fair Value

The second part of the proposed analysis links fair dealing with fair value; a variation of the theory "let the punishment fit the

594. "When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous interest in fairness of the bargain." Weinberger, 457 A.2d at 710.
595. Id. at 711.
596. See supra text accompanying notes 168-349.
597. See supra text accompanying notes 168-349.
598. See supra text accompanying notes 225-34.
599. See supra text accompanying notes 338-49.
600. Kirby, 413 A.2d at 140. See also supra note 587.
601. See supra text accompanying notes 163-67.
602. The court's objective was to find the minority shareholder's interest in the premerger value of a going concern. Kirby, 413 A.2d at 141.
603. Id.
604. Weinberger, 457 A.2d at 711.
crime." If a high level of unfair dealing is found by the court, the fair value for the minority shareholder should be found within the spectrum of possible arm's length values, but at a high level. However, if no unfair dealing is found, the fair value for a minority shareholder should likewise be found on the spectrum of possible arm's length values, but at a low level. Although an infinite number of fairness levels exist, this note considers the fair value concept under the following situations:

1. Complete fairness level—Where the majority shareholder dealt fairly with the minority shareholders, but the dissenting shareholder merely viewed the consideration for his stock as too low.
2. An unfair level—Where the majority shareholder breached a fiduciary duty in his dealings with the minority shareholders.
3. A highly unfair level—Where the majority shareholder either recklessly or intentionally misled the minority shareholders.

Using the proposed guidelines, the objective under the first level is to determine the fair value at the lowest level of possible arm's length values, the value of a minority interest. Determination of this value was also the objective of the traditional Delaware block valuation method. In Delaware and jurisdictions which follow Delaware's lead, modern analysis can now be used to determine this value as previously described. The objectives of the corporation statutes are promoted by finding a fair value at the lowest level in cases where fair dealing is found. The result of such a policy should be to promote mergers and cash-out transactions with full disclosure and fairness, while providing the minority shareholders an incentive for not demanding an appraisal merely in hopes of reaping a windfall profit. However, a higher level of unfair dealing would necessitate

605. Weinberger stated that fair dealing and fair value are not bifurcated tests. See supra note 576. Therefore, a balancing approach to the components of entire fairness is appropriate.

606. The proposed guidelines are consistent with the Kirby holding. Where fair dealing is found, the appropriate value would be the value of a minority interest.

607. See supra notes 18, 108.

608. Weinberger, 457 A.2d at 712.

609. One purpose of the corporation statutes is to "fully compensate shareholders for whatever their loss may be." Weinberger, 457 A.2d at 715. However, the analysis proposed in Weinberger is couched in terms of fairness, implying just results.

610. If the minority shareholder knows approximately the price he could expect
a finding of fair value on a higher level of possible arm's length values.

In situations where the majority shareholder breached a fiduciary duty, the fair value should be found at a higher level of value than the value of a minority interest. This value, while difficult to determine precisely, should reflect the degree of unfair dealing which occurred.\(^{611}\) If a serious violation of fiduciary duty is found, a high arm's length value of an 100 percent owner, would be appropriate.\(^{612}\) In contrast, if the breach of fiduciary duty or the nondisclosure, though material, was not serious, a lower value should be considered such as the value of a minority interest adjusted for the undisclosed information, or, as in the case of a two-step merger, the value of controlling interest.\(^{613}\)

By proportionally increasing the finding of fair value to compensate the minority shareholder for the majority shareholder’s practice of unfair dealing, the majority shareholder is deprived of any windfall profits resulting from his unfair practices. The majority shareholder should, therefore, be deterred from dealing unfairly with the minority shareholder. At the same time, because the minority shareholder may benefit from stopping (or slowing them down by filing suit) the majority shareholders' unfair practices, he is encouraged to bring a suit when the majority shareholder does deal unfairly.\(^{614}\) To effectuate this objective, if the unfair dealing reaches an extreme, the highest level of damages would be required to justify "fair value."\(^{615}\)

If the majority shareholder recklessly or intentionally misled the

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611. At the judge’s discretion, he would compensate the minority shareholder in terms of fair value for the level of unfair dealing attained by the defendant.

612. Where a breach of fiduciary duty was found, the Weinberger court allowed the value of 100 percent ownership ownership to be tested as a fair value. The court stated that the chancellor at his discretion could include elements of rescissory damages, if he found “fraud, misrepresentation, self dealing, deliberate waste of corporate assets, or gross and palpable overreaching. . . .” Weinberger, 457 A.2d at 714.

613. A two-step merger is one where the acquiring entity first purchases controlling interest, then shortly thereafter purchases the balance of the firm’s equity. Brudney and Chirelstein advocate giving the minority shareholder the value of the controlling interest at a minimum when two-step mergers are involved. Brudney, supra note 555, at 340-41.

614. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946), was the first private cause of action under section 10(b) and Rule 10b-5. See supra note 577. This "private attorney general" concept is encouraged as a means of enforcing the SEC rules.

615. Complete rescission or depriving the wrongdoer of the benefit of the
minority shareholders, the appropriate remedy would be to value the minority interest at the highest possible arm's length value, the value to the acquirer. 616 This value is greater than rescissory damages because it includes value which is solely related to the acquiring company, or majority shareholder. The value to the acquirer includes the value of synergy, a characteristic unique to the acquiring company. 617 The acquiring company might have been able to realize this synergy value by acquiring another similarly situated company. Therefore, by giving this portion of value to the minority shareholder, he is receiving something which was not part of his ownership interest in the firm. Consequently, the minority shareholder actually benefits from the wrongful or fraudulent activity of the majority shareholder, if he institutes legal action. The benefit received will encourage private civil actions against fraudulent activities, while deterring such activities by the majority shareholder. 618

Summary And Benefits Of The Proposed Analysis

The approach advocated by this note defines fair value as a value within the range of possible arm's length values, 619 but bases the level of fair value on the degree of unfair dealing by the majority shareholder. 620 This concept is consistent with the objectives and findings of fair value in both the federal and state jurisdictions. The guidelines resulting from the proposed concept will reduce uncertainty, and thus promote merger and cash-out activities, but on a fair basis.

Adoption of any guidelines would be beneficial because some uncertainty will be removed from the market. 621 Companies and

bargain would be appropriate when extreme unfairness occurs.

616. This would require the calculation of the value to the acquirer. Therefore, the reason for the merger would have to be given or hypothesized so that the value of synergy could be determined. See supra notes 452, 453.

617. Id.

618. Professor Winters argues that the various jurisdictions, in trying to attract new incorporations within their state, will not gravitate to the bottom; that is, provide little or no protection for the minority shareholder in order to protect the firm's management. Rather, each jurisdiction will provide minority shareholder protection because such protection eliminates risk, which enhances the value of the company's stock. An increase in stock value reduces the firm's cost of equity, thereby increasing the value of the firm. Management will, therefore, incorporate in states that provide some management protection, as well as some minority shareholder protection. Winters, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. L. STUD. 251 (1977).

619. See supra text accompanying notes 424-84.

620. See supra text accompanying notes 573-618.

621. By reducing uncertainty, planning is facilitated.
majority shareholders will have fair notice regarding the possible consequences resulting from their failure to deal fairly with the minority shareholders. The proposed guidelines facilitate planning by relieving some uncertainty about the costs of acquisitions, therefore promoting additional acquisitions and efficient use of available capital. The minority shareholder will also benefit from definite guidelines.

The minority shareholder will know what he can expect from his investment, and will be encouraged to sell his stock if treated fairly or to pursue relief if he is treated unfairly. If the majority shareholder deals fairly and offers a price that represents the value of a minority interest, the minority shareholder will be discouraged from pursuing the expensive and time consuming appraisal remedy. On the other hand, if a majority shareholder deals unfairly with a minority shareholder, the minority shareholder will know he can receive an adequate remedy through the courts, thus promoting private attorney general actions. In sum, the proposed analysis will promote the policies of the state and federal statutes and encourage their enforcement.

SECTION VII—Conclusion

In the 1983 Weinberger case, the Delaware Supreme Court eliminated an outmoded, misleading, and restrictive valuation analysis termed the "Delaware block." The Delaware Supreme Court has opened the door to the use of modern financial valuation analysis and expanded the traditional restriction of the "going concern value" to other possible arm's length values such as the value of 100 percent ownership. While the court has not clarified whether it is defining fair value in light of possible arm's length values or is merely allowing additional elements to be weighed in determining fair value, it has held the majority shareholders more accountable to the minority shareholders. No matter what form the future appraisals take in Delaware, the wide range of arm's length values can now be considered in the valuation analysis.

Delaware has taken a giant step toward protection of the minority shareholder, a step which should benefit all parties: the minority shareholders, the majority shareholders, the corporations and the state. However, the next important step to be taken is the adoption of a flexible set of guidelines expounding the "fairness" concept. Guidelines such as those propounded by this note will facilitate

622. See supra note 612.
planning and provide fair notice through increased consistency in the holdings. They will further the aims of the federal and state statutes, facilitate corporate planning, and provide additional minority shareholder protection.

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