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RATIONALIZING APPRAISAL STANDARDS IN COMPULSORY BUYOUTS

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Abstract: This Article argues that the “going concern value” standard adopted by the Delaware courts as the measure of “fair value” in share valuation proceedings is superior, in both fairness and efficiency, to its two main competitors, market value and third-party sale value. That superiority, however, depends upon two propositions. First, going concern value must be measured in a way that includes not only the present value of the corporation’s existing assets, but also the present value of the reinvestment opportunities available to and anticipated by the firm at the time of merger. Second, going concern value should not include the value of corporate control where the merger creates control through the aggregation of previously dispersed shares. In that case, the benefits created by the aggregation of shares belong to the party that created the increased value. Where a pre-existing, controlling shareholder squeezes out the minority, however, the minority shareholders are especially vulnerable to an acquisition at a price that fails to reflect the firm’s going concern value. Where such a controller fails to present a valid discounted cash flow analysis, it deprives the minority shareholders and the court of access to projections of future free cash flows of the firm. In this situation, the courts should adopt a penalty default presumption that fair value includes the value of control as reflected in comparable company acquisitions. This presumption comports with common law doctrines of fiduciary duty and the entire fairness standard, as well as adverse evidentiary inferences drawn from

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failure to produce relevant evidence. The controller, as faithful fiduciary, can avoid the proposed presumption by preparing and submitting to judicial scrutiny a valid, discounted cash flow analysis. The opportunistic controller, on the other hand, is subjected to a fair value determination that amounts to third-party sale value minus synergies.

INTRODUCTION

This Article presents a normative analysis of the principal alternative valuation standards—market value, third-party sale value, and going concern value—that might be used to provide dissenting shareholders with fair value for their shares in a cash-out transaction.¹ Two countervailing considerations frame this analysis. First, an inappropriately low valuation standard will encourage opportunism by bidders who can engage in value-decreasing transactions because the valuation standard allows them to pay less than the value of the shares being acquired. Second, and conversely, an inappropriately high standard will discourage value-enhancing transactions in which the shares of non-consenting shareholders are acquired. We argue that, of the three principal alternative valuation standards, the going concern value standard best balances these two considerations, has the fewest perverse incentive effects, and is most workable in the types of cases where the appraisal remedy is available.² As a consequence, we agree with the Delaware courts' consistent holding that the statutory requirement of fair value is best measured by going concern value.³

In advocating in favor of the going concern value standard we stress the importance of correct measurement.⁴ Here again, we agree with the Delaware courts that the discounted value of the corporation's free cash flow is the appropriate measure of going concern value.⁵ We stress, however, that going concern value must include not only the discounted free cash flow ("DCF") to be generated by the corporation's current assets, but also the discounted free cash flow to be generated by the reinvestment opportunities anticipated by the corporation at the time of the squeeze-out transaction.⁶ This is especially important in

¹ See *infra* notes 79–125 and accompanying text.

² See *infra* notes 79–125 and accompanying text.

³ See *infra* notes 79–125 and accompanying text.

⁴ See *infra* notes 41–42 and accompanying text.

⁵ See *infra* notes 41–42 and accompanying text.

⁶ Lawrence A. Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. CORP. L. 119, 137–38 (2005) (showing the necessity of including the present value of the firm's growth opportunities when calculating going concern

cases of a going-private transaction initiated by an existing controller, where neither synergies nor elimination of agency costs is ordinarily an economic justification for the transaction.⁷ In such situations, judicial attention to the potential for misappropriation of reinvestment opportunities serves as an important check on opportunism by controlling shareholders.⁸

Despite the consensus surrounding the appropriate use of discounted free cash flow analysis to determine “fair value,” there are lingering doubts about what the going concern value standard actually means in the context of other valuation approaches, particularly comparable company analysis.⁹ Where a valuation relies on ratios of share prices of comparable companies, for example, there is considerable controversy about whether, and to what extent, to give effect to a measure of fair value that relies on the value of the firm in a sale to a third party.¹⁰

According to one view, going concern value inevitably requires some consideration of third-party sale value.¹¹ An underlying assumption is that going concern value necessarily exceeds the trading value of shares because (a) companies are invariably sold at premiums to market, (b) synergies do not account for all—or even very much—of those premiums, and therefore (c) going concerns must be worth more than their aggregate share market capitalization.¹² Under this view, then, any valuation standard that relies on trading prices must understate “fair value” or going concern value, and an upward adjustment is necessary to compensate for this perceived “implicit minority discount.”¹³

We suggest that the foregoing syllogism contains a faulty premise: namely, that corporate control—a key component of acquisition premiums—inherently belongs to the enterprise itself and must be deemed part of going concern value and the “fair value” of dissenting shares.¹⁴ We disagree with this view of corporate control.¹⁵ Control value does not exist in a corporation owned by a fluid, disaggregated

value). Although we use the conventional abbreviation, “DCF,” we believe the term “discounted free cash flow” more accurately describes the valuation technique in question.

⁷ See *infra* notes 79–125 and accompanying text.

⁸ See *infra* notes 79–125 and accompanying text.

⁹ See *infra* notes 126–177 and accompanying text.

¹⁰ See *infra* notes 126–177 and accompanying text.

¹¹ See *infra* notes 126–177 and accompanying text.

¹² See *infra* notes 126–177 and accompanying text.

¹³ See *infra* notes 126–177 and accompanying text.

¹⁴ See *infra* notes 155–177 and accompanying text.

¹⁵ See *infra* notes 155–177 and accompanying text.

mass of shareholders.¹⁶ Rather, it is created by the aggregation of shares.¹⁷ Such aggregation of shares entails a reduction in agency costs, resulting in the creation of value that fairly belongs to the entity aggregating the shares.¹⁸ We therefore continue to urge that a routine upward adjustment of the results of comparable company analyses, relying on the premise that share market prices reflect an inherent or implicit minority discount, is inappropriate as a matter of both finance and fairness.¹⁹

With these considerations in mind, and in place of the implicit minority discount, we propose that in the case of a squeeze-out merger by a controlling shareholder, and in the absence of reliable DCF analysis, the courts can appropriately continue to estimate going concern value by reference to acquisition prices of comparable companies, minus some estimate of synergies included in such deal prices.²⁰ Our rationale turns on an analysis of the benefits of control and, in particular, whether those benefits belong to the corporation or to the minority shareholders in a squeeze-out merger.²¹ We argue that where a corporation had been owned by a fluid aggregation of shareholders, the benefits of control belong to the controller who aggregates the shares.²² Where control is already concentrated, however, the benefits associated with such control should be reflected in the minority shareholders' proportionate share of the value of the enterprise.²³

Consequently, this Article proposes a method for determining fair value in a class of cases in which the appraisal remedy plays a particularly significant role—squeeze-outs by controlling shareholders. In our view, this proposed method shows that, despite the erroneous implicit minority discount assumption, the Delaware courts have in fact arrived at the proper valuation results.²⁴ Specifically, we show that the implicit

¹⁶ The Supreme Court of Delaware has formulated the concept as the “fluid aggregation of unaffiliated stockholders.” See *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994). That formulation drew upon Chancellor Allen’s 1989 statement that “control of the corporation existed in a fluid aggregation of unaffiliated shareholders representing a voting majority—in other words, in the market.” *Paramount Commc’ns, Inc. v. Time, Inc.*, No. 10866, 1989 Del. Ch. LEXIS 77, at *64–65 (Del. Ch. July 17, 1989).

¹⁷ See *infra* notes 155–177 and accompanying text.

¹⁸ See *infra* notes 155–177 and accompanying text.

¹⁹ See generally Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the “Implicit Minority Discount” in Delaware Appraisal Law*, 156 U. PA. L. REV. 1 (2007).

²⁰ See *infra* notes 155–177 and accompanying text.

²¹ See *infra* notes 155–177 and accompanying text.

²² See *infra* notes 155–177 and accompanying text.

²³ See *infra* notes 155–177 and accompanying text.

²⁴ See *infra* notes 200–226 and accompanying text.

minority discount has been used exclusively in cases where going concern value is approximated, not by discounted cash flow methodology, but by comparable company analysis.²⁵ This is the setting where the potential for opportunism is the highest and where the Delaware courts have long identified the need for heightened scrutiny.²⁶ One important concern in this setting arises where the absence of reliable DCF projections and analysis by the respondent requires the parties, experts, and the courts to substitute comparable company analysis for DCF methodology.²⁷ In that situation, the respondent's own failure to develop such projections and analysis enables it to avoid judicial scrutiny that might reveal future returns on existing assets or reinvestment opportunities in which all shareholders would, but for the merger, be entitled to share.²⁸

Our analysis proceeds as follows. In Part I, focusing on Delaware law, we examine the legal setting in which the courts define standards for valuing corporate shares.²⁹ In Part II, we first review in detail the alternative standards for determining the fair value of shares, examining their analytical premises and normative merits.³⁰ Based on this analysis, we then recommend that the going concern value standard is the appropriate standard for determining the fair value of shares. In Part III, we examine the controversy in Delaware case law in applying the going concern standard, focusing on the critical role played by the benefits of control.³¹ In Part IV, we apply the conclusions previously developed and suggest a framework for judicial treatment of valuation issues that emphasizes use of DCF analysis but suggests standards for applying comparable company analysis as an alternative measure of going concern value.³²

²⁵ See, e.g., *Andaloro v. PFPC Worldwide, Inc.*, No. 20336, 2005 Del. Ch. LEXIS 125, at *65 (Del. Ch. Aug. 19, 2005); *Dobler v. Montgomery Cellular Holding Co.*, No. 19211, 2004 Del. Ch. LEXIS 139, at *17 (Del. Ch. Sep. 30, 2004); *Prescott Group Small Cap, L.P. v. Coleman Co.*, No. 17802, 2004 Del. Ch. LEXIS 131, at *84–85 (Del. Ch. Sep. 8, 2004); *Lane v. Cancer Treatment Ctrs. of Am. Inc.*, No. 12207-NC, 2004 Del. Ch. LEXIS 108, at *129 (Del. Ch. July 30, 2004); *Doft & Co. v. Travelocity.com, Inc.*, No. 19734, 2004 Del. Ch. LEXIS 75, at *45–46 (Del. Ch. May 21, 2004); *Borruso v. Commc'ns Telesys. Int'l*, 753 A.2d 451, 459 (Del. Ch. 1999); *Kleinwort Benson Ltd. v. Silgan Corp.*, No. 11107, 1995 Del. Ch. LEXIS 75, at *8 (Del. Ch. June 15, 1995); *Hodas v. Spectrum Tech., Inc.*, No. 11265, 1992 Del. Ch. LEXIS 252, at *5 (Del. Ch. Dec. 7, 1992).

²⁶ See *infra* note 187 and accompanying text.

²⁷ See *infra* notes 178–226 and accompanying text.

²⁸ See *infra* notes 178–226 and accompanying text.

²⁹ See *infra* notes 33–62 and accompanying text.

³⁰ See *infra* notes 63–125 and accompanying text.

³¹ See *infra* notes 126–177 and accompanying text.

³² See *infra* notes 179–226 and accompanying text.

I. LEGAL SETTING

The legal prescription in Delaware for determining share value in compulsory share buyouts derives from the appraisal rights statute, section 262 of the Delaware General Corporation Law.³³ Subsection (h) of that statute sets forth the relevant parameters for determining value, stating that in appraisal proceedings the Court of Chancery

shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors³⁴

This statutory formulation contains two important instructions that are relevant to the subject at hand: first, shareholders who object and appropriately dissent from a merger are entitled to an award of their shares' "fair value"—a term that the statute does not further define; and second, "fair value," whatever it does mean, does not include any "element of value arising from the accomplishment or expectation of the merger or consolidation."³⁵ We next examine these two instructions in more detail.

"Fair value" is a legal term, the substantive content of which dates back more than half a century to *Tri-Continental Corp. v. Battye*.³⁶ In that 1950 case, the Delaware Supreme Court stated: "The basic 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."³⁷ Other cases have characterized this concept in a shorthand way as "going concern value,"³⁸ while still other cases describe the concept as the true or "intrinsic" value of the stock that has been taken by the merger.³⁹

Although these concepts are helpful in selecting appropriate finance methods for measuring fair value, there is room for ambiguity.

³³ DEL. CODE ANN., tit. 8, § 262 (2008).

³⁴ *Id.*

³⁵ *See id.*

³⁶ *See* 74 A.2d 71, 72 (Del. 1950).

³⁷ *Id.*

³⁸ *See infra* note 79 and accompanying text.

³⁹ *See* *Chicago Corp. v. Munds*, 172 A. 452, 455–56 (Del. Ch. 1934); *see also* *Roessler v. Sec. Sav. & Loan Co.*, 72 N.E.2d 259, 260 (Ohio 1947).

For example, what is the “intrinsic” value of the stock, a term that has no precise counterpart in finance theory?

In 1983, in *Weinberger v. UOP, Inc.*, the Delaware Supreme Court established that the method for measuring fair value should be generally accepted techniques used in the financial community.⁴⁰ As the Delaware Supreme Court’s direction has been applied over the years since *Weinberger*, the Court of Chancery has increasingly come to favor DCF analysis of modern finance theory as the principal approach to measuring value.⁴¹ In this theory, the value of an asset is the present value of the discounted stream of future free cash flows that the asset can generate.⁴² The discount rate used in this method is one of several mean/variance theories of discount rates, of which the most well known is the capital asset pricing model.⁴³ The *Weinberger* decision and its progeny thus establish that the technique to be applied, whenever possible, in determining the “fair value” of shares is indeed the tech-

⁴⁰ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983) (“[T]o the extent [the Delaware block method] excludes other generally accepted techniques used in the financial community and the courts, it is now clearly outmoded. It is time we recognize this in appraisal and other stock valuation proceedings and bring our law current on the subject.”).

⁴¹ See, e.g., *Grimes v. Vitalink Commc’ns Corp.*, No. 12334, 1997 Del. Ch. LEXIS 124, at *3 (Del. Ch. Aug. 26, 1997) (observing that the discounted cash flow approach is “increasingly the model of choice for valuations in this Court”); *Ryan v. Tad’s Enters., Inc.*, 709 A.2d 682, 702 (Del. Ch. 1996) (“[T]he discounted cash flow valuation methodology that both sides have used and endorsed is the approach that merits the greatest confidence.”), *aff’d*, 693 A.2d 1082 (Del. 1997).

⁴² In 1999, in *ONTI, Inc. v. Integra Bank*, the Court of Chancery of Delaware stated:

The DCF model entails three basic components: an estimation of net cash flows that the firm will generate and when, over some period; a terminal value equal to the future value, as of the end of the projection period, of the firm’s cash flows beyond the projection period; and finally a cost of capital with which to discount to a present value both the projected net cash flows and the estimated terminal or residual value.

751 A.2d 904, 917 (Del. Ch. 1999) (quoting *Cede & Co. v. Technicolor, Inc.*, No. 7129, 1990 Del. Ch. LEXIS 259, at *24 (Del. Ch. Oct. 19, 1990)). The terminal value can be estimated in a number of different ways. The court typically assigns the term “DCF analysis” to one particular estimate of the terminal value; namely the Gordon growth model where the terminal value is estimated by discounting to the present value the last period free cash flow divided by the difference between the market capitalization or discount rate minus the assumed future growth rate in free cash flow. However, DCF analysis, as that term is used in modern finance, also includes methods where the terminal value is estimated by capitalizing the last period earnings or book value by using either a stock market-based price-earnings multiple or a multiple of book value. See RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 535–37 (9th ed. 2008).

⁴³ See BREALEY ET AL., *supra* note 42, at 215–16 (presenting a discussion of the capital asset pricing model).

nique that generations of business students have been taught as the core approach to valuing assets.⁴⁴

This finance theory, however, is highly stylized and dependent on a host of assumptions that are rarely met. In addition, this theory is in fact weakest in those areas where appraisal is available.⁴⁵ The result is competing definitions of “fair value.”⁴⁶ For example, can market prices be used as the best available measure of firm value? After all, finance theory has canonized not only DCF analysis, but the efficient capital market hypothesis as well, an endorsement that may appear to favor the exclusive use of market prices as a measure of fair value.⁴⁷ Alternatively, could third-party sale value be used in valuing the company? After all, the definition of value used by economists is a version of third-party sale value—that is, the opportunity cost of the asset in its next best use.⁴⁸

We address below some normative considerations in evaluating the relative merits of adopting third-party sale or market value as the standard for determining the fair value of shares.⁴⁹ We turn first, however, to the second instruction from the appraisal statute—excluding from fair value “any element of value arising from the accomplishment or expectation of the merger.”⁵⁰ This legal instruction, as we now show, has the important consequence of precluding reliance on third-party sale value as the determinant of the fair value of shares.⁵¹

Third-party sale value necessarily derives from transactions in which corporate control is acquired.⁵² The Delaware cases establish, however, that it is *the nature of the enterprise* itself at the time of the

⁴⁴ See *Weinberger*, 457 A.2d at 712; *Grimes*, 1997 Del. Ch. LEXIS 124, at *3; *Ryan*, 709 A.2d at 702; BREALEY ET AL., *supra* note 42, at 214–16.

⁴⁵ The capital asset pricing model applies only to publicly traded companies and thus does not offer a theory for close corporations. In addition, the theory assumes that the stock trades in liquid capital markets which rules out closely held, but publicly traded stock. The courts’ use of DCF analysis in evaluating close corporation shares thus depends on the use of alternative methods for estimating the corporation’s cost of equity capital (for example, by reference to observations of trading in shares of comparable companies the shares of which trade in liquid markets). See Hamermesh & Wachter, *supra* note 6, at 125, n.33.

⁴⁶ See *infra* notes 79–125 and accompanying text.

⁴⁷ Efficient markets and the capital asset pricing model are taught in all major finance textbooks. See, e.g., BREALEY ET AL., *supra* note 42; STEPHEN A. ROSS ET AL., CORPORATE FINANCE (7th ed. 2005).

⁴⁸ BREALEY ET AL., *supra* note 42, at 14–15.

⁴⁹ See *infra* notes 79–125 and accompanying text.

⁵⁰ DEL. CODE ANN., tit. 8, § 262.

⁵¹ See *id.*

⁵² See *infra* notes 91–108 and accompanying text.

merger that is the key parameter in the valuation exercise.⁵³ Because the prices paid in such transactions reflect elements of value created by the transaction—notably synergies—that would not otherwise exist in the enterprise itself, the use of such prices in determining fair value conflicts with the statutory mandate that “any element of value arising from the accomplishment or expectation of the merger or consolidation” must be excluded.⁵⁴ Following this logic, Delaware case law has consistently held that third-party sale value, to the extent that it includes synergies created by the merger, cannot be used as a measure of fair value.⁵⁵

One more preliminary point deserves noting: these two primary valuation instructions from the appraisal statute dominate all discussion by the Delaware courts of the fair value of shares and not just in formal statutory appraisal proceedings.⁵⁶ Although claims of breach of fiduciary duty are generally considered to be outside the proper scope of ap-

⁵³ M.G. Bancorp., Inc. v. Le Beau, 737 A.2d 513, 525 (Del. 1999) (“[T]he corporation must be valued as a going concern based upon the ‘operative reality’ of the company as of the time of the merger.”); *Cede & Co.*, 684 A.2d at 298 (“[T]o the extent that value has been added following a change in majority control before cash-out, it is still value attributable to the going concern, i.e., the extant ‘nature of the enterprise,’ on the date of the merger. The dissenting shareholder’s proportionate interest is determined only after the company has been valued as an operating entity on the date of the merger.” (internal citation omitted)).

⁵⁴ See DEL. CODE ANN., tit. 8, § 262. We are aware that this conflict is not perfectly literal. See *id.* The Delaware appraisal statute merely excludes value arising from the specific transaction giving rise to appraisal rights; it does not literally prohibit reference to synergistic values arising in other transactions. See *id.* Still, and as the Court of Chancery has properly concluded, a fair reading of the statute precludes a standard that would define “fair value” by reference to a transaction—a hypothetical sale to a third party—that would include elements of value solely arising from the transaction. See *Union Ill. 1995 Inv. Ltd. P’ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 356 (Del. Ch. 2004) (explaining that “[b]y its plain terms, § 262 only excludes from the amount awardable to the petitioners ‘value arising from the accomplishment or expectation of the merger’ The literal terms of § 262 do not preclude a court from using a comparable-transactions analysis that considers the price at which the subject company would likely sell in an auction.”).

⁵⁵ See *infra* notes 91–108 and accompanying text. As we have previously explained, *Weinberger’s* discussion of the statutory exclusion of value attributable to the accomplishment or expectation of the merger could be interpreted to preclude only elements of value that are “speculative,” and that non-speculative synergistic value might be taken into account in determining fair value. See *Hamermesh & Wachter, supra* note 6, at 126–27 (discussing *Weinberger*, 457 A.2d at 712). In our view, however, *Weinberger’s* discussion is referring to the future value of the enterprise that is the target of the merger. See 457 A.2d at 712. More specifically, it is not referring to the new corporation or combination that will result from the merger. See *id.* Accordingly, *Weinberger* should not be interpreted to conflict with the widely recited proposition that “fair value” may not include synergistic gains. See *id.*

⁵⁶ See DEL. CODE ANN., tit. 8, § 262.

praisal proceedings,⁵⁷ “fair price”—an evaluation of the fairness of the price paid to minority shareholders in squeeze-out mergers by controlling shareholders—is a key component of the “entire fairness” standard by which the courts evaluate the fiduciary conduct of controlling shareholders.⁵⁸

Moreover, it is generally accepted in the Delaware case law and the major treatises on Delaware corporate law that in evaluating the “entire fairness” of a squeeze-out merger, “the courts generally utilize the same valuation analysis for both the fair price prong of the fiduciary duty action and the appraisal action.”⁵⁹ Indeed, the “fair price” component of the “entire fairness” standard mirrors the definition of “fair value” as articulated in the appraisal cases.⁶⁰ As the Delaware Supreme Court explained in 1985 in *Rosenblatt v. Getty Oil Co.*, “[i]n terms of the concept of fair price, *Weinberger* is consistent with *Sterling v. Mayflower Hotel Corp.*, . . . where this Court stated that the correct test of fairness is ‘that upon a merger the minority stockholder shall receive the substantial equivalent in value of what he had before.’”⁶¹ Accordingly, the valuation standard adopted under the appraisal statute will also serve an important

⁵⁷ See, e.g., *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 248 (Del. 2001); *Ala. By-Prod. Corp. v. Neal*, 588 A.2d 255, 257 (Del. 1991) (acknowledging the pertinence of unfair dealing in assessing credibility, but reiterating that “claims for unfair dealing cannot be litigated in the context of a statutory appraisal”).

⁵⁸ See, e.g., *Weinberger*, 457 A.2d at 710–11 (“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,” and “[t]he concept of fairness has two basic aspects: fair dealing and fair price.”).

⁵⁹ See DAVID A. DREXLER ET AL., 2-36 DELAWARE CORPORATION LAW AND PRACTICE § 36.06 (2008) (citing *Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130, 1153 n.127 (Del. Ch. 2006)) (“[I]n general, the techniques used to determine the fairness of price in a non-appraisal stockholder’s suit are the same as those used in appraisal proceedings.”); EDWARD P. WELCH & ANDREW J. TUREZYN, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 251.6.2 (1999) (“In general, the techniques used to determine the fairness of price in a non-appraisal stockholder’s suit are the same as those used in appraisal proceedings.”); see also *Metro. Life Ins. Co. v. Aramark Corp.*, No. 16142, 1998 Del. Ch. LEXIS 70, at *6 (Del. Ch. Feb. 5, 1998) (recognizing “fiduciary duty . . . to pay stockholders who are cashed out the fair value of their stock as that term is defined in the appraisal cases and in the breach of fiduciary duty cases in merger transactions”).

⁶⁰ See, e.g., *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 940 (Del. 1985).

⁶¹ *Id.* (quoting *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 114 (Del. 1952)); see also WELCH & TUREZYN, *supra* note 59 (“[F]airness requires only that the consideration paid be equivalent to the pre-merger value of the exchanged shares and pays no attention whatsoever to any resulting post-merger gains.”) (citing *Harriman v. E.I. du Pont de Nemours & Co.*, 411 F. Supp. 133, 154 (D. Del. 1975); *Tanzer v. Int’l Gen. Indus., Inc.*, 402 A.2d 382, 395 (Del. Ch. 1979) (“[F]ailure of a dominant stockholder to recognize the possible synergistic effect of a merger in arriving at a price to be offered for the shares of the stockholders being frozen out, is not therefore valid grounds to challenge the merger.”)).

purpose in litigation, defining and enforcing the fiduciary duties of controlling shareholders in squeeze-out transactions.⁶²

II. APPRAISAL THEORY, AGENCY COSTS, AND THE BENEFITS OF CONTROL

A. *The Purpose of Share Valuation Remedies in Compulsory Buyouts*

Before turning to the first of our central topics—the merits of alternative standards for determining fair value—it is important to identify the problem that appraisal seeks to resolve. The traditional answer supplied by the courts is that appraisal was a statutory price paid for taking away an individual shareholder’s right to veto a merger.⁶³ Because a merger agreed upon by two boards of directors acting at arms-length is presumptively value enhancing, this hypothesized statutory bargain removed a possible source of oppression by the minority: it deprived minority shareholders of the ability to hold out for non-pro rata benefits in order to sell their veto power to the majority.⁶⁴ On the other hand, to avoid oppression of the minority by the majority, the hypothesized statutory bargain required some mechanism to ensure that the

⁶² See *Rosenblatt*, 493 A.2d at 940. We acknowledge that one cannot assume that the existing legal remedies, such as appraisal and fiduciary duty litigation, that address the problem of what to pay forced sellers in compulsory buyouts are the optimal approach to the issue. As John Coates has pointed out, however, there is plenty of room for private ordering—most notably in charter provisions—to define solutions to the forced seller problem. John C. Coates IV, “Fair Value” As an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. PA. L. REV. 1251, 1287–95 (1999) (describing contract and charter mechanisms to contract around Delaware appraisal law). Yet use of such private ordering alternatives is rare at best, leaving a fair presumption that the combination of appraisal and fiduciary duty remedies is at least a reasonable set of default rules. See *id.* at 1295.

⁶³ See, e.g., *Applebaum v. Avaya, Inc.*, 812 A.2d 880, 893 (Del. 2002); *Ala. By-Products Corp. v. Cede & Co.*, 657 A.2d 254, 258 (Del. 1995). The historical accuracy of this trade-off story is questionable, however, given the fact that the appraisal remedy was often added well after the adoption of statutes permitting mergers without unanimous consent. See Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law*, 84 GEO. L.J. 1, 14 (1996).

Appraisal statutes are often presented as having been enacted in tandem with statutes authorizing consolidation or merger by less than unanimous vote, but there was a significant difference in the spread of the two statutes. By the turn of the century, a dozen states had statutes authorizing consolidations for corporations generally, but only five of those states had appraisal statutes.

Id. On the other hand, even if the trade story did not happen in precisely the manner traditionally suggested, the function of the merger statutes and the appraisal remedy to eliminate minority hold-up of value-creating transactions remains significant. *Id.* at 15–16.

⁶⁴ See Hamermesh & Wachter, *supra* note 6, at 130.

merger not be used by the majority to appropriate to itself value belonging to the minority shareholders.⁶⁵

Accordingly, the appraisal remedy has been structured to require that mergers satisfy a Pareto superior test, under which the dissenting shareholders are not made worse off.⁶⁶ To implement this requirement, the courts have insisted that merger proponents pay the dissenting shareholders the cash equivalent of the present value of the future benefits that such shareholders could have expected to receive if they had continued to hold their shares.⁶⁷

Applying this formulation is not a trivial task, however, and even with its limited reach, the appraisal remedy requires a carefully accomplished legal balancing act.⁶⁸ Both parties have an interest in a legal rule that encourages some individuals or entities to become controllers, while protecting the interests of the minority shareholders.⁶⁹ This means that controllers can continue to exercise the rights of control, which, in the context of the appraisal and merger statutes, means allowing them to engage in squeeze-out mergers.⁷⁰ It also means protecting minority shareholders so that they are willing to invest in companies with controllers.⁷¹ In cash-out mergers, the rule must ensure that the minority shareholders are not made worse off by the transaction.⁷²

But minority shareholders also need controlling shareholders and would be worse off if the legal rules made it unprofitable for controlling shareholders to serve in that capacity.⁷³ The controlling sharehold-

⁶⁵ *See id.* at 130–31.

⁶⁶ *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 139 (1991) (stating that appraisals “require that shareholders receive the equivalent of what they give up but do not require sharing of the gain from the change in control”).

⁶⁷ *See, e.g.*, *Cede & Co. v. Technicolor, Inc.*, 684 A.2d at 298; *see also Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1145 (Del. 1989). The court in *Cede & Co. v. Technicolor, Inc.* stated:

The underlying assumption in an appraisal valuation is that the dissenting shareholders would be willing to maintain their investment position had the merger not occurred. Accordingly, the Court of Chancery’s task in an appraisal proceeding is to value what has been taken from the shareholder, *i.e.*, the proportionate interest in the going concern.

684 A.2d at 298 (internal citation omitted).

⁶⁸ *See Hamermesh & Wachter, supra* note 6, at 131.

⁶⁹ *See id.*

⁷⁰ *See id.*

⁷¹ *See id.*

⁷² *See id.*

⁷³ *See id.*

ers of the world are non-diversified shareholders who take on unsystematic, company-specific risk by being incompletely diversified.⁷⁴ They do so in return for the benefits of exercising control.⁷⁵ The obvious benefit of having controlling shareholders is that agency costs are reduced because the interests of the controller are more aligned with the corporation.⁷⁶ Minority shares can be a very profitable investment for shareholders who essentially ride the coattails of the non-diversified, and hence focused, controlling shareholder.⁷⁷ With the correct balance achieved, the controlling shareholder can exercise its rights of control, restricted only by a constraint that it pay fair value when it acquires minority shares without their holders' consent, or, in other words, that its actions not make the minority shareholders worse off.⁷⁸

B. *Three Alternative Measures of Fair Value*

Despite their early articulation of going concern value as the correct concept for defining fair value,⁷⁹ the Delaware courts have applied a variety of other standards for measuring fair value. More specifically, the courts have considered three principal approaches: market value, third-party sale value, and going concern value as measured by the present value of future free cash flows. The market value approach relies on the market price of the shares to determine fair value. The third-party sale value approach measures fair value by reference to the value of the entire company in a hypothetical sale to a third party. The going concern value approach measures fair value by reference to the value of the company as a going concern, determined most commonly by

⁷⁴ See Hamermesh & Wachter, *supra* note 6, at 130, n. 51.

⁷⁵ See *id.*

⁷⁶ See *infra* notes 143–154 and accompanying text.

⁷⁷ See Hamermesh & Wachter, *supra* note 6, at 131.

⁷⁸ See *id.*

⁷⁹ The term “going concern value” is standard parlance in the Delaware case law describing the valuation standard to be applied in statutory appraisal proceedings. See, e.g., Gholl v. eMachines, Inc., No. 19444-NC, 2004 Del. Ch. LEXIS 171, at *17 (Del. Ch. Nov. 24, 2004), *aff'd*, 875 A.2d 632 (Del. 2005); Dobler v. Montgomery Cellular Holding Co., No. 19211, 2004 Del. Ch. LEXIS 139, at *13 (Del. Ch. Sep. 30, 2004); Prescott Group Small Cap, L.P. v. Coleman Co., No. 17802, 2004 Del. Ch. LEXIS 131, at *40 (Del. Ch. Sep. 8, 2004); Lane v. Cancer Treatment Ctrs. of Am., Inc., No. 12207-NC, 2004 Del. Ch. LEXIS 108, at *56 (Del. Ch., July 30, 2004); Doft & Co. v. Travelocity.com Inc., No. 19734, 2004 Del. Ch. LEXIS 75, at *14 (Del. Ch. May 21, 2004); Ng v. Heng Sang Realty Corp., No. 18462, 2004 Del. Ch. LEXIS 69, at *7 (Del. Ch. May 18, 2004); Cede & Co. v. Technicolor, Inc., No. 7129, 2003 Del. Ch. LEXIS 146, at *1 (Del. Ch. Dec. 31, 2003), *aff'd in part, rev'd in part*, 884 A.2d 26 (Del. 2005); Taylor v. Am. Specialty Retailing Group, Inc., No. 19239, 2003 Del. Ch. LEXIS 75, at *6 (Del. Ch., July 25, 2003).

using the discounted value of the company's future free cash flows. We review the merits of each of these approaches below.

1. Market Value

The advocates of a share market value standard for determining fair value assert that, because financial markets are efficient, one can simply use the market value of the shares as the best available measure of fair value.⁸⁰ In fact, the courts do rely on the efficiency of financial markets to provide measures of fair value in cases where the appraisal remedy is available.⁸¹ Most notably, the courts necessarily rely on share market pricing when they use the capital asset pricing model to select a discount rate to apply in DCF analysis.⁸² Likewise, they rely on share market pricing when they add to the discount rate an estimate of the excess returns experienced by small company stocks.⁸³

Share market prices, however, cannot be used to determine fair value for the simple reason that in the types of cases where appraisal is most likely to occur, there is either no publicly traded market price at all or the share price may not reflect going concern value, for example, because of illiquidity.⁸⁴

Moreover, there are other reasons to question the utility of share market prices in the important category of cases in which the merger

⁸⁰ See BREALEY, ET AL., *supra* note 42, at 353–54 (making the point that all assets in efficient markets sell for the value of their discounted free cash flow); Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in CONCENTRATED CORPORATE OWNERSHIP 247, 250 (Randall K. Morck ed., 2000); Benjamin Hermlin & Alan Schwartz, *Buyouts in Large Companies*, 25 J. LEG. STUD. 351, 370 (1996).

⁸¹ See *infra* notes 82 and 83 and accompanying text.

⁸² See, e.g., *Del. Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 338–39 (Del. Ch. 2006) (discussing the role of the capital asset pricing model and its tensions with the “build-up model” in estimating the weighted average cost of capital); *Lane*, 2004 Del. Ch. LEXIS 108, at *113–14 (describing the capital asset pricing model method of deriving cost of equity in estimating the weighted average cost of capital).

⁸³ See, e.g., *Gesoff v. IIC Indus.*, 902 A.2d 1130, 1159 (Del. Ch. 2006) (“The small-size premium, although somewhat controversial, is a generally accepted premise of both financial analyses and of this court’s valuation opinions.”); *Del. Open MRI*, 898 A.2d at 338 n.129 (supporting the use of a premium on small-size stocks, despite the “great debate” over whether it is appropriate); *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 920 (Del. Ch. 1999) (“This Court has traditionally recognized the existence of a small stock premium in appraisal matters.”).

⁸⁴ See, e.g., *Del. Open MRI*, 898 A.2d at 331; *Andaloro v. PFPC Worldwide, Inc.*, No. 20336, 2005 Del. Ch. LEXIS 125, at *57 (Del. Ch. Aug. 19, 2005); *Lane*, 2004 Del. Ch. LEXIS 108, at *119; *Borruso v. Commc’ns Telesys. Int’l*, 753 A.2d 451, 459–60 (Del. Ch. 1999), *ONTI*, 751 A.2d at 915–16; *Hodas v. Spectrum Tech., Inc.*, No. 11265, 1992 Del. Ch. LEXIS 252, at *14–15 (Del. Ch. Dec. 7, 1992).

involves a controlling shareholder, even where the minority's shares are widely traded. An efficient market will value the firm based on the plans of the controller.⁸⁵ If the market believes that the controller will under-manage the firm or divert resources to its own use in a way that evades judicial oversight, the price will fall to reflect this belief.⁸⁶ In such situations, the financial markets' usual corrective mechanisms are not available. Furthermore, and most importantly, the market for corporate control is also absent because the controller can veto any transaction that it disfavors.⁸⁷ Other market mechanisms will likewise fail to work. For example, if the controller needs access to financial markets in order to raise new capital, then market scrutiny would be present in such circumstances. A controller interested in an opportunistic going-private transaction, however, can easily avoid such controls by simply timing the transaction to occur when there is no need to raise new capital.

Indeed, defining "fair value" as market value would engender uniquely detrimental incentives. Because the efficient market will correctly value the firm in terms of its discounted free cash flows, any opportunism that is known to the market will result in a lower stock price. Consequently, in the case of publicly traded companies where a controller is present, a market value definition for "fair value" would encourage opportunism. To the extent that fiduciary-duty litigation could not remedy such opportunism, the market price of the shares would be lower. A market value standard would thus reward the controller for misappropriation by allowing it to take the corporation private at a price reflecting such misappropriation. For that reason alone, share market price cannot be a generally appropriate measure of fair value, and particularly not in the most problematic situation, where a controlling shareholder is squeezing out minority shares.

Financial economists who adhere to a strong view of market efficiency might claim, on the other hand, that market prices might be used to determine fair value in the case of a publicly traded company

⁸⁵ See Hamermesh & Wachter, *supra* note 6, at 132.

⁸⁶ Bebchuk & Kahan, *supra* note 80, at 250.

The very power of a controlling shareholder to freeze out the minority shares—and to set the freezeout price equal to the prefreezeout market price—will depress the prefreezeout market price of the minority shares. As a result, the prefreezeout market price of minority shares will be substantially below the expected 'intrinsic' value of the minority shares absent a freezeout.

Id.

⁸⁷ See *infra* note 187.

that has no controlling shareholder, but whose shares trade with a liquidity discount because they are thinly traded.⁸⁸ The liquidity discount means that the shares do not trade at the pro rata value of the enterprise.⁸⁹ Should the value of the dissenters' shares in an appraisal case include the discount?

A reasonable argument is that the dissenter should receive the reduced or discounted price. After all, when the shares do trade—albeit infrequently—they trade at a lower price reflecting this discount. Consequently, the average dissenter purchased shares at the average discount. Awarding a non-discounted share value pays the dissenter a greater value than the value of the shares that have been involuntarily taken from him. Thus, one could argue that the fair value of the shares of this enterprise should be reduced by the amount of the liquidity discount. The law, however, rejects this argument,⁹⁰ and so do we because of the perverse incentives that it creates.

The concern here is the same as in the case of a corporation with a controller: namely, the potential for opportunistic behavior by those in control of the enterprise. The non-managing shareholders in such thinly traded companies are protected by the right to vote in certain transactions. Because they constitute a majority of the shares (there being no controlling shareholder), they could presumably vote their shares in their own interest, thereby reducing the potential for opportunism. But the voting solution is not sufficiently broad to protect even a majority of the shareholders from actions taken by the shareholders who serve on the board of directors. For example, the board could vote to repurchase shares in the market, thereby exacerbating the discount for lack of marketability. Moreover, such actions could precede an acquisition in which those exercising control were equity participants in the acquiring entity. The board, without shareholder approval, could gain control and, absent a judicial unwillingness to give effect to liquidity discounts, take advantage of the minority by having accomplished

⁸⁸ See, e.g., Reimier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices As an Acquisition Motive*, 88 COLUM. L. REV. 891, 891 (1988) (It is "a common presumption in the finance literature that informed securities prices credibly estimate the underlying value of corporate assets.").

⁸⁹ See SHANNON P. PRATT ET AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 414 (4th ed. 2000) ("This valuation adjustment, or discount, is the discount for illiquidity (i.e., the discount for lack of marketability of the controlling business ownership interest.)").

⁹⁰ See, e.g., *Cavalier Oil Corp.*, 564 A.2d at 1145 ("The application of a discount to a minority shareholder is contrary to the requirement that the company be viewed as a 'going concern.'").

the earlier liquidity reducing purchases. Therefore, share-market prices cannot be relied upon to determine fair value in this situation as well.

2. Third-Party Sale Value

The second potential standard for determining fair value in appraisal is third-party sale value.⁹¹ The attractiveness of this standard is that if the value of the entity is the controlling consideration, then the reference to the sale price of the entity is consistent with a standard that relies on the price at which individual shares would be bought and sold by willing buyers and sellers at market transactions. The simple extension is to state that the relevant market transaction is the purchase of all the shares and not simply the minority shares.

On the surface, third-party sale value may appear attractive because it fits the definition of value that is typically employed in economics and finance.⁹² Economics and finance teach us that the value of an asset is its opportunity cost or, alternatively stated, its value in its next best use.⁹³ The term “next-best-use” does indeed rely on indicators of third-party sale value.⁹⁴

At the outset, however, we advance a normative objection to the third-party sale value standard as a determinant of “fair value” in the case of compulsory share buyouts. The premise of our objection is that estimates of third-party sale value necessarily look to acquisitions of companies deemed comparable to the firm in question; thus, those estimates necessarily include value attributable to some, or even all, of the synergies anticipated by the buyers. We have already seen that such synergies must be excluded, for legal reasons, in determining fair value.⁹⁵

⁹¹ See, e.g., *In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1004 (Me. 1989).

The valuation focus under the appraisal statute is not the stock as a commodity, but rather the stock only as it represents a proportionate part of the enterprise as a whole. The question for the court becomes simple and direct: What is the best price a single buyer could reasonably be expected to pay for the firm as an entirety? The court then prorates that value for the whole firm equally among all shares of its common stock.

Id.

⁹² See BREALEY ET AL., *supra* note 42, at 15.

⁹³ See *id.*

⁹⁴ See *id.*

⁹⁵ See *supra* notes 33–62 and accompanying text. Thus, the Delaware courts have in recent years come to estimate fair value, in cases where the company is acquired by a third party, by reference to the acquisition price less estimated synergies associated with the transaction. See, e.g., *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 59 (Del. Ch.

They must, therefore, be excluded for the normative reason that they reflect value to which shareholders have no individual entitlement; share ownership carries with it the right to share in the profits of the corporation itself, but it does not carry with it the right to share in the profits associated with a different, combined enterprise.

Similarly, estimates of third-party sale value derived from comparable company acquisitions commonly include value associated with the acquisition of control from disaggregated shareholders. As we discuss below, such acquisitions of control create material benefits—indeed, it is widely understood that acquirers of firms pay a premium for obtaining control.⁹⁶ But as we also discuss below, control is another element of value to which shareholders who do not have control have no entitlement; ownership of disaggregated noncontrolling shares carries with it the right to participate in the profits of the corporation itself, but does not carry with it the right to participate in the profits of the corporation managed differently in the hands of someone with control.⁹⁷ Excluding value associated with control from the measurement of fair value does not impose a “minority discount;”⁹⁸ it simply denies shareholders value that does not inhere in the firm in which they are invested. Thus, third-party sale value is an inappropriate standard for determining the fair value of dissenting shares because it incorporates elements of value—associated with acquisitions of control by third parties—that do not belong to the acquired enterprise or to shares of stock in that enterprise.

There is also a more subtle policy objection to the use of third-party sale value in determining “fair value”—one that identifies a potential for creating perverse incentives. That objection begins with the observation that the economics definition of value is an equilibrium concept because all resources are assumed to be in their best use.⁹⁹ In

2007) (holding that a court may derive fair value by using the third party sale price “if the sale of the company in question resulted from an arm’s-length bargaining process . . . [but] [t]he court must, however, exclude synergistic elements from the sale price to arrive at a fair value.”); *Union Ill. 1995 Inv. Ltd. P’ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 343 (Del. Ch. 2003) (finding that when the sales process is effective, “fair value is the value of the Merger Price minus synergies”).

⁹⁶ See *infra* notes 141–154 and accompanying text.

⁹⁷ See *infra* notes 126–177 and accompanying text.

⁹⁸ Whatever that is. Various authorities make clear that “fair value” must not be reduced by a “minority discount,” but they do not explain what a minority discount is, or how it might be measured. *E.g.*, MODEL BUS. CORP. ACT § 13.01(4)(iii), Official Comment on “Fair Value” (2008); AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (2005) § 7.22(a) & cmt. e.

⁹⁹ See BREALEY ET AL., *supra* note 42, at 16.

equilibrium, all value-enhancing transactions have already taken place, so that the opportunity cost or next-best-use of the corporation's assets has a lower value than the resources in their current use.¹⁰⁰

It is true that real-world purchases of assets take place at a premium. It is these transactions that bring the economic system into equilibrium. Accordingly, commentators argue that the definition of fair value should be taken from the price paid by a willing buyer of control of the asset.¹⁰¹ We agree with this proposition, at least in general: when there is a third-party bid for a corporation or its assets, then the value of the bid represents a reasonable measure of value—perhaps not “fair value,” but certainly value in some sense.¹⁰²

It is incorrect, however, to assume that most corporations would be sold at a premium if they were put on the auction block. In the world of real transactions all that we see is a highly selective set of transactions—namely those cases where a willing buyer has emerged who is willing to pay more than the company's going concern value. It is reasonable to assume that the lack of active bids for the vast majority of corporations reflects the idea that most of the time, most of the assets are indeed in their best use. The next-best-use would be at a lower price. This is the story about the dogs that do not bark.¹⁰³ We hear only the dogs that bark; most of the time, the vast majority of dogs are not barking.

The non-barking dog metaphor explains why, even in a world with huge amounts of capital available to take public companies private, the number of transactions relative to the number of companies remains tiny.¹⁰⁴ There should be no presumption that all corporations could be

If other investors agree with your forecast of a \$420,000 payoff and your assessment of its risk, then your property ought to be worth \$375,000 once construction is underway. If you tried to sell it for more, there would be no takers, because the property would then offer an expected rate of return lower than the 12% available in the stock market. Thus the office building's present value is also its market value.

Id.

¹⁰⁰ *See id.*

¹⁰¹ *See id.*

¹⁰² *See id.*

¹⁰³ *See* ARTHUR CONAN DOYLE, *The Adventure of Silver Blaze*, in *SHERLOCK HOLMES: THE COMPLETE ILLUSTRATED SHORT STORIES* 235, 254 (2002).

¹⁰⁴ In 2007, for example, there were 480 acquisitions of public companies (including acquisitions of controlling interests), as compared to approximately 12,000 public companies (defined as those registered under the Securities Act of 1933 and the Securities Exchange Act of 1935). SEC OFFICE OF INSPECTOR GEN., SEMI-ANNUAL REPORT TO CONGRESS, OCTOBER 1, 2008 – MARCH 31 5 (2009), available at <http://www.secoig.gov/Reports/>

sold at a higher valuation were they forced to be put up for bid.¹⁰⁵ Although we recognize that transaction costs associated with acquisitions prevent the market for corporate control from eliminating all suboptimal pricing discrepancies, it is simply implausible to believe that underpriced stocks are persistently passed over by private equity firms, hedge funds, and other institutional investors.

In fact, in cases of well-managed firms, the absence of a third-party acquisition bid suggests that there is no buyer willing to pay more than the firm's going concern value, and a third-party sale value standard would provide a lower share valuation than the going concern value standard.¹⁰⁶ The flaw of the third-party sale value argument is that it assumes that assets are generally deployed inefficiently so that a higher use is readily available in an appraisal setting. One reason that the great majority of firms are not up for sale at every moment is that higher bidders do not naturally lurk in the shadows waiting for the "for sale" sign to be posted.

This set of observations brings us once again to the problem of perverse incentives. What would happen if a third-party sale value rule governed the determination of fair value? Again, we examine the case of a controller that wants to take the company private. Suppose the company is very well managed by the controller. Under the going concern value standard, these efficient managers have to pay their shareholders the going concern value which includes their efforts as efficient managers.¹⁰⁷ Suppose the third-party sale view were taken literally; that is, the dissenters' shares would be appraised at the highest bid. In some cases, management may be the only bid and, in many cases, the efficient managers may be the highest possible bidders. Because the efficient managers only have to beat the next best offer in an auction set-

Semiannual/2009/semiapr09.pdf; FACTSET MERGERSTAT, LLC, ACQUISITIONS OF PUBLICLY TRADED COMPANIES, 1993-2007 (2008).

¹⁰⁵ See ASWATH DAMODARAN, DAMODARAN ON VALUATION 481 (2d ed. 2006) ("[T]he control premium should be zero for firms where management is already making the right decisions."); PRATT ET AL., *supra* note 89, at 358-59 (identifying acquisitions of control at discounts, rather than premiums, to prior public trading prices); Gilbert E. Matthews, *Misuse of Control Premiums in Delaware Appraisals*, 27 BUS. VAL. REV. 107, 115 (2008) ("[C]ontrol value of a company may not differ greatly [from] and may even be below its publicly traded minority share value." (quoting PHILIP J. CLEMENTS & PHILIP W. WISLER, THE STANDARD & POOR'S GUIDE TO FAIRNESS OPINIONS 94 (2005))).

¹⁰⁶ See Matthews, *supra* note 105, at 114 (referring to "the dot.com" euphoria as a "clear example[] of periods when most companies in certain industries trade at prices that exceed the price that any cash buyer would pay").

¹⁰⁷ See *supra* note 53 and accompanying text.

ting by a small amount, they could buy the company for less than going concern value.

In effect, a third-party sale value rule would create a new potential for controller opportunism. The current concern is that the controller will use the squeeze-out when the going concern value is low and about to increase.¹⁰⁸ Under a third-party sale value rule the concern would be the converse, namely that the controller would time the squeeze-out to occur when third-party sale value is arguably lower than going concern value. In particular, a controller could wait until acquisition price ratios are unusually low and rely on such deflated ratios to justify a fair value that would undervalue the firm's going concern value.

3. Going Concern Value

The third possible measure of fair value, and the one adopted by the courts, is the going concern value standard.¹⁰⁹ Going concern value, or more directly, the enterprise value, is estimated using DCF analysis, which is simply the discounted value of the free cash flows generated by the company's assets.¹¹⁰

As we have previously observed, DCF analysis is a forward-looking concept that must be divided into two components.¹¹¹ The first component is the free cash flows generated by the assets already owned by the firm.¹¹² Although the future cash flows can vary with the business cycle and industry conditions, the current asset base of the company is known and there are various methods of determining the value of the

¹⁰⁸ As we discuss in the next section, we believe that going concern value, appropriately calculated, can deal with this problem. *See infra* notes 109–125 and accompanying text.

¹⁰⁹ *See, e.g., Harnett*, 564 A.2d at 1144–45; *Bell v. Kirby Lumber Corp.*, 413 A.2d 137, 140–42 (Del. 1980).

¹¹⁰ *See supra* note 42 and accompanying text. This DCF-oriented approach to “fair value,” however, is probably inappropriate in regard to investments other than common stock. *See, e.g., In re Appraisal of Metromedia Int'l Group, Inc.*, 971 A.2d 893, 900 (Del. Ch. 2009). In appraisal cases involving preferred stock with limited returns and other defining contractual features, the case law emphasizes a valuation based on an assessment of the value of those contract rights. *See id.* (“[T]he valuation of preferred stock must be viewed through the defining lens of its certificate of designation, unless the certificate is ambiguous or conflicts with positive law.”); *In re Appraisal of Ford Holdings, Inc. Preferred Stock*, 698 A.2d 973, 977 (Del. Ch. 1997) (terms of the preferred stock defining what the holder is entitled to receive in a merger control the determination of “fair value”).

¹¹¹ *See Hamermesh & Wachter, supra* note 6, at 137.

¹¹² *See id.*

free cash flows that it will generate that are consistent with DCF analysis.¹¹³

The term “going concern,” however, may obscure the second component of DCF analysis because it conjures up a picture of a firm with a fixed capital stock that is owned by the firm and is fully known at the time of the valuation exercise.¹¹⁴ This picture is incomplete. Typically, a company that is generating free cash flow does not pay it all out in dividends.¹¹⁵ Instead, some of that cash will be used to reinvest in profitable projects.¹¹⁶ Thus, the decision to retain earnings amounts to a manifestation that there are future profitable investment opportunities for the corporation. These investment opportunities belong to the corporation and are a component of the firm’s going concern value. Consequently, the present value of the firm is not only the free cash flows from the existing assets, but also the free cash flows that will be earned on the new investments to be made from retained earnings.¹¹⁷ This second component can easily be as large as or larger than the first, but, in any case, it cannot be ignored. In finance textbook terminology, this second element is the present value of the firm’s growth opportunities.¹¹⁸ In total, then, the firm can be divided into the present value of a level stream of earnings based on the current assets and the present value of the growth opportunities generated by reinvestment opportunities.¹¹⁹

This two-part conception of DCF analysis conveniently addresses valuation disputes in the most difficult cases, where the controller squeezes out the minority shareholders, and where there is the greatest

¹¹³ See BREALEY ET AL., *supra* note 42, at 98.

¹¹⁴ See Hamermesh & Wachter, *supra* note 6, at 137.

¹¹⁵ See BREALEY ET AL., *supra* note 42, at 442.

¹¹⁶ See *id.*

¹¹⁷ See Hamermesh & Wachter, *supra* note 6, at 137–38.

¹¹⁸ See BREALEY ET AL., *supra* note 42, at 99–101.

¹¹⁹ This breakdown of value into the two components is different from, and should not be confused with, the other two-part division used by the courts in the calculation of fair value using a DCF analysis. See Hamermesh & Wachter, *supra* note 6, at 138. In this standard and well-accepted calculation, there is an initial period where annual forecasts are available on the key parameters and a terminal value where one resorts to an estimate about future growth and discount rates applicable in the future. See, e.g., Cede & Co. v. JRC Acquisition Corp., No. 18648-NC, 2004 Del. Ch. LEXIS 12, at *6 (Del. Ch. Feb. 10, 2004). This two-part formulation is also the most common way of performing a DCF in appraisal cases. See *id.* The reinvestment opportunity component is not an overlapping concept with terminal value. See Hamermesh & Wachter, *supra* note 6, at 138. Indeed, in our categorization reinvestment opportunities are likely to have a significant effect on value by affecting the cash flows during the period when annual forecasts of the key parameters are available. See BREALEY ET AL., *supra* note 42, at 97.

potential for the controller to take exclusive advantage of new reinvestment opportunities available to the firm. The finance perspective would say that these opportunities should be included as long as they are known to the controller and are part of the corporate policy of the existing firm before the merger, whether or not they are disclosed to anyone else at that time.¹²⁰ Consequently, the correct calculation of the value of the firm includes the discounted free cash flows from these opportunities.¹²¹

The law should—and usually does—produce the same results.¹²² If the minority shareholders were not being squeezed out, they could continue to hold the stock into the future.¹²³ What they lose in the squeeze-out is thus the discounted value of the free cash flows of both the original assets and the return on the reinvestment opportunities.¹²⁴ These shareholders can then be made no worse off, as long as they are paid their proportional share of both components of that discounted value.¹²⁵

III. WHAT IS THE CONTROVERSY?

The discussion above makes the normative case supporting the Delaware courts' use of going concern value as the correct standard for determining the fair value of dissenters' shares in a merger.¹²⁶ Similarly, the discussion supports the courts' use of DCF analysis as the preferred method for calculating going concern value.¹²⁷ Up to this point there is no controversy. It is also uncontroversial that when the DCF methodology is used to estimate going concern value, one can move seamlessly between enterprise and share value by either multiplying the share price by the number of shares or dividing enterprise value by the number of shares.¹²⁸

¹²⁰ See BREALEY ET AL., *supra* note 42, at 99–102.

¹²¹ *See id.*

¹²² See Hamermesh & Wachter, *supra* note 6, at 138.

¹²³ See *supra* note 67 and accompanying text.

¹²⁴ See Hamermesh & Wachter, *supra* note 6, at 138.

¹²⁵ *See id.*

¹²⁶ See *supra* notes 79–125 and accompanying text.

¹²⁷ See *supra* notes 79–125 and accompanying text.

¹²⁸ This proposition is generally correct, but does need to be slightly adjusted to fit the corporation that has debt as well as equity. In the standard valuation methodology, the market value of the debt is first subtracted from the value of the enterprise's total invested capital. The value of the equity is then estimated using the capital asset pricing model. With the debt removed, the ability to move between the value of the enterprise and the value of the shares by either multiplying or dividing by the number of outstanding shares is

The potential for controversy arises when the data for a DCF analysis is either not available or not entirely reliable, and the expert relies on comparable company analysis to estimate going concern value. In that method, the trading prices of comparable companies are the starting point for the analysis. Those trading prices provide the basis for multiples such as price/earnings (“P/E”) ratios or market/book ratios. The ratios, in turn, are then used to calculate the enterprise value. For example, suppose the comparable company has earnings of \$1 a share and a share price of \$15, yielding a P/E ratio of fifteen. If the company being appraised earns \$1.67 per share, then the P/E multiple of fifteen is applied to its earnings, yielding a share value of \$25.

In standard finance, there is still no controversy, assuming that the “comparable companies” are truly comparable. In the example above, the value of the shares of the appraised company is \$25 and the value of the enterprise is the share value multiplied by the number of shares. If there are one million shares outstanding, the enterprise value of the corporation is \$25 million. Finance texts routinely conclude or assume that traded share prices of companies—whether of comparable companies or the appraised company—trade at the value of the enterprise divided by the number of shares.¹²⁹ To move from share value to enterprise equity value requires only a multiplication of the number of outstanding shares by the share value estimated via comparable company analysis. No finance text claims that the result has to be adjusted upward on the premise that the comparable companies’ share prices impound some inappropriate discount.

The Delaware courts, on the other hand, have had problems reaching the same conclusion.¹³⁰ The competing judicial view to the

restored. With the equity value of the corporation so estimated, the market value of the debt is added back in to yield the enterprise value.

¹²⁹ See BREALEY ET AL., *supra* note 42, at 88–91. Ross, Westerfield, and Jaffe define the value of common stocks in an identical fashion. STEPHEN A. ROSS ET AL., *CORPORATE FINANCE* 109 (6th ed. 2002). These textbooks define the value of a stock as the discounted value of dividends and elsewhere define the value of the firm as the discounted value of future free cash flows. As Damodaran points out, these values measure the same thing—cash flows to equity holders. DAMODARAN, *supra* note 105, at 174–75. Damodaran discusses scenarios in which dividend discounting and free cash flow discounting could lead to different valuations, namely when free cash flows are neither paid as dividends nor reinvested in the firm. *Id.* at 188. However, these scenarios may represent a form of an agency cost which, as discussed in detail below, are appropriately reflected in (a reduced) going concern value. See *infra* notes 143–154 and accompanying text. In any event, Damodaran notes that his analysis switches freely between per share and aggregate valuations. See DAMODARAN, *supra* note 105, at 191–92. He makes no mention of a need to include a discount when moving from a value of the firm as a whole to the value of individual shares. See *id.*

¹³⁰ See Hamermesh & Wachter, *supra* note 19, at 7–24.

finance theory proceeds along the following lines. First, enterprises are routinely sold at a premium relative to their shares' trading prices.¹³¹ Second, synergies—value created by the business combination itself—account for only some, and perhaps very little, of such acquisition premiums.¹³² Therefore, the value of the enterprise itself necessarily exceeds the trading value of its shares. An explanation proffered for this distinctive viewpoint is that the shares and the entity are separate commodities; the shares have limited rights and, in particular, limited control, and therefore inherently do not reflect the full value of the enterprise itself.¹³³ Thus, the courts have held that share trading prices incorporate an “implicit minority discount” (“IMD”) relative to enterprise value.¹³⁴ The size of the IMD adjustment is substantial, with the more recent cases favoring a thirty percent adjustment.¹³⁵

In our example above, the appraised company's stock price is calculated to be \$25 before the IMD adjustment. If an IMD adjustment of thirty percent is used, then the appraisal litigation awards the dissenting shareholders a price of \$32.50 per share.

Let us return to the comparable company for a moment and see how that company's value would be determined in an appraisal hearing. Consistent with finance texts, we say that the \$15 trading price of the comparable company's stock reflects the present value of its future free cash flows. An IMD-based award, however, would value that company's shares at \$19.50 instead of \$15. In other words, the IMD award would view the comparable company as having a value of \$19.50 per share, thus valuing the company as if, contrary to fact, it was owned by a controlling shareholder and was thus free of the agency costs associated with the separation of ownership and control.

Taken literally, the courts' insistence on the existence of an implicit minority discount cannot be squared with modern precepts of corporate finance, which argue that efficient financial markets' share prices reflect the pro rata value of the corporation's discounted free cash flows.¹³⁶ In an efficient market, a firm with a DCF value of \$19.50

¹³¹ See *id.* at 30.

¹³² See *id.*

¹³³ See, e.g., Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. Rev. 761, 825 (1985) (“[T]here is no basis for the assertion that prices prevailing in the stock market measure value of a firm to a potential acquiror.”).

¹³⁴ See, e.g., *Doft & Co. v. Travelocity.com, Inc.*, No. 19734, 2004 Del. Ch. LEXIS 75, at *45–47 (Del. Ch. May 21, 2004); see also Hamermesh & Wachter, *supra* note 19, at 20–24.

¹³⁵ See Hamermesh & Wachter, *supra* note 19, at 23.

¹³⁶ See *id.* at 49.

cannot consistently and persistently be trading at \$15 per share. Assuming that the comparable company also has one million shares outstanding, the direct implication is that the company's enterprise value based on its trading shares is \$15 million whereas the enterprise value, based on a DCF analysis, is actually \$19.5 million.

We believe that the solution to reconciling this inconsistency lies in the fact that markets may be efficient at pricing minority shares, but minority shares are worth less than control shares. Hence in our example, the minority shares are worth \$15, while the control shares are worth \$19.50. In other words, the comparable company has an indicated enterprise value of \$15 million based on trading share prices, but it would be worth \$19.5 million if valued from the perspective of a controller. Consequently, one cannot move seamlessly between the publicly traded share price of \$15 per share and the enterprise value of \$19.5 million. Simply multiplying the share trading price of \$15 by the one million outstanding shares no longer yields the value of the firm.¹³⁷

The basis for this disconnect emerges clearly from the Delaware courts' reasons for making an adjustment for the perceived implicit minority discount.¹³⁸ Quite simply, the courts view the adjustment as necessary in order to share the value of control among all shareholders.¹³⁹ As best expressed by the Delaware Court of Chancery in the 2004 *Doft & Co. v. Travelocity.com* case, "appraisal cases . . . correct the valuation for a minority discount by adding back a premium 'that spreads the value of control over all shares equally' . . ."¹⁴⁰

We applaud the clarity with which the Delaware courts have put forward their control value-spreading rationale for adjusting for a perceived implicit minority discount.¹⁴¹ As a general matter, however, this rationale is inconsistent with appraisal theory as expounded above.¹⁴² To explain why this is so, it is necessary to examine the value created when a controller aggregates previously disaggregated corporate

¹³⁷ This example assumes that there are no synergies in taking the firm private. We could easily adjust the numbers to reflect the synergies, but the result would only be a more complex example without a difference in results.

¹³⁸ See, e.g., *Doft*, 2004 Del. Ch. LEXIS 75, at *46-47 (citing *Agranoff v. Miller*, 791 A.2d 880, 887 (Del. Ch. 2001)).

¹³⁹ See *id.*

¹⁴⁰ See *id.* ("[C]orrection for a minority discount requires the addition of a premium that spreads the value of control over all shares equally."); see also *Bomarko, Inc. v. Int'l Telecharge, Inc.*, 794 A.2d 1161, 1186-87 n.11 (Del. Ch. 1999), *aff'd*, 766 A.2d 437 (Del. 2000); *Borruso v. Commc'ns Telesys. Int'l*, 753 A.2d 451, 458-59 (Del. Ch. 1999).

¹⁴¹ See, e.g., *Doft*, 2004 Del. Ch. LEXIS 75, at *46-47 (citing *Agranoff*, 791 A.2d at 887).

¹⁴² See *supra* notes 79-125 and accompanying text.

shares. If, as we believe, the value of control is a significant component of acquisition premiums, the critical issue emerges: to whom does the value of control belong? Is it value belonging to the enterprise itself, as the Delaware courts have suggested, so that the fair value of corporate shares must include their proportional share of such control value? Or should the value of control be said to belong to the person possessing it and not to the enterprise itself? We assert that it belongs to the individual or entity that creates control by aggregating the shares.

In order to discuss our reasoning, we first need to address two related concepts: agency costs and the benefits of control. As explained below, we believe that these two concepts, properly understood, demonstrate that the value of owning a controlling block of corporate shares should not be viewed as belonging to the enterprise itself, and as a consequence, the existence of acquisition premiums does not establish that share trading prices inherently and systematically understate enterprise value.

A. Agency Costs

To understand the concept of agency costs and its relation to the issue at hand, it is useful to differentiate among types of firms according to whether they have a controller and, if so, whether there are minority shareholders. The two polar cases are the firm with a sole controlling shareholder who also manages the firm and the firm without a controlling shareholder where the shares are owned by a fluid disaggregation of shareholders. We denote the value of the firm where the owners are the managers as V_{OM} and the value of the firm with disaggregated shareholders and no controller as V_{NC} .

Adolf Berle and Gardiner Means were among the first to point out that the separation of ownership and control provides managers with discretion to further their own interests rather than the interests of shareholders.¹⁴³ The result of this separation is agency costs (“AC”), which create a wedge between the values of the same firm when it is owner-managed and when the managers are not the owners.¹⁴⁴

¹⁴³ See ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 116 (Transaction Publishers 1991) (1932) (“The concentration of economic power separate from ownership has, in fact, created economic empires, and has delivered these empires into the hands of a new form of absolutism, relegating ‘owners’ to the position of those who supply the means whereby the new princes may exercise [sic] their power.”).

¹⁴⁴ See Hamermesh & Wachter, *supra* note 19, at 33.

We therefore have:

$$V_{NC} = V_{OM} - AC$$

Since the work of Michael Jensen and William Meckling, it has been recognized that in transactions that disperse ownership (such as initial public offerings), the burden of agency costs falls on the owner-managers who are separating ownership from control.¹⁴⁵ As they wrote:

[T]he owner will bear the entire wealth effects of these expected costs so long as the equity market anticipates these effects. Prospective minority shareholders will realize that the owner-manager's interests will diverge somewhat from theirs, hence the price which they will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interest and theirs.¹⁴⁶

The agency costs thus reflect the assumption that managers will maximize their own welfare, which will not be entirely consistent with the interest of the corporation.¹⁴⁷ The agency cost concept includes the full cost of the managers' compensation, including the part of the compensation that is above what the firm needs to pay to hire the managers in the competitive labor market.¹⁴⁸ It also includes any higher supplier costs, employee labor costs, etc., that the managers allow to creep into the cost structure because they bear a relatively small part of the loss.¹⁴⁹ The agency cost concept may also include whatever revenue sources are lost if the managers are less attentive to customer needs once they are no longer the owner-operators of the firm.¹⁵⁰ Finally, agency costs include the high bonding costs associated with the disclosure and other requirements of publicly traded companies.¹⁵¹ Whatever

¹⁴⁵ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 313 (1976).

¹⁴⁶ *See id.*

¹⁴⁷ *See id.* In its simplest terms, the owner-manager may be willing to work 24-7, while the CEO with a one percent ownership stake may work more civilized hours. *See* Hamermesh & Wachter, *supra* note 19, at 34. This divergence also explains why owner-managers are willing to sell the company at a price which discounts the agency costs. *See id.* After the transaction, the original owner-managers can work a less hectic schedule. *See id.* In addition, the original owners are willing to bear the agency costs because they benefit from the ability to diversify their wealth with the cash received from the sale. *See id.*

¹⁴⁸ Hamermesh & Wachter, *supra* note 19, at 35.

¹⁴⁹ *See id.*

¹⁵⁰ *See id.*

¹⁵¹ *See id.*

they include, the agency costs of the firm with dispersed ownership are reflected in the free cash flows of the firm.

Management actions that give rise to agency costs do not in any way necessarily involve a violation of fiduciary duties. Agency costs are as real a cost as any other.¹⁵² This is also not to deny that agency costs may include the effects of breaches of fiduciary duty. In general, however, agency costs are an inevitable burden on publicly held companies and largely involve no breach of fiduciary duty at all.

The process of separating ownership and control thus results in a loss in corporate value equal to the size of the agency costs. The reverse is true in a going-private transaction, where ownership and control are once again unified. The process of unifying ownership and control creates value by eliminating the agency costs associated with separation of ownership and control.

One immediate implication of this analysis is that if the ownership-dispersing transaction is reversed, by means of a transaction that aggregates share ownership, the shareholders do not have to be compensated for the agency costs. The shares sold by the original owner were discounted by the amount of the agency costs and thus the manager taking the firm private should pay V_{NC} to the cashed out shareholders and not the higher V_{OM} that includes the value of reduced agency costs. In the appraisal setting, the now cashed out shareholders receive the going concern value of the holdings that they sell, V_{NC} , which are net of the agency costs.

Agency cost reductions are thus a factor, separate from synergies, that create value in change-in-control transactions.¹⁵³ For the moment, we put aside the synergies question since there is no controversy in how, at least conceptually, synergistic gains from a merger are to be treated. As noted earlier, all commentators agree that such gains must be excluded in determining fair value.¹⁵⁴ That leaves the question as to who owns or should be credited for the reduction in agency costs: the controller who aggregates the shares or the minority shareholders?

¹⁵² See *id.* at 34. For example, an agency cost is the compensation of the CEO that exceeds the labor market clearing compensation of comparably skilled managers. See *id.* While such compensation may at times be viewed as excessive, it is not necessarily or even ordinarily, a breach of fiduciary duty. See *id.* In general, the existence of agency costs does not imply the taking of a corporate opportunity, the use of corporate assets for private purposes, or engaging in conflicted transactions without board approval. See *id.* at 34–35.

¹⁵³ See *id.* at 35.

¹⁵⁴ See *supra* notes 33–62 and accompanying text.

B. *Identifying and Allocating the Benefits of Control*

As this Article argued above, the aggregation of shares, which eliminates agency costs in the process, is a value-creating transaction.¹⁵⁵ It comes as no surprise, then, that control achieved through the aggregating of shares is distinctly valuable and that acquirers pay premiums over disaggregated share prices to obtain it.¹⁵⁶ Control blocks are worth more because of the greater ability of the controller to direct the strategy of the firm.¹⁵⁷ This enhanced control includes the ability of the controller to appoint or change management, determine compensation, set operational and strategic policy, and change the course of the business.¹⁵⁸

Finance theorists and the courts both recognize these benefits.¹⁵⁹ For example, Aswath Damodaran discusses the control premium entirely as value brought by changes in management.¹⁶⁰ He differentiates between the present value of the corporation and its optimal value, where the difference reflects the changes in policy brought by management.¹⁶¹ In a recent article, Damodaran is more explicit, stating “that the value of controlling a firm has to lie in being able to run it differently (and better).”¹⁶² To the same effect, Christopher Mercer and Travis Harms present a diagram similar to the one set out below, in which: (1) the “financial control” premium and the “minority interest discount” are identical, (2) those adjustments equally explain the difference between “financial control value” and “marketable minority” value,¹⁶³ and (3) the so-called “marketable minority value” can be derived from a DCF analysis, i.e. a valuation generated “by ‘build-up’

¹⁵⁵ See *supra* notes 126–154 and accompanying text.

¹⁵⁶ See PRATT ET AL., *supra* note 89, at 349.

¹⁵⁷ See *id.*

¹⁵⁸ *Id.* at 347–48.

¹⁵⁹ See, e.g., DAMODARAN, *supra* note 105, at 495 (reporting evidence of premiums paid to acquire large blocks of shares); see also *Paramount Commc'ns. Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1994) (characterizing the control premium as the price for the “privilege of exerting the powers of majority ownership”); *Cheff v. Mathes*, 199 A.2d 548, 555 (Del. 1964) (“[A] substantial block of stock will normally sell at a higher price than that prevailing on the open market, the increment being attributable to a ‘control premium.’”).

¹⁶⁰ See DAMODARAN, *supra* note 105, at 457.

¹⁶¹ See *id.*

¹⁶² Aswath Damodaran, *The Value of Control: Implications for Control Premia, Minority Discounts and Voting Share Differentials*, 2 (Stern Sch. of Bus., 2005), available at <http://pages.stern.nyu.edu/~adamodar/pdfiles/papers/controlvalue.pdf>.

¹⁶³ In this Article, we identify “financial control value” as V_{OM} and “marketable minority” value as V_{NC} .

methodologies that develop capitalization rates by estimating required rates of return in relation to public markets.”¹⁶⁴

| STRUCTURE OF DISCOUNTS AND PREMIUMS | |
|---|---|
| Value Per Share | Premium/Discount |
| \$20.00 Nonmarketable Minority Value | |
| | Adjustment A |
| \$25.00... V_{NC} Going Concern value (Value of freely traded shares) | \$5.00 (25% premium to eliminate marketability discount) |
| | Adjustment B |
| \$32.50... V_{OM} Value of shares with a controller. | \$7.50 (30% premium reflecting value of control) |
| | Adjustment C |
| \$40.00... V_{3PS} Value of shares in a 3rd party acquisition. (Includes synergies) | \$7.50 (23% acquisition premium; with Adjustment B, a 60% premium over freely traded share value) |

This table illustrates three issues that need to be resolved in a valuation proceeding. First, do minority shareholders receive the value of shares discounted for a lack of marketability or do they receive going concern value, V_{NC} ? In our example, do they receive \$20 or \$25? The case law is settled on this point—the minority shareholder receives \$25.¹⁶⁵ This resolution of the question is perfectly consistent with our normative discussion of the issues.¹⁶⁶

Secondly, do the dissenting shareholders receive the synergies resulting from the merger? In this case, as a matter of statute, the dissenting shareholders do not receive the synergies, and there is a good normative reason for this statutory rule.¹⁶⁷ The value created by the merger would not exist but for the merger proposed by the bidder. To encourage bidders to create value through proposing such mergers, the bidder should receive the value that it creates, even if the target company shareholders receive some of that value in a negotiated deal. In our table, then, the dissenting shareholders do not receive the \$40 that includes the acquisition premium.

¹⁶⁴ Z. CHRISTOPHER MERCER & TRAVIS W. HARMS, BUSINESS VALUATION: AN INTEGRATED THEORY, 64, 71 (2nd ed. 2008).

¹⁶⁵ Bell v. Kirby Lumber Corp., 413 A.2d 137, 147 (Del. 1980) (mentioning that there is no authority in Delaware corporate law for granting discounts for lack of a market); Cavalier Oil Corp. v. Harnett, No. 7959, 1988 Del Ch. LEXIS 28, at *30 (Del. Ch. Feb. 22, 1988) (explaining that in appraisal cases, “the thing being valued is the entire corporation as a going concern, not individualized configurations of its shares”).

¹⁶⁶ See *supra* notes 91–108 and accompanying text.

¹⁶⁷ See DEL. CODE ANN., tit. 8, § 262 (2008).

Finally, do minority shareholders receive the value of control that is created by the aggregation of shares and the creation of a new controller? In our example, do they receive \$25, or \$32.50? Embracing the concept of an “implicit minority discount,” the courts would award the dissenters \$32.50 instead of \$25, on the theory that fair value should not be reduced for lack of control.¹⁶⁸

But to whom does the value of control belong? For our purposes, the key point is that the aggregation of the shares is value-creating because a controller can then exercise the control rights involving directing the strategy and managing the firm.¹⁶⁹ Absent a controller, the corporation is valued at the lower V_{NC} rather than at the higher V_{OM} . That is, for the dispersed shareholders the value of their corporation is V_{NC} . Since the value is created by the aggregation process and does not exist independent of it, the logical and normatively compelling conclusion is that the value creation should accrue to the party that has created it.

The normative justification for awarding the value of control to the controller parallels the rationale for awarding the value of synergies to the bidder. Efficiency requires that those who create an efficient transaction—either through creating synergies or eliminating agency costs—should receive the value that they create. As a normative matter, awarding synergies or control value to the dissenters is normatively incorrect because it confers upon them a share of value that they have not created.

The situation is different, however, where an already existing controller squeezes out the minority shareholders. In this situation, control is already present, and the value of the company already incorporates the benefits of reduced agency costs. If the controller decides to squeeze out the minority shareholders, there will perhaps be some value creation, but it is likely to be relatively small.¹⁷⁰ The gain is the

¹⁶⁸ See *Andaloro v. PFPC Worldwide, Inc.*, No. 20336, 2005 Del. Ch. LEXIS 125, at *70 (Del. Ch. Aug. 19, 2005) (“What is being corrected for [by adding a control premium] is the difference between the trading price of a minority share and the trading price if all the shares were sold.”); *Borruso*, 753 A.2d at 458–59 n.10 (finding that “[the market value of invested capital] derived using the comparable companies approach does *not* reflect any element of value for control” and must be adjusted by applying a control premium); *Le Beau v. M. G. Bancorp., Inc.*, No. 13414, 1998 Del. Ch. LEXIS 9, at *39 (Del. Ch. Jan. 29, 1998) (explaining that a control premium is not the result of post-merger synergies, but “[r]ather [it] reflects an independent element of value existing at the time of the merger . . .”).

¹⁶⁹ See PRATT ET AL., *supra* note 89, at 347–48.

¹⁷⁰ In fact, in their treatment of control, neither Pratt nor Damodaran identifies or discusses a value associated with eliminating minority shareholders. See DAMODARAN, *supra* note 105, at 457–96; PRATT ET AL., *supra* note 89, at 343–88.

elimination of the agency costs associated with the elimination of minority shareholders. The gain associated with the creation of control, however, is largely absent.

In both situations, the gains from the aggregation of the shares and the gains from the elimination of the minority shareholders are created by the transaction and thus belong to the controller.¹⁷¹ There is no difference here. In the latter case, however, where the only gain is the elimination of the minority shareholders, the court will need to be particularly cognizant of possible gains associated with the diversion of corporate value to the controller. The difference becomes visible in cases where an existing controller squeezes out minority shareholders because there is a greater possibility that the gains represent a diversion of a corporate opportunity.

Take the likely example where the evidence indicates that the firm, with the minority squeezed out, will be better managed for reasons that can arise from any number of factors. To whom does such a gain belong? In our categorization, the answer is that this gain must be shared with the minority shareholders. Because there was no change in control, the existing controller could have made the changes that would have resulted in improved management without squeezing out the minority. The only effect of the squeeze-out is that the controller no longer has to share the gains with the minority shareholders, unless the gains are somehow incorporated into determining the fair value of the minority shares.

In sum, whether the value of control is part of “fair value” belonging to existing shareholders depends on whether control has already been consolidated. As previously noted, however, the Delaware courts have applied an implicit minority discount analysis based on the proposition that all shareholders are inherently entitled to a proportionate share of the value of control, even in firms in which control has not been aggregated.¹⁷² We disagree with that proposition as a general matter. It might be argued, however, that the proposition follows from the Delaware Supreme Court’s analysis in 1994 in *Paramount Communications, Inc. v. QVC Network, Inc.*, where the court stated:

¹⁷¹ We do not disregard the possibility that introduction of a controller could impair the value of minority *shares*, due to actual or threatened misappropriation. We do not expect, however, that controllers will ordinarily impair the value of the *firm* in which they own a controlling interest.

¹⁷² See *supra* note 140 and accompanying text.

The acquisition of majority status and the consequent privilege of exerting the powers of majority ownership come at a price. That price is usually a control premium which recognizes not only the value of a control block of shares, but also compensates the minority stockholders for their resulting loss of voting power.¹⁷³

The court's statement could be read to imply that the collective voting power of even disaggregated shareholders must always be compensated for when control is acquired.¹⁷⁴

We submit, however, that *QVC* itself does not compel this implication, at least as far as the concept of fair value is concerned.¹⁷⁵ Quite simply, the focus of the *QVC* opinion was not on fair value—i.e., the shareholders' proportional share of the value of the existing corporation—but on the value that could be achieved by directors charged with the fiduciary duty “to seek the transaction offering the best value reasonably available to the stockholders.”¹⁷⁶ That “best value” will include whatever share of merger gains, including synergies, the company's directors are able to extract from the buyer through negotiation or a competitive bidding process, or both. “Best value” and “fair value” are not the same thing. Whatever *QVC* may require of directors selling the company, it does not require that fair value include a share of enterprise value that would not exist but for the transaction that creates a controlling share position.¹⁷⁷

IV. IMPLICATIONS FOR JUDICIAL SHARE VALUATION IN COMPULSORY BUYOUTS

A. *Redefining Valuation Methodologies to Fit the Type of Merger Involved*

In our view, the foregoing analysis of agency costs and the benefits of control has important normative consequences in the discussion of appropriate share valuation standards in compulsory share buyouts. We review those consequences by reference to three different situations: (1) the acquisition of corporate control by a third party in an entirely arm's length transaction, (2) the acquisition of control in a manage-

¹⁷³ 637 A.2d 34, 43 (Del. 1994).

¹⁷⁴ *See id.*

¹⁷⁵ *See id.*

¹⁷⁶ *Id.*

¹⁷⁷ *See id.*

ment buyout, and (3) the squeeze out of minority shareholders by an existing controller.

1. Valuation in the Absence of a Controlling Shareholder

We begin with the case of dissenting shareholders who are being squeezed out by a third-party buyer acquiring their company. In light of our analysis, the firm's going concern value can be estimated in this case as the actual purchase price minus synergies minus control value. Control value, as well as synergies, must be subtracted from the purchase price. Otherwise, failure to make this subtraction would result in the minority/dissenting shareholders receiving a share of the value of corporate control, the benefits of which are not reflected in the value of the existing firm with disaggregated shareholders. Thus, a DCF analysis would not reflect returns associated with the existence of a controlling shareholder. Likewise, an appropriate measure of going concern value in a comparable company analysis should not involve any adjustment that would confer control value on the dissenting shareholders. Therefore, the implicit minority discount concept, discussed in both our earlier paper and in this Article, is out of place and incorrect.

We note that in a true third-party purchase situation, in which the target company's board of directors and shareholders are disinterested, there is no material concern that value is being misappropriated from the dissenting minority. First, an acquisition of control by a third party can only be completed upon approval by the target's board of directors,¹⁷⁸ acting subject to generally applicable fiduciary duties, and by a vote of shareholders.¹⁷⁹ Second, in a sale for cash, the directors will be subject to *Revlon* duties, under which commitments that hinder subse-

¹⁷⁸ See, e.g., DEL. CODE ANN., tit. 8, § 251(b) ("The board of directors of each corporation which desires to merge or consolidate shall adopt a resolution approving an agreement of merger or consolidation and declaring its advisability."); MODEL BUS. CORP. ACT, § 11.04(a) ("The plan of merger or share exchange must be adopted by the board of directors."); cf. *id.* § 11.04(b) (A board may submit a plan of merger to a shareholder vote if it determines "that because of conflicts of interest or other special circumstances it should not make such a recommendation . . .").

¹⁷⁹ See, e.g., DEL. CODE ANN., tit. 8, § 251(c) (requiring stockholder approval for a merger agreement); MODEL BUS. CORP. ACT, § 11.04(e) (same); *id.* § 8.30(a) ("Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation."); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("In the specific context of a proposed merger of domestic corporations, a director has a duty under title 8, section 251(b) of the Delaware Code, along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders.").

quent superior bids are subjected to significant judicial scrutiny.¹⁸⁰ Thus, the market for corporate control, aided by a disclosure regime in which information about pending takeover bids is widely and promptly disseminated, provides significant assurance that target company shareholders are treated fairly.¹⁸¹

On the other hand, application of an upward adjustment to a comparable company analysis for a perceived implicit minority discount, while conceptually and normatively inappropriate, is unlikely to have significant impact in the third-party purchase situation, as a practical matter. Ordinarily, it should be expected that the target board of directors, bargaining at arms-length, will bargain for a share of both the benefits of control and synergies. The resulting purchase price is thus likely to exceed going concern value. Hence, there is little incentive for

¹⁸⁰ See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (“The directors’ role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”); see also *Mills Acquisition Corp. v. MacMillan, Inc.*, 559 A.2d 1261, 1279 (Del. 1989) (“[Even] under the relatively broad parameters of the business judgment rule, . . . the relevant inquiry must focus upon the ‘fairness’ of the auction process in light of promoting the maximum shareholder value as mandated by this Court in *Revlon*.”). The court in *Paramount Communications, Inc. v. QVC Network, Inc.* explained:

[Higher] scrutiny is mandated by: (a) the threatened diminution of the current stockholders’ voting power; (b) the fact that an asset belonging to public stockholders (a control premium) is being sold and may never be available again; and (c) the traditional concern of Delaware courts for actions which impair or impede stockholder voting rights.

637 A.2d 34, 45 (Del. 1994). We recognize that because of infirmities in the voting process, it is not impossible that shareholders could formally approve a merger that is contrary to their collective interests. See *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346, 355 (Del. Ch. 2008) (seeking appraisal remedy where highly positive news emerged after board approval of merger agreement, but before the shareholder vote, yet shareholders narrowly approved the merger). See generally Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006); Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO L.J. 1227 (2008).

¹⁸¹ The periodic disclosure requirements of the Securities Exchange Act, together with the other elements that tend to create relatively efficient markets for the securities of registered issuers, promote broad dissemination of information about pending merger proposals. See generally Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523 (2003). As a general matter, such dissemination can be expected to elicit competing, superior bids for a company in the event that the terms of a proposed merger significantly undervalue the target company. See generally *In re Netsmart Techs., Inc. S’holders Litig.*, 924 A.2d 171 (Del. Ch. 2007); *In re Ft. Howard Corp. S’holders Litig.*, No. 9991, 1988 Del. Ch. LEXIS 110 (Del. Ch. Aug. 8, 1988).

shareholders to seek an appraisal remedy because the court's award will likely be below the original purchase price.¹⁸²

2. Valuation in Management Buyout Situations

The second situation we examine is where an existing management group, not part of a controlling shareholder, participates in a buyout by a third party. Despite the inclusion of management in this scenario, our analysis is the same as in the third-party purchase in which management does not participate. Here again, going concern value should exclude not only synergies, if they exist, but should also exclude any value resulting from the aggregation of shares that creates control. The reasoning is the same as in the prior case: including a share of control, by use of an upward adjustment based on a perceived implicit minority discount, inappropriately confers upon minority shareholders value for control that they do not possess and that does not exist until the acquisition is complete.

Here again, as a result of structural mechanisms that protect minority interests the potential for misappropriation of minority shareholders is slight. In this situation, at least where the company's shares are listed on a major stock exchange, there remains a majority of disinterested directors whose vote is necessary to approve the transaction.¹⁸³ The transaction must also be approved by shareholders, a majority of which are disinterested, given the absence of a controlling shareholder. Likewise, the directors' fiduciary obligations, including *Revlon* duties, remain the same.¹⁸⁴ To be sure, some of these protections may break down in practice: a court may be rightfully suspicious that where the CEO is a significant equity participant in the acquiring firm, even a largely independent board of directors may not fully and effectively pursue the highest available acquisition price.¹⁸⁵ Recent decisions in

¹⁸² See, e.g., *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 59–64 (Del. Ch. 2007) (using a fair value calculation of merger price minus synergies, therefore necessarily finding an appraisal value lower than the merger price); *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 343 (Del. Ch. 2003) (finding that when the sale process is effective, the merger price minus synergies is the best evidence of fair value).

¹⁸³ See, e.g., NYSE, INC., Listed Company Manual ¶ 303A.01 available at <http://nyse.manual.nyse.com/LCM/Sections> ("Listed companies must have a majority of independent directors.").

¹⁸⁴ See *supra* notes 179 and 180 and accompanying text.

¹⁸⁵ See, e.g., *In re Netsmart*, 924 A.2d at 193–94 (classifying a CEO's "virtually unlimited access" to an independent board of directors' merger deliberations as inviting "suspicion" and an indication that the "process [was] driven by management"); *In re SS&C Techs., Inc., S'holders Litig.*, 911 A.2d 816, 820 (Del. Ch. 2006) (arguing that when negotiations have

the Delaware courts, however, have deemed it sufficient protection in such circumstances to leave the matter to the vote of disinterested shareholders, as long as they are adequately informed about the background of the effort to sell the company.¹⁸⁶

Yet here again, we are not too troubled by an award of fair value that reflects an incorrect adjustment for an implicit minority discount, as long as the merger involves synergies as well as a change in control. As in the pure third-party purchase situation, the merger price (including a bargained-for share of synergies and control value) will likely exceed going concern value. Consequently, any award that contains an adjustment for a perceived implicit minority discount is still likely to be below the deal price, which contains some sharing of the gains from synergies as well as the gains from control. Again, dissenting shareholders would receive less than the deal price and would have no incentive to pursue valuation litigation.

If the case does not involve synergies, however, an IMD-related upward adjustment creates a potential for mischief in the form of unnecessary and inefficient litigation. Although the board is likely to negotiate a buyout price that shares the control value, it is unlikely to secure one hundred percent of that value. In this case, a minority shareholder would have an incentive to seek appraisal in order to obtain a fair value reflecting the full value of control—despite the fact that the enterprise has had no controlling shareholder, and its value as a going concern would not reflect the benefits of such control. Appraisal litigation would therefore discourage value-creating transactions that create control by aggregating shares. In such a management-buyout situation the courts should avoid automatically resorting to an upward

already been tainted by an unreliable negotiator, a committee of disinterested directors may be unable to correct for that negotiator's preemptive activities); *Gholl v. eMachines, Inc.*, No. 19444-NC, 2004 Del. Ch. LEXIS 171 at *64–65 (Del. Ch. Nov. 24, 2004) (explaining that members of the board may have ulterior motives in approving a low merger price, such as “creating a liquidity event for themselves”); *Mills Acquisition*, 559 A.2d at 1268–69 (finding that when interested directors choose the members of a supposedly independent “special committee” that essentially acts as a figurehead for those interested directors, the special committee is neither independent nor neutral).

¹⁸⁶ *In re Netsmart*, 924 A.2d at 207 (trusting that once shareholders are properly informed about both the proposed merger and the company's financial state, they will make “important voting and remedial decisions based on their own economic self-interest”); *La. Mun. Police Employees' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1192 (Del. Ch. 2007) (finding that despite “serious questions remain[ing] regarding the process surrounding the merger negotiations, [the] Court places great trust in the decisions of informed, disinterested shareholders”); *Upper Deck Co. v. Topps Co. (In re Topps Co. S'holders Litig.)*, 926 A.2d 58, 92–93 (Del. Ch. 2007) (enjoining a merger vote by shareholders until the board of directors apprised shareholders of a potentially advantageous offer by a new buyer).

adjustment for an incorrectly perceived implicit minority discount when performing a comparable company analysis.

3. Valuation in Controller Squeeze-Out Mergers

In contrast, in the third situation—where an already existing controller is squeezing out the minority shareholders—an upward adjustment of the sort the courts use when invoking the IMD may actually help reach an appropriate award, although still for the wrong reason. We note again that when the respondent and the dissenters litigate the case using the DCF method, the issue of the implicit minority discount does not arise and hence our normative position would be the same as the outcome that the court reaches. The question becomes: how should the court handle the situation where the parties use a comparable company analysis exclusively or in addition to their DCF analysis?

Based on our analysis, we treat this situation very differently from cases in which the transaction is creating control where none existed before. The prior existence of a controller obviously means that the transaction at issue does not involve a change in control. Hence, most of the control value—the amount related to the separation of ownership and control—is already built into the value of the corporation prior to the transaction and reflected in any analysis of its future cash flows.

Consequently—and contrary to the prior fact patterns—the value of control is already an element of going concern value. That is, the value of the firm, to which the minority is entitled to a proportionate share, incorporates the value associated with control. Although the squeeze-out may still reduce agency costs—costs associated with dealing with minority shareholders—this amount should ordinarily be relatively small.

From a policy perspective, controller squeeze-outs of minority shareholders raise several concerns. First, this is precisely the type of case where the minority shareholder is most vulnerable in terms of the available legal remedies.¹⁸⁷ Second, assuming there are no synergies

¹⁸⁷ Where a controlling shareholder is acquiring the shares of the minority there is no inherent protection afforded by the general requirement of director and shareholder approval, since those formal requirements can be satisfied by the controlling shareholder's own exercise of its power to elect directors and cast the necessary shareholder vote in favor of the transaction. Moreover, given the controller's ability to veto any sale of the company that it does not support, the directors have no *Revlon* duties to obtain the highest available sale price. See *McMullin v. Beran*, 765 A.2d 910, 919 (Del. 2000) ("When [an] entire sale to a third-party is proposed, negotiated and timed by a majority shareholder . . . the board

that might occur if the controller is able to merge the company with another one that it already controls, the gains from the squeeze-out transaction are limited to those associated with eliminating the minority shareholders.¹⁸⁸ Unless the controller discloses good reasons for ridding itself of the minority shareholders,¹⁸⁹ the court can be rightfully suspicious that the transaction makes sense only because of the diversion of corporate opportunities, such as an impending sale to a third party for a large premium over the company's going concern value.

Within this category of troublesome cases, the most troublesome case occurs where the controller bases its valuation solely on a comparable company analysis and not on a discounted cash flow analysis. In most appraisal cases, the dissenters use the respondent's information as a starting point for their own analysis. This is to be expected since it is the respondent who has all the information advantages. It is the respondent who knows why the transaction is profitable to it, and it is the respondent who has had continuing access to the company's planning.

Where the respondent uses the discounted cash flow analysis and presents it in valuation litigation, it is reducing the information asymmetries. In the standard DCF-based case, the valuation report will contain the respondent's own projections of profitability and investment opportunities over the next several years that were developed prior to the proposed squeeze-out transaction. Although the respondent's expert may decide to use her own assumptions with respect to profitability over the next several years, the disclosure of the controller's own pro-

cannot realistically *seek* any alternative because the majority shareholder has the right to vote its shares in favor of the third-party transaction it proposed for the board's consideration"); *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987) (rejecting the imposition of an "affirmative duty on majority shareholders to auction the corporation when seeking to cash-out the minority" and reaffirming that *Revlon* duties are only applicable when the company is up for sale and it is unlikely that competing bidders will emerge in a market check). On the other hand, enforcement of the fiduciary duty of loyalty may be a significant check on controller misappropriation in squeeze-outs, and there is at least some evidence that existing legal rules sufficiently protect minority shareholders. See Thomas W. Bates et al., *Shareholder Wealth Effects and Bid Negotiation in Freeze-Out Deals: Are Minority Shareholders Left Out in the Cold?*, 81 J. FIN. ECON. 681, 681 (2006) (concluding that "minority claimants and their agents exercise significant bargaining power during freeze-out proposals").

¹⁸⁸ We would expect that such gains would ordinarily be limited to elimination of the costs of shareholder communications and other matters associated with registration under the federal securities laws.

¹⁸⁹ *Ng v. Heng Sang Realty Corp.*, No. 18462, 2004 Del. Ch. LEXIS 69, at *5-6 (Del. Ch. May 18, 2004) (acting as a case in which there was a strong and openly disclosed value-creation justification for squeezing out the minority shareholders: specifically, the conversion of the company from a subchapter C corporation to a subchapter S corporation).

jections is critical in narrowing the information asymmetry gap. The same is true when the respondent's expert proposes and provides a rationale for using a particular growth rate in calculating the terminal value and a discount rate for discounting future free cash flows. Although the choices of the growth rate and the discount rate are made by the expert, they are made after discussions with the insider and are thus informed by the insider's thinking.

The petitioner's expert thus has considerable information to use as a starting point for her own projections. In the adversarial appraisal environment, the petitioner's projections are likely to be based on a more optimistic view of the respondent's information. The respondent's information provides the anchor, allowing the petitioner's expert to float a lower discount rate and a higher growth rate, or to otherwise challenge assumptions or judgments built into the respondent's model.¹⁹⁰

Suppose, however, that the respondent's expert only uses a comparable company analysis. Suppose further that the respondent has not developed cash flow projections that contain any independent badge of accuracy (for example, for use in capital budgeting decisions), and as a result, the court is compelled to rely solely on a comparable company approach to determine fair value. Comparable company analysis ordinarily reveals and relies on historical measures of firm performance, such as past earnings or cash flow.¹⁹¹ The controller's projections and plans for the future of the firm are thus now essentially hidden from the minority shareholders. In these circumstances, the dissenting shareholders obtain almost no information on the company's longer-term prospects, with the result that the information asymmetry is as wide as possible.

How should the court handle a valuation measure that relies on only a few data points with all of them in the past? One possibility is that the controller is also ignorant of the future and is buying the company without any reliable projections as to whether the corporation's prospects support the offered price. This is certainly possible. Another possibility is that the controller has some estimates of future cash flows but prefers to keep them hidden because they suggest higher future cash flows than the historical data would suggest. We believe the latter case is more likely, and accordingly we submit that the courts can ap-

¹⁹⁰ See, e.g., Del. Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 314 (Del. Ch. 2006) (describing how shareholder plaintiff's expert adopted different premises than those in the DCF analysis submitted by the company's expert).

¹⁹¹ See Jay W. Eisenhofer & John L. Reed, *Valuation Litigation*, 22 DEL. J. CORP. L. 37, 116-19 (1997) (describing the elements of comparable company analysis).

appropriately draw a negative inference from the controller's sole reliance on historical data—namely, that the use of that data would underestimate the fair value of the corporation.¹⁹²

We emphasize that such an inference is entirely consistent with the common law approach to this situation, where: (i) the party in possession of the best information who fails to produce it should suffer an adverse inference from that failure,¹⁹³ and (ii) the fiduciary who brings about a transaction, from which it benefits at the potential expense of the minority, must establish the fairness of the transaction.¹⁹⁴

Therefore our proposed solution in this situation is to create the rebuttable presumption that hypothetical third-party sale value, measured by deal-price ratios in acquisitions of comparable companies, minus estimated synergies associated with those comparable company acquisitions, serves as a better proxy for the firm's going concern value. Based on our analysis of agency costs and the benefits of control, this suggested presumption is quite reasonable because it would roughly yield a valuation premised upon a pro rata sharing of the benefits of control, while not conferring synergistic values on minority shareholders.

In fact, this is precisely the approach taken by the courts when they apply an IMD adjustment to the result of comparable company analysis.¹⁹⁵ Our approach, however, does not rely on a non-existent IMD associated with shares of publicly traded firms. Instead, we rely on the proposition that where the controller is squeezing out the minority, the firm should be valued on a basis that presumes that the value of control is already an element in going concern value.

In our proposed approach, a controlling shareholder/respondent would rebut the presumptive valuation technique by presenting a reliably based DCF analysis to be evaluated by the minority shareholders and the court. We believe that most controllers are capable of generating a DCF analysis and would thus have minimal concern over the application of the presumption we advocate. Moreover, and perhaps sup-

¹⁹² See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983); see also *supra* note 187 and accompanying text. Note that we are *not* asserting that the price/earnings or similar ratios observed in comparable companies are systematically inaccurate or inapplicable to the controlled company.

¹⁹³ *Van Gorkom*, 488 A.2d at 878 (“[T]he production of weak evidence when strong is, or should have been, available can lead only to the conclusion that the strong would have been adverse.”), citing *Interstate Circuit, Inc. v. United States*, 306 U.S. 208, 226 (1939).

¹⁹⁴ E.g., *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994); *Weinberger*, 457 A.2d at 710; *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952).

¹⁹⁵ See *supra* note 140 and accompanying text.

plementally, the controller could adduce evidence that the elimination of minority shareholders created significant additional value not already achieved by virtue of the pre-existing control.¹⁹⁶

Critics have been suggested that this approach does not sufficiently address the case of a controller who achieves control through open market transactions and thereafter uses the firm to obtain private benefits at the expense of the minority before squeezing them out.¹⁹⁷ We believe that these concerns have been adequately addressed already. First, the minority shareholders have the duty of loyalty remedy available to prohibit such diversion.¹⁹⁸ Second, as we pointed out in our earlier article, the definition of fair value is flexible enough to incorporate a proportionate share of going concern value improperly diverted by a controller.¹⁹⁹

B. *Most Implicit Minority Discount Cases Reach an Appropriate Result*

Judged under the foregoing analysis, many—if not all—of the Delaware valuation cases that have relied on the IMD easily can be viewed as having reached an appropriate valuation result, albeit on the basis of the financially untenable “implicit minority discount.”²⁰⁰ We review some of these cases below, to further reinforce the appropriateness of the preceding suggested approach to resolving valuation disputes in squeeze-outs by controlling shareholders.

Borruso v. Communications Telesystems Int'l., decided by the Delaware Court of Chancery in 1999, nicely illustrates this point.²⁰¹ In that case the controlling shareholder effected a short-form merger, cashing out the minority shares at \$0.02 per share.²⁰² Both sides’ experts relied solely on comparable company market price ratio analysis.²⁰³ Apparently, because the company’s operating history was quite short, neither the respondent nor the petitioner presented any DCF analysis, despite the suggestion that the company was hopeful that its operations could become profitable with an infusion of capital.²⁰⁴ The fair value estab-

¹⁹⁶ See *Ng*, 2004 Del. Ch. LEXIS 69, at *5–6.

¹⁹⁷ See *Rapid-Am. Corp. v. Harris*, 603 A.2d 796, 799–800 (Del. 1992).

¹⁹⁸ See *Weinberger*, 457 A.2d at 710–14.

¹⁹⁹ Hamermesh & Wachter, *supra* note 6, at 159–60 (describing *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989), which approved the inclusion of the value of a previously usurped corporate opportunity for purposes of determining fair value).

²⁰⁰ See *infra* notes 201–225 and accompanying text.

²⁰¹ 753 A.2d 451 (Del. Ch. 1999).

²⁰² See *id.* at 454.

²⁰³ See *id.* at 455.

²⁰⁴ See *id.* at 453, 455 n.5.

lished by the court (\$0.6253/share) exceeded the merger price by a factor of over thirty.²⁰⁵ The court arrived at that result by deriving a value based on comparable company share trading price ratios, adding a thirty percent control premium, calculated by deriving an estimated premium observable in comparable company acquisitions, and subtracting ten percent “to reflect the elimination of impermissible elements of post-merger value.”²⁰⁶

We approve the method of valuation used in *Borruso*, in light of the analysis outlined in the preceding subsection.²⁰⁷ No reliable DCF analysis was presented that would have permitted the petitioners to effectively test estimates of the present value of the company’s future returns.²⁰⁸ Therefore, as the court observed, there was no meaningful choice but to rely on comparable company market price ratio analysis.²⁰⁹ And by its “elimination of impermissible elements of post-merger value,” the court was properly attempting to exclude value attributable to synergies that might be reflected in comparable company acquisition prices.²¹⁰

What remained after that subtraction was a value that included the value of control—which, in the situation presented in that case, should have been fully or at least largely reflected in the going concern value of the company being valued.²¹¹ Stated this way, the court’s analysis and the result it reached were entirely proper.²¹² The court was appropriately protecting against controller opportunism in the situation—a short-form squeeze-out merger—in which the minority shareholders are most vulnerable.²¹³ To reach its appropriate fair value result, on the other hand, the court had no need to insist that “minority trading values . . . [are] not fully reflective of the intrinsic worth of the corporation on a going concern basis”²¹⁴

²⁰⁵ *See id.* at 462.

²⁰⁶ *See id.* at 459.

²⁰⁷ *See Borruso*, 753 A.2d at 459.

²⁰⁸ *See id.* at 455, n.5.

²⁰⁹ *See id.* at 455.

²¹⁰ *See id.* at 459.

²¹¹ *See id.*

²¹² *See id.*

²¹³ *See Borruso*, 753 A.2d at 459.

²¹⁴ *Id.* at 458. Other cases in which the courts have relied on the IMD appear to fit the model suggested in *Borruso*. *See, e.g.*, *Dobler v. Montgomery Cellular Holding Co.*, No. 19211, 2004 Del. Ch. LEXIS 139 (Del. Ch. Sep. 30, 2004); *Lane v. Cancer Treatment Ctrs. of Am. Inc.*, No. 12207-NC, 2004 Del. Ch. LEXIS 108, at *129 (Del. Ch. July 30, 2004); *M.G. Bancorp. v. Le Beau*, 737 A.2d 513, 523 (Del. 1999); *Kleinwort Benson Ltd. v. Silgan Corp.*, No. 1107, 1995 Del. Ch. LEXIS 75, at *7 (Del. Ch. June 15, 1995); *Hodas v. Spectrum*

We similarly support the approach applied by the Vice Chancellor in *Doft & Co. v. Travelocity.com, Inc.*, decided in 2004 by the Delaware Court of Chancery.²¹⁵ As we pointed out in our prior article, the court could have relied on the petitioner's DCF analysis to justify, on a more analytically sound basis, the result reached through application of the IMD.²¹⁶ We now take our approval of this approach one step further and offer a non-IMD based justification for the valuation approach actually adopted by the court. Invoking the IMD, the court in *Travelocity* adjusted the result of a comparable company share price ratio valuation upward by thirty percent—considerably below the estimated fifty percent premium over market price reflected in acquisitions of control of comparable companies.²¹⁷ Although the court was not explicit on this point, such a middling approach is certainly consistent with an approach that explicitly starts with estimated third-party sale value and subtracts some estimate of synergy contributions.²¹⁸ And we suggest that such an approach is a reasonable way to determine fair value in the case of a control shareholder squeeze-out where no reliable DCF analysis is available. This is because the going concern value of the firm, which the minority shareholders share proportionately, reflects the benefits of control. With this view, there is no need to assert that the comparable companies' share prices significantly understate the going concern value of *those* companies.

One more example illustrates the operation of the approach we suggest. In *Andaloro v. PFPC Worldwide Inc.*, a 2005 short-form squeeze-out merger case, Vice Chancellor Strine relied significantly on a DCF analysis based on what he described as “responsible management projections.”²¹⁹ In fact, the petitioners—consistent with the approach advocated by this Article—had opposed using any approach other than the DCF analysis.²²⁰ Nevertheless, the Vice Chancellor also chose to give

Tech., Inc., No. 11265, 1992 Del. Ch. LEXIS 252, at *5 (Del. Ch. Dec. 7, 1992). In all these cases, a controlling shareholder was freezing out the minority shareholders. While a DCF analysis was presented in some of these cases, and the use of third-party sale value minus estimated synergies might therefore not have been presumptively correct in our view, that valuation approach was at least a reasonable measure of fair value. In none of these cases, however, was it necessary to have relied upon the core IMD assertion that enterprise values inherently exceed trading market prices.

²¹⁵ See No. 19734, 2004 Del. Ch. LEXIS 75, at *46–48 (Del. Ch. May 21, 2004).

²¹⁶ Hamermesh & Wachter, *supra* note 19, at 59.

²¹⁷ *Doft*, 2004 Del. Ch. LEXIS 75, at *46–48.

²¹⁸ See *id.*

²¹⁹ *Andaloro v. PFPC Worldwide, Inc.*, No. 20336, 2005 Del. Ch. LEXIS 125, at *78 (Del. Ch. Aug. 19, 2005).

²²⁰ See *id.* at *63.

some weight (one-fourth, to be precise) to a comparable company analysis based on market price ratios of publicly traded comparable companies.²²¹ He then made an upward IMD adjustment to that result.²²²

This upward adjustment—based on acquisition premiums minus some amount attributable to estimated synergies—was entirely appropriate in the circumstances of that case.²²³ It allowed the court to arrive at a going concern value that reflected the fact of a pre-existing controlling shareholder.²²⁴ Interestingly, the result yielded by the IMD-adjusted comparable company analysis that the court used was fairly close to the result of the DCF analysis—\$34.99 per share, compared to the \$32.08 per share DCF result. This observation further corroborates our view that in a firm with a controlling shareholder, an estimate of third-party sale value minus estimated synergies should be a reasonable proxy for a DCF-oriented measure of going concern value.²²⁵

For the reasons reviewed in the preceding subsection, however, we maintain that this valuation approach ought to be limited to situations where there is an existing controlling shareholder and where no reasonably reliable DCF valuation is available. Thus, we would agree with the Delaware courts' initial rejection of an IMD adjustment. As we pointed out in our prior article, that rejection occurred in a case involving an acquisition by a third party of a company with no controlling shareholder.²²⁶ The shareholders in that case did not share in the benefit of reduced agency costs since it was the acquirer who created that benefit. In such situations, it would have been normatively incorrect to insist that fair value be determined by reference to values that include control—values that necessarily arise, even when estimated synergies are subtracted, when fair value is measured by comparable company acquisitions. In these cases, the correct approach to using comparable company analysis is to rely on share trading price ratios, with no upward adjustment at all. Thus, it is the ownership configuration of the company being valued, rather than any putative discount associated with comparable company share prices, that should determine the preferable approach to comparable company analysis.

²²¹ *See id.* at *78.

²²² *See id.* at *69–70.

²²³ *See id.*

²²⁴ *See id.*

²²⁵ *Andaloro*, 2005 Del. Ch. LEXIS 125, at *62, *77.

²²⁶ *Hamermesh & Wachter*, *supra* note 19, at 17.

CONCLUSION: OUR NORMATIVE CLAIMS SUMMARIZED

The case law rule that awards dissenting shareholders in an appraisal case the pro rata going concern value of the enterprise is normatively sound. Dissenting shareholders should be given the value of what has been taken from them. If the merger is not approved, the shareholders who continue to hold the shares receive a stream of expected dividends and capital appreciation. If the merger is approved and dissenting shareholders perfect their appraisal rights, then the dissenting shareholders are paid an amount which is equal to the discounted value of those expected dividends and capital appreciation of their shares.

Conversely, acquirers who initiate transactions that create gains by means of synergies or aggregation of shares to create control are allowed to retain those newly created benefits themselves. This is the outcome if the going concern value standard is applied. From a normative perspective, the award has the advantage that it makes the merger, which gives rise to appraisal, a Pareto superior transaction: the value-creating acquirer benefits and the dissenting shareholders are no worse off.

The use of the going concern value standard, appropriately determined, effectively implements that Pareto superiority. Critical to our normative claim is that the going concern value standard be determined so as to award dissenting shareholders not only the present discounted value of the assets currently owned by the corporation, but also the present value of the reinvestment opportunities anticipated by the firm at the time of the merger. The courts appear to have accepted this proposition.²²⁷

Cases where an already existing controller seeks to take the firm private, however, are a cause for concern. As we emphasize above, most of the premium associated with control shares is due to the ability of the controller to direct the strategy of the firm, including the ability of the controller to appoint or change management, determine compensation, set operational and strategic policy, and change the course of the business. Where a controller already exists, the benefits of control are already reflected in the anticipated cash flows of the firm and there-

²²⁷ Del. *Open MRI Radiology Assocs. v. Kessler*, 898 A.2d 290, 313 (Del. Ch. 2006) (citing *Hamermesh & Wachter*, *supra* note 6, and holding that “if the concept of opening [new MRI centers] was part of the business plans of Delaware Radiology as of the merger date, then the value of those expansion plans must be taken into account in valuing Delaware Radiology as a going concern . . .”).

fore belong to the minority shareholders pro rata. The potential rightful gains to the controller are thus limited to those specifically associated with a firm where the minority shareholders have been squeezed out.

Consequently, any going-private transaction forced on minority shareholders by a controller has to be closely inspected by the court to ensure that the controller's gains from the transaction are not largely diversionary in character. The stress on reinvestment opportunities should correctly identify these gains and capture them for the benefit of minority shareholders. Where DCF analysis is performed, the respondent's detailed valuation projections are available to the petitioner. Thus, the petitioner can append its own projections of reinvestment opportunities directly into its own DCF analysis.

A problem arises, however, where the controller fails to present a valid DCF analysis and relies instead solely on a comparable company analysis that is based solely on historical data. This is problematic because minority shareholders and the court have no access to projections of future free cash flows of the firm. As noted above, this may be due to the controllers' ignorance about the businesses' future prospects or because the controller prefers to keep that information hidden.

In this Article, we propose a remedy for this situation. Specifically, we advocate a penalty default in the form of a rebuttable presumption that fair value includes the value of control as reflected in comparable company acquisitions. That presumption is consistent with longstanding common law rules, including the doctrine that requires controlling fiduciaries to establish the fairness of transactions in which they potentially benefit at the expense of the minority.

This rule creates incentives for the controller to present a DCF analysis. The controller, as faithful fiduciary, can avoid the proposed presumption by preparing and submitting a valid DCF analysis to judicial and shareholder scrutiny. The opportunistic controller, on the other hand, is subjected to a fair value determination that amounts to third-party sale value minus synergies.