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Volume 49
Issue 3 *Summer 1984*

Article 3

Summer 1984

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THE NEW LAW OF FREEZE-OUT MERGERS*

RICHARD A. BOOTH**

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I. INTRODUCTION

The recent Delaware Supreme Court decision in *Weinberger v. UOP, Inc.*[1] appears to undo six years of development of the law of interested mergers; i.e., mergers in which one of the corporations controls the other at the time the merger is proposed and approved. However, the decision changes the law much less than may first appear. Rather *Weinberger* is notable because it provides the potential for a coherent theoretical framework for analyzing all mergers and because it represents the recognition of the fact that, even though a merger is "tainted" by conflict of interest, it may nonetheless be beneficial to both the majority and minority shareholders.

The most common type of interested merger, and the one in which the issues are most graphically presented, is the "freeze-out" merger. Simply stated, a freeze-out merger occurs when a minority shareholder is forced to give up his shares of stock in a corporation to the controlling majority in exchange for cash or some non-equity instrument.[2] This can be lawfully accom-

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1. 457 A.2d 701 (Del. 1983).

2. The phrase "freeze-out" is only one of many names given to mergers which eliminate minority shareholder interests. Other names include "take-out," "cash-out" and "squeeze-out." "Freeze-out" is widely regarded as somewhat perjorative but is used here despite the fact that the position taken is that such mergers are quite justifiable. Aside from a natural contrariness on the part of the writer, the phrase is used because it serves as a constant reminder that those who carry out such mergers do

plished by the parent corporation using its voting control over a subsidiary to propose and approve a merger (or other combination) between the parent and the subsidiary.[3] If there is no pre-existing parent, one can be formed and the shares of the majority transferred to it in exchange for all of the new corporation's stock.[4]

The obvious objections to freeze-out mergers are that the parent decides whether and when the minority will sell, and it decides the price in the absence of arm's length bargaining. There is nothing to insure that a fair price will be set. Even if the price is fair, there is every reason to expect the parent to set the lowest defensible fair price.[5] Thus, courts have traditionally been willing to scrutinize interested mergers although the availability of the appraisal remedy[6] has inclined them to insist that plaintiffs show particular examples of advantage taking.[7] While this approach gave the parent the ultimate right to freeze out the subsidiary's minority,[8] the courts, in effect, reserved the right to increase the price if unfairness appeared.

When corporate freeze-outs became popular in the middle 1970s, courts began to recognize, as commentators had urged,[9] that there was a serious

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indeed have a duty to those who are frozen-out and because it is more colorful than the alternatives.

3. The transaction may be accomplished in numerous ways. For a concise discussion of techniques, see Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974).

4. Such transactions are often referred to as "going private" mergers since they involve only one going business and serve no significant purpose other than the elimination of minority shareholders. "Going private" is often also used to describe a variety of non-merger techniques for eliminating minority shareholder interest. *See* Borden, *supra* note 3, at 990-93, 997-1000.

5. The motivations and abuses of freeze-outs have been well catalogued. *See* Borden, *supra*, note 3; Brudney, *A Note on "Going Private"*, 61 VA. L. REV. 1019 (1975); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter cited as Brudney & Chirelstein, *A Restatement*]; Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); NOTE, *Going Private*, 84 YALE L.J. 903 (1975).

6. Simply stated, a shareholder is entitled to have his shares appraised and repurchased for cash by the issuing corporation upon the occurrence of certain fundamental changes such as mergers. All states' corporation codes provide such a right though the rights differ greatly in detail from state to state. *See* Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023, 1023-26 (1976). In Delaware, appraisal is governed by DEL. CODE ANN. tit. 8, § 262 (1983).

7. *See e.g.* Stauffer v. Standard Brands, Inc. 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962); *see also* Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). The classic discussion of the plaintiff's burden to show facts which justify a full scale trial on fairness grounds is Vorenberg, *Exclusiveness of the Dissenting Stockholders' Appraisal Right*, 77 HARV. L. REV. 1189 (1964). *See also* Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 653-55 & n.191 (1981).

8. *See* Weiss, *supra* note 7, at 650-54.

9. *See* note 5, *supra*.

question whether it was fair to force a shareholder out of equity participation at *any* price. It was argued that, from a shareholder's point of view, fairness may mean more than fair price. That is, even a shareholder in a publicly traded company, who has no expectation of participating in management, may have a legitimate interest in the *form* of his investment. To deny a minority shareholder potential appreciation of his investment (and to force him to identify substitute investments) should require something more than a fair price.[10] As a result, Delaware courts have applied the "business purpose" doctrine which requires that there be some good reason to get rid of the minority other than the personal motivations of the majority.[11]

Thus, for the six years before *Weinberger,* freeze-out mergers were governed by principles enunciated in 1977 in *Singer v. Magnavox Corp.*[12] In *Singer*, the parent had acquired an 84% interest in the subsidiary through a friendly tender offer at $9 per share. The parent then announced its intention to acquire any remaining shares through any legal means.[13] Less than a year after the tender offer, the parent effected a freeze-out merger of the remaining 16% minority also at $9 per share. Representatives of the minority sued the parent claiming that the merger was illegal because it was not undertaken for a valid business purpose. They claimed that the sole purpose of the merger was to eliminate the minority and that the price paid was inadequate.

The parent argued that the merger was accomplished within the letter of the law and that the minority's right to an appraisal and cash payment was an adequate remedy for any unfairness. The Delaware Supreme Court, in a landmark decision, reasoned that the parent-majority owed a fiduciary duty to the minority and that mere compliance with the letter of the law in the corporation code did not necessarily satisfy that duty. The court expressly recognized the shareholder's interest in the form of his investment.[14] The court ruled that a merger undertaken for the sole purpose of eliminating the minority was illegal and that even when a proper purpose is shown, the transaction will be scrutinized for "entire fairness."[15]

Subsequently, in *Tanzer v. International General Industries,*[16] the Delaware Supreme Court held that a legitimate business purpose of the parent, rather than the subsidiary, was sufficient to justify a freeze-out merger.[17]

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10. *See* Vorenberg, *supra* note 7, at 1200-05.
11. *See* text at notes 58-74, *infra.*
12. 380 A.2d 969 (Del. 1977).
13. *Id.* at 971. The management of the target had opposed an offer at $8 per share but were guaranteed their jobs at existing salary levels in connection with the $9 offer, which they did not oppose but apparently did not endorse.
14. *Id.* at 975-80.
15. *Id.* at 980. The notion of "entire fairness" descends from *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 298, 93 A.2d 107, 109-10 (Del. 1952), another "interested merger" case.
16. 379 A.2d 1121 (Del. 1977).
17. *Id.* at 1124-25.

Thereafter, in *Roland International Corp. v. Najjar*,[18] the same court held that the principles of *Singer* and *Tanzer* applied with equal force to short-form mergers—a special procedure for merging a 90% owned subsidiary into the parent without a vote of the subsidiary's shareholders. [19]

Unlike the situation in *Singer*, the freeze-out merger in *Weinberger* apparently was not planned with any certainty at the time the parent obtained control and the merger was not effectuated until three years thereafter. These facts made it a stronger case for the kind of relief afforded the minority in *Singer*.[20] In *Weinberger* the parent had acquired a bare majority (50.5%) of the subsidiary in a friendly tender offer at $21 per share in April 1975. The subsidiary's stock was trading at just under $14 at the time, and the tender offer was greatly oversubscribed.[21] Having surplus cash and having found no other suitable acquisitions, the parent decided to propose a freeze-out merger in February 1978. It offered the same $21 per share price, which still represented a substantial premium over the $14.50 market price of the subsidiary's stock.[22]

The price had first been proposed internally to the parent in a report that stated the parent could pay up to $24 per share and still derive an adequate return of 15.5%.[23] The report was apparently based in part on information obtained from the subsidiary; the subsidiary's board was controlled by the parent and included four members who were also four of five top ranking officers of the parent and members of the parent's board.[24] The proposal was submitted to the subsidiary's board, but the parent's maximum price was not disclosed, except, of course to the dual members who prepared the report and who excused themselves from the decision to approve the merger.[25] The merger was submitted to a vote of the shareholders—still without disclosure of the parent's maximum price—and was approved by 92% of minority shares

18. 407 A.2d 1032 (Del. 1979).

19. *Id.* at 1035-36. The short form merger statute is found in DEL CODE ANN. tit. 8, § 253 (1983). The long form merger, which requires approval by the shareholders of both parent and subsidiary and the board of directors of the subsidiary, is found in § 251. For an explanation of the origin and purposes of this special merger provision, see Weiss, *supra* note 7, at 641-49.

20. Several commentators have argued that distinctions should be drawn between arm's length 100% acquisitions which are carried out in two steps, partial acquisitions in which the parent later decides to acquire 100% of the subsidiary's stock and pure "going private" transactions in which the parent has no independent business but is formed only to oust the minority. *See* Brudney, *A Note*, *supra* note 5, at 1028-30; Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1357-76; Greene, *supra* note 5, at 491-96; Weiss, *supra* note 7, at 654 n.184; *see also*, Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 308 (1974)[hereinafter cited as Brudney & Chirelstein, *Fair Shares*].

21. 457 A.2d at 704.

22. *Id.* at 705-06.

23. *Id.* at 705, 708-09, 711-12.

24. *Id.* at 705.

25. *Id.* at 707.

voting.[26]

Representatives of the minority sued, initially alleging only that the freeze-out merger lacked a business purpose and that the price was unfair, not yet having discovered the nondisclosures. The trial court dismissed the suit on the theory that, if the majority does not use its controlling position to *force* approval of the merger, there is no self-dealing.[27]

Plaintiffs amended their complaint to add the allegation that non-disclosures had tainted the minority vote. The trial court held that it was plaintiffs' burden to point to particular reasons for judicial review, and apparently concluded that plaintiffs had not overcome the presumption of fairness created by the vote.[28] While the court did not need to reach the business purpose issue, it nonetheless held that the parent had shown a legitimate business purpose, namely, that the acquisition of the remaining minority interest was a good investment.[29] Since this is probably true in all freeze-out mergers, the decision rendered the business purpose test utterly meaningless.[30]

The Delaware Supreme Court reversed, holding that it is the majority's burden to show a fair vote, and the minority's burden to prove unfairness by specific acts of fraud, misrepresentation, or other misconduct by the majority.[31] The court found that, because the parent failed to disclose the directors' report and the cursory nature of the fairness opinion obtained from an investment bank, the vote was tainted and the transaction was unfair.[32]

It is not clear that the rule set forth by the Delaware Supreme Court differed much from that applied by the trial court. The supreme court agreed that the plaintiff must allege specific acts of fraud.[33] The court also placed the burden on the majority to show a fair vote, but never specified who bore the first burden. It would seem evident that it should be the plaintiff, since the same facts which would show fraud would also show that the vote was not fair. But if that is the case, the trial court's formulation is equivalent to the supreme court's.[34] It seems, then, that the disagreement between the courts had to do with the seriousness of the nondisclosures. This conclusion is supported by the fact that the supreme court held that the vote was tainted and that the

26. *Id.* at 708, 712.

27. Weinberger v. UOP, Inc., 409 A.2d 1262 (Del. Ch. 1979).

28. Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), *rev'd*, 457 A.2d 701 (Del. 1983).

29. *Id.* at 1350.

30. 457 A.2d at 715. *See* Weiss, *supra* note 7, at 671, n.300.

31. 457 A.2d at 703. Initially, the decision of the trial court was affirmed, but reargument was granted and the original opinion was withdrawn. Deutsch, Weinberger v. UOP: *Analysis of a Dissent*, 6 CORP. L. REV. 29 (1983).

32. 457 A.2d at 703. The court relied on Michelson v. Duncan, 407 A.2d 211, 224 (Del. 1979) for the proposition that shareholder ratification shifts the burden of proof of unfairness from defendants to plaintiff. *See also* Tanzer v. International Gen. Indus., 402 A.2d 382, 386 (Del. Ch. 1979) (on remand).

33. 457 A.2d at 712

34. *See* note 7, *supra.*

merger was unfair. It did not merely remand for additional factual inquiry.[35]

Even though *Weinberger* primarily addresses disclosure, it is clear that the Delaware court substantially altered the principles of fiduciary duty developed in *Singer*. *Singer* itself was notable for recognizing the tension between the majority's fiduciary duty and the competing legitimate interests of majority shareholders.[36] The changes wrought by *Weinberger*, however, have to do with specificity and burden.

Under *Singer* and its progeny, a freeze-out merger generated what amounted to a per se presumption of a violation: the majority was required to prove a business purpose, and even if it did the merger would be scrutinized for "entire fairness." In turn, the notion of "entire fairness," which at first suggests nothing but the court's holding that these mergers should be *really* fair instead of just fair, seems to have been the result of the inadequacy of a simple self-dealing approach to freeze-outs. In *Singer*, for example, while there was an obvious conflict of interest, the price was presumably fair because it was equal to the tender offer price which had induced over 84% of the shareholders to sell less than a year before.[37] The additional requirement of business purpose, however, allowed for further scrutiny, and the notion of "entire fairness" allowed for a potential remedy even in cases where simple fairness was quite apparent. In other words, the *Singer* business purpose test served primarily to afford case by case review of interested mergers.

Thus, as *Singer* was finally mapped out, plaintiffs bore little of the burden of persuasion. Now, under *Weinberger*, plaintiffs must prove specific acts of fraud and unfairness where the majority has shown a fair vote. *Weinberger* therefore provides a road map for the majority to avoid any serious challenge to the legality of a freeze-out. Even in cases in which the majority bears the burden of proving fairness (e.g. when no vote is taken), it gains the benefit of specific allegations to answer.

The *Weinberger* court's implicit approval of properly structured freeze-out mergers effectively relegates the minority to its appraisal remedy.[38] Therefore, the court also undertook to reform the appraisal remedy to make it easier for dissenting shareholders to prove unfairness.[39] The court held that future appraisal proceedings should take into account any methods of valuation "gen-

35. 457 A.2d at 703, 714. Though it is conceivable that ultimately the trial court will again find the price paid to be fair, the supreme court's opinion is so strongly worded that it is difficult to believe that the decision was not meant to be one on the merits. For example, the court states that the parent's failure to disclose the full range of fair prices "cannot but undermine a conclusion that this merger meets reasonable test of fairness." *Id.* at 712.

36. 380 A.2d at 976. *See* Borden, *supra* note 3, at 1013-15; Note, *Fairness in Freezeout Transactions: Observations on Coping with Going Private Problems*, 69 KY. L.J. 77 (1980-81).

37. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1362-65.

38. *See* note 6, *supra*.

39. *See* text at notes 116-22, *infra*.

erally considered acceptable in the financial community," and that a narrow definition of post-merger gains should be applied.[40]

Prior to *Weinberger,* Delaware invariably followed the "block method" of valuation for determining fair price. The block method considered a weighted average of asset value, market price, and earnings value.[41] *Weinberger* indicates that now Delaware courts will recognize discounted cash flow and premiums paid in comparable transactions as evidence of fair price.[42] While the court did not expressly abandon the block method, the court did state that it "shall no longer exclusively control such proceedings."[43] It would thus not be surprising to find discounted cash flow and comparable premiums as the overwhelming and possibly exclusive factors in most future appraisals. The court's language suggests this would be acceptable by allowing for the possibility that an appraiser might decide not to apply the block method at all in an appropriate case. Further, the court's implicit endorsement of the discounted cash flow method suggests that it could be heavily relied on since its underlying assumptions contradict, to some extent, the assumptions underlying earnings value in the block method.[44]

In addition, before *Weinberger*, a shareholder was entitled only to the value of his shares before the merger. For example, he would receive no additional compensation based on any premium the acquiring company would be willing to pay because it knew the target could be managed more efficiently.[45] Yet that may well be the very sort of assessment the shareholder makes when he decides to buy shares in a particular company; he may figure that the company is ripe for a take-over, or indeed a freeze-out. It hardly seems fair that a minority shareholder who has correctly perceived that kind of value should have it taken away.[46] Now, after *Weinberger*, such value may be compensated by appraisal.

Although the Delaware appraisal statute provides for payment of fair value "exclusive of any element of value arising from the accomplishment or

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40. 457 A.2d at 712-14.

41. *Id.* at 712.

42. *Id.*

43. *Id.* at 713.

44. As the name suggests, cash flow analysis focuses on the cash that may be extracted from a business while "earnings" or "income" (as those words are used by accountants) includes accrued transactions which have not necessarily been followed by cash receipts or payments at the time the accountant's statement is rendered. *See* Weinberger v. UOP, Inc., 426 A.2d 1333, 1357 (Del. Ch. 1981), *rev'd,* 457 A.2d 701 (Del. 1983); S. SIEGEL & D. SEIGEL, ACCOUNTING AND FINANCIAL DISCLOSURE 118-28 (1983).

45. *See* Tanzer v. International Gen. Indus., 402 A.2d 382 (Del. Ch. 1979) (on remand).

46. *See* Weiss, *supra* note 7, at 677-80. *See generally* Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439, 1451 (1981).

expectation of a merger,"[47] the court reasoned that the addition of the word "fair" by amendment in 1976 and its reemphasis in 1981 amendments signaled a legislative intent that shareholders be fully compensated.[48] This argument is not weighty, though it is difficult to make such assessments in a rarified atmosphere in which "entire fairness" connotes so much. The rule is, however, quite defensible: the fact that the legislature directs that a company be valued on the basis of its initial management and business does not dictate whether a premium to acquire the business should be considered inherent in the business or inherent in the merger. As will be seen, however, there are good reasons to consider such a premium as part of the intrinsic worth of the original business.[49]

Finally, the *Weinberger* court held that, in the discretion of the chancellor, an appraisal award may include the elements of rescissory damages, e.g., the monetary value of the shares in question as of the time of trial.[50] Appraisal, in short, must afford the full complement of potential relief. Now there is nothing a plaintiff may obtain by litigation that he cannot get in an appraisal.

The *Weinberger* court does not say in so many words that proving unfairness will now be easier, but it is impossible to deny the solicitude paid minority shareholders. Besides adding wholly new categories of value to those compensable to shareholders, the court describes the new approach as "more liberal" and an "expanded" remedy, and it describes the Chancellor's powers as "complete to fashion any form of equitable and monetary relief as may be appropriate."[51] One could argue that this last comment refers only to litigation, though the argument is unconvincing given the unmistakable changes in the appraisal remedy.

In the final analysis, the changes effected by *Weinberger* are less drastic than they may appear to be. First, the business purpose test was never very well established and there were numerous signals prior to *Weinberger* that it would soon be rejected altogether. *Weinberger* did, however, substitute the requirement of fair dealing, which is best understood as an emphasis on shareholder voting or good faith efforts to replicate arm's length negotiations, a change which does indeed signal a new attitude that even interested mergers may be mutually beneficial. Second, and herein lies the decision's greater innovation, *Weinberger* renovates certain key concepts under the Delaware appraisal statute so as to allow the courts to construct a fair dealing outcome in cases of self-dealing. This change raises some vital questions; for example, because the court has granted an expanded appraisal right applicable in all mergers, dissenters may be able to prove they deserve additional compensation

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47. DEL. CODE ANN. tit. 8, § 262(h) (1983).
48. 457 A.2d at 713-14.
49. *See* text at notes 147-65, *infra.*
50. 457 A.2d at 714.
51. *Id.* at 713-15.

in many cases, even in the absence of fraud. As will be seen, however, analysis of the new kinds of evidence which may be introduced compels the conclusion that appraisal will not generate any additional compensation for dissenters in fairly approved mergers.[52]

II. THE DEMISE OF THE BUSINESS PURPOSE TEST

In order to state a claim for unfairness under *Singer*, as it was finally elaborated, a plaintiff was required to allege that no legitimate business purpose existed for the freeze-out merger, that the price to be paid to the minority shareholders was inadequate and that the minority was unable to veto the transaction.[53] The *Singer* test differed from the traditional approach primarily in including business purpose. Prior to *Singer*, self-dealing and price inadequacy often sufficed to achieve judicial review of a transaction in Delaware.[54] It was somewhat more difficult, however, to obtain a fairness review at equity if appraisal rights were available. One was generally required to allege specific acts of self-dealing, which can be quite difficult in carefully planned freeze-outs. Thus, the business purpose test justified a higher level of scrutiny, even though the Delaware court could simply have held that freeze-outs were per se self-dealing.[55] That was, in essence, the conclusion reached in *Tanzer* when

52. Another summary of *Weinberger* may be found in Weiss, *The Law of Take Out Mergers:* Weinberger v. UOP, Inc. *Ushers in Phase Six*, 4 CARDOZO L. REV. 245 (1983) (updating Weiss, *supra*, note 7). There, as in the earlier piece, it is argued that the business purpose test was designed to allow the courts to pass on mergers without grappling with the issues of valuation. *Id.* at 248. It is also argued that *Weinberger* indicated sympathy for the notion that fair value is the price the minority could obtain if the subsidiary were sold to an outsider and that fair dealing invariably requires the parent to disclose to the subsidiary its valuation of the minority interest. *Id.* at 251-56. The argument advanced here is quite to the contrary.

53. *See* Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 496 (Del. 1982).

54. *See* Sterling v. Mayflower Hotel, 33 Del. Ch. 293, 93 A.2d 107, 109-10 (Del. 1952).

55. This is not to suggest that the business purpose test was *contrived* for resolving freeze-out suits. Rather it is an established exception to the business judgment rule. *See* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979). Application of the test to freeze-outs was indicated in that typically the test was used in situations in which arguable self-dealing was clearly authorized or necessary. *See, e.g.*, Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). The test is in effect a fall-back standard to be used when simple self-dealing analysis begs the question. As such the standard it sets for management is necessarily lower. It is similar to the literal meaning of "gross and palpable overreaching." *See* Meyerson v. El Paso Natural Gas Co., 245 A.2d 789, 794 (Del. Ch. 1967); Arsht, *supra*, at 107. However, the test applied in *Singer* and its descendants was very different from the standard application. In practice, once management had shown *a* substantial reason for its challenged action, its burden was satisfied. In short, it was up to the plaintiff to prove that there was no business purpose for the challenged action. *See, e.g.*, Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964). Just about the only way of doing that would be to show that there existed alternative ways of accomplishing management's ends that were less prejudicial to the minority. *See, e.g.*, Jones v. H.F.

the court held that despite a showing of business purpose a minority shareholder was still entitled to a fairness hearing and potentially a remedy.[56]

The *Singer* court did not focus on the inability of the minority to veto the merger as a factor to be established by plaintiffs. This element of the cause of action was later recognized in *Harman v. Masoneilan International, Inc.*,[57] as being essential to showing self-dealing. It is a principle virtually congruent to placing the burden of proof of unfairness on the minority when the transaction has been ratified by a majority of the minority. Note, however, that the rule as stated in *Harman* was not merely a refinement of *Singer*, but, in fact, a partial reversal. The *Singer* court had found no actionable self-dealing where the merger statute had been followed to the letter. Apparently, this induced the court to superimpose the business purpose test. The *Harman* court, on the other hand, recognized that, even though self-dealing is unavoidable in a freeze-out merger, the potential for objectionable advantage taking by insiders could be avoided by a fair vote, thus eliminating the rationale for the business purpose test as a means of distinguishing which freeze-outs would be allowed to proceed.

The concept of business purpose also applied at the remedy stage once plaintiff had made out a claim under *Singer*.[58] The defendant parent was then required to show the entire fairness of the transaction, one element of which was its business purpose. If the defendant failed to demonstrate that the entire transaction was fair, it faced equitable relief including paying a higher price after the fact.

Despite all this, except for establishing a per se cause of action for freeze-outs, nothing ever depended on a merger's business purpose except the jurisdiction of the court of equity.[59] Indeed, the plaintiff needed only to allege its absence. It was up to the majority to prove specifics. Thus the business purpose test was little more than an excuse to allow minority shareholders their day in court instead of relegating them to their appraisal remedy. Plaintiffs were thus allowed to attack the fairness of the transaction in litigation, whereas in the absence of a business purpose test (and some plea for equitable relief) a plaintiff's claim would be for inadequacy of price and nothing more. Since there is a statutory remedy for simple unfairness, namely appraisal, any recognition of a dual remedy would have been difficult to limit to particular kinds of mergers as *Harman* itself demonstrated.[60] Moreover, few freeze-out

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Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 3d 592 (1969); Wilkes v. Springside Nursing Home, 370 Mass. 842, 353 N.E.2d 657 (1976); Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1346.

56. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).

57. 442 A.2d 487 (Del. 1982).

58. *See* Tanzer v. International Gen. Indus., 402 A.2d 382, 390 (Del. Ch. 1979).

59. *See* Weiss, *supra* note 7, at 667-71.

60. *Harman* was a stock for stock merger and did not, therefore, raise any clear question of the shareholder's rights to the form of his investment. The shareholder

mergers were ever enjoined.[61] Courts of equity fell back to monetary awards. Indeed, in *Roland International Corp. v. Najjar*,[62] the supreme court held that a complaint requesting only money damages stated a claim in equity.

Notwithstanding any potential efficacy the business purpose test may have developed, it was quite severely confined almost from the start. In *Tanzer*,[63] it was held that the business purpose need not be that of the subsidiary. The business purpose of a parent or majority shareholder would suffice. Indeed, the trial court in *Weinberger* held that it was sufficient that the parent regarded the subsidiary as a good investment.[64] But what parent would even propose a venture that it did not consider a good business move? As the Delaware Supreme Court and at least one commentator recognized, the business purpose test had been "interpreted out of existence."[65]

Interestingly, "business purpose," as defined in *Weinberger*, is very close to the abuse that many commentators saw when freeze-out mergers became popular. Since the parent has inside information, it could be expected to attempt a freeze-out at a time when business was about to improve or when it otherwise believes that the subsidiary's stock is worth more than the minority thinks it is. Even though it might be difficult to prove that the majority had failed to disclose anything about the bright prospects for the company, a freeze-out would not be proposed when business was declining. The odds greatly favored the majority. Thus it was argued that the mechanism of the freeze-out was so prone to abuse that it should be prohibited altogether, or at least in the absence of a proper business purpose.[66]

There is, however, justification for the *Weinberger* trial court's view. As was recognized in *Singer* and *Tanzer*, the parent is entitled to exercise its

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argued, however, that the merger in question was designed to eliminate the minority from further meaningful equity participation and the complaint was ultimately upheld. Ironically, the parent itself was cashed out in a subsequent merger. Sterling v. Mayflower Hotel, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952), from which the entire fairness standard descends, was also a stock for stock merger which calls into question the form-of-investment rationale or at least calls for a better explanation than the notion that the shareholder has a right to continued equity participation. As will be seen, however, valid questions *can* be raised about the form of investment even in stock for stock transactions. *See* text at notes 70-82, and note 161, *infra*.

61. *See, e.g.*, Young v. Valhi, Inc., 382 A.2d 1372 (Del. Ch. 1978).

62. 407 A.2d 1032 (Del. 1979).

63. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).

64. 426 A.2d at 1342-43, 1348-50.

65. 457 A.2d at 715; Weiss, *supra*, note 7, at 671 n.300.

66. *Supra* note 5; Kerr, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33 (1975). Professors Brudney and Chirelstein saw the business purpose test as "misdirected" and having "no role whatever to play in this field." Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1356. They reasoned that economic efficiencies could arise from mergers between two functioning enterprises and that business purpose was inherent in such mergers. *Id.* And in their view, since no such efficiencies could arise from a mere rearrangement of stock ownership, going private mergers should be banned. *Id.* at 1367; *see also* Weiss, *supra* note 7, at 667-68.

rights as a shareholder just as is the minority.[67] The parent has the largest stake in the subsidiary. But the minority effectively establishes the value of the subsidiary, since the trading activity of the minority generates the market price.[68] If the market price is too low, the parent is harmed whenever it uses its shares in the subsidiary (for example, as payment for an acquisition or in connection with an employee incentive plan).[69]

It is perfectly legitimate for the majority and the minority to differ on the value of the enterprise. It is generally agreed shareholders value dividends.[70] Dividends may be obtained in two forms. The corporation may pay them out of leftover cash, or the corporation may reinvest the cash in investments. These investments will generate more cash in the future leading to still higher dividends and causing a present increase in the value of the corporation's stock.

To the extent that the company chooses to pay out cash, it is easy for a shareholder to calculate the return. However, it is difficult to assess the riskiness of those returns and hence to know whether the return is adequate.[71] It is still more difficult to assess the value of investments made by the corporation with the cash it has retained, since reasonable minds may differ both as to the expected return and the risk. Even if it were possible to attain wide agreement in return and risk, the majority and the minority might differ on the cost of the funds being invested. If the majority can raise money at lower rates than those demanded by shareholders for the same income stream, it will view the minority stock as worth more than the minority thinks.

Finally, it may be that the parent has discovered an investment opportunity that it is not required to share with the subsidiary but which nonetheless

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67. Professor Borden argues that freeze-outs should be viewed primarily as controversies between groups of *shareholders* and not as matters of corporate governance. Sisk, Book Review, 38 BUS. LAW. 271, 273 (1982) (reviewing A. BORDEN, GOING PRIVATE (1982)). Indeed the principle is mentioned in *Singer,* 380 A.2d at 976, and expressly recognized in *Tanzer*, 379 A.2d at 1123. Numerous other courts have recognized that there exists a realm of legitimate competition between majority and minority shareholders, that is, an area in which the majority, despite its fiduciary duty to the minority, may legitimately pursue its self-interest. *See* note 55, *supra.*

68. *See* text at notes 151-59, *infra.*

69. *See* Kaufmann v. Lawrence, 386 F.Supp. 12 (S.D.N.Y.1974), *aff'd*, 514 F.2d 283 (2d Cir. 1975); Borden, *supra* note 3, at 1013-14 (controlling shareholders have an obvious interest in the success or failure of their business). In this regard, going private is no different from any other freeze-out. *See* note 66, *supra.*

70. *See* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 211-12 (1980).

71. As used here, returns refer to the cash that may be expected by the investor, that is, a weighted average of the possible outcomes. Risk refers to the dispersion of those possible outcomes, that is, it is a measure of how drastic the possible divergence from the average is, which, of course, the average itself does not disclose. *See id.* at 145-55. The higher the risk, the higher the rate of return an investor will demand. *See* J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 362-63, 432-33 (1978). Thus as between two different stocks with the same expected total dividend, the riskier one will sell for less and hence will generate a higher percentage return.

fits in well with the subsidiary's business. No doubt some would argue that there are no such opportunities since the majority has a strict and overwhelming duty to run the company for the benefit of all the shareholders.[72] However, that view seems a bit too strict since it implies that once a shareholder attains control he must forego any opportunity that would be useful to the corporation no matter where or how the opportunity may have been found.[73] Indeed, if that were the law it would be reason enough to seek to eliminate minority interests.[74]

The disagreement between majority and minority over the value of a company may be viewed as one over business policies and strategies which are virtually universally agreed to be matters left to the sole discretion of the board of directors. Suppose that in the parent's view the subsidiary is worth much more than the minority appears to think it is worth. This is not an unlikely state of affairs since the parent bought and held its controlling position presumably because it was optimistic about the subsidiary's business. The low market price, however, is indicative of the shareholders' belief that dividends will not be increasing as a result of management's new investments as fast or as much as management seems to think. The low price is an implicit demand for a higher rate of return either in the form of current dividends or a more popular investment program looking to quicker or more apparent growth.[75] The shareholders thus suffer from management's policies. Although the parent believes its policies are optimal, it suffers from the public perception whenever it uses the subsidiary's stock.

On the other hand, the parent's failure to adjust its policies is equivalent to its retaining the equity it perceives without generating any return for the shareholders. But such retention of equity and failure to pay dividends contravenes management's implicit contract with investors that the company will find investments that are better than those the shareholders can find on their own.[76] The shareholders too may be thought of as in breach of their bargain with management; they insist, in effect, that management change either its

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72. *See generally* Brudney, *supra* note 5; Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 998 (1981).

73. For an exposition of the prevailing analysis of corporate opportunity cases, see Burg v. Horn 380 F.2d 897 (2d Cir. 1967), Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d. Cir 1934), *cert. denied*, Biddle v. Irving Trust Co., 294 U.S. 708 (1935); Johnston v. Greene, 35 Del. Ch, 479, 121 A.2d 919 (Del. 1956); Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503, (Del. 1939). Ultimately the issue is one of deciding, with respect to particular behavior, whether it is within or without the realm of activity which the manager has contracted to undertake as a fiduciary.

74. *See* Johnson v. Trueblood, 629 F.2d 287, 292 (3d. Cir. 1980) *cert. denied*, 450 U.S. 999 (1981).

75. Of course there are situations in which the market price is intentionally driven down, either by withholding dividends or otherwise, simply in order to make going private cheaper to the insiders. *See, e.g.*, Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 342 A.2d 566 (1975).

76. *See* W. KLEIN, *supra* note 70, at 214-15.

payout or investment policy.[77]

Ultimately, the parent cannot justify retaining unused equity.[78] The straightforward way of solving this problem is for the majority (which thinks the stock is worth more) to buy out the minority (which thinks the stock is worth less). This can be done, of course, only with some degree of force since it is impossible to negotiate with hundreds of shareholders. Even if it were possible, some would hold out, either irrationally or strategically,[79] the latter in the belief that the majority will pay more to eliminate the last vestiges of a public market which could continue to set a low price.[80] Some coercion may thus be excused because of the harm visited on the parent.

If minority shareholders are almost always correct in these "disputes," a presumption against freeze-outs can be justified. But it would seem that insiders are in a better position to devise and pursue the most profitable investment strategies. At the very least the law should not incorporate the opposite presumption in favor of outsiders. That is equivalent to presuming that the minority's business judgment should be followed or, at least, that the minority should have a veto over business strategies it dislikes.

Thus, although the business judgment rule always seemed out of place in defense of freeze-outs,[81] at a deeper level it is quite to the point. The minority should not be favored in the struggle if for no other reason than that it cannot

77. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Berwald v. Mission Dev. Co., 40 Del. Ch. 509, 185 A.2d 480 (Del. 1962); Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919).

78. Indeed, in Dodge v. Ford Motor Co., 204 Mich 459, 170 N.W. 668 (1919), while the court upheld management's retention of the vast majority of the funds in question, it ordered the corporation to pay out $19,000,000 in surplus funds which were found unnecessary to carry out any of the company's plans. In effect, a company undervalued on the market (that is, worth more as a private concern) is retaining equity to no good use, though that may only be apparent to the insiders. If the company is undervalued because of pessimism concerning its investment plans (and not because of any repressive refusal to pay dividends in order to drive down the market price) and if it is in a cash position to do it, one could argue that there is a *duty* under such circumstances to freeze-out the public at the insider's view of a (higher) fair price, or to repurchase stock on the open market since both are the functional equivalent of declaring a dividend. Relegating shareholders to the open market, when they disagree in any significant numbers with either pay-out or investment policies, is an inadequate response.

79. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1359-60.

80. Indeed, if the number of outstanding shares remaining is sufficiently small, the market price will be further depressed for lack of "float" with which to make a market. *See* Kaufmann v. Lawrence, 386 F. Supp. 12, 16-17 (S.D.N.Y. 1974), *aff'd*, 514 F.2d 283 (2d Cir. 1975); Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1369; Note, *supra* note 6, at 916-19. Despite the fact that the market is "efficient," *see* note 160, *infra*, it thus apparently discounts some stocks for reasons having nothing to do with the value of the issuer's income stream.

81. *Cf.* Brudney, *supra* note 5, at 1026-30. Since the economic gain, if any, resulting from going private is appropriated by those who remain shareholders, the ordinary deference to the business judgment of those in control is not in order. *Id.*

perform the management function. It is too diverse and diffuse. Indeed, even if it were possible to put matters of investment strategy to a vote, it would not be a reliable way of proposing investment strategies.[82]

It might be suggested, however, that a veto of policies that do not serve the interests perceived by outside shareholders could work. The stock market serves, in a sense, as a continuing referendum on management's policies. Although the shareholders cannot propose the kind of investment or payout strategy they prefer, if management pays enough attention to the market's movements it will eventually divine the shareholders' desires. Again, this ignores the competing financial interest of the majority and, as will be seen in more detail, using the stock market as an indicator of minority preferences may be quite misleading.[83]

All of this argues that freeze-outs can be justified even in the absence of operating efficiencies. Freeze-outs invariably involve substantial premiums over market price being paid to minority shareholders.[84] The minority receives more for its stock than it could otherwise hope to realize over the short term.[85] This seems to be precisely what the minority has been demanding, increased dividends, albeit in a lump sum payment. Of course one must also believe the majority thinks the stock is worth more than it is paying. That alone, however, hardly argues that freeze-outs constitute questionable advantage taking by majorities. Disparate perceptions of value are a prerequisite to any transaction.[86] In short, if arm's length bargaining were possible, minorities would often freely agree to be frozen out.

It has been argued, too, that it is unfair for a company to go public at a high price and to freeze out its public shareholders after the market has fallen. That amounts, it is argued, to the company's selling short its own stock.[87] It is far from clear, however, that there is any real loss to a frozen-out shareholder merely because the stock market as a whole has fallen.[88] This means only that

82. The impropriety of using a system of voting to make investment decisions—where there are typically many more than three alternatives—is amply demonstrated by Arrow's General Impossibility Theorem. K. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963). *But see* G. TULLOCK, TOWARD A MATHEMATICS OF POLITICS 37-49 (1967). One could favor a negotiating committee (as the *Weinberger* court suggested for protecting minority rights in freeze-outs) but there is no reason to believe that an adversary setting fosters the development of more profitable investment policies. The very fact that the idea seems to make some sense at first suggests that some of the legal thinking about corporations suffers from the fact that it is done by lawyers.

83. *See* text at notes 151-59, *infra.*

84. Chazen, *supra* note 46, at 1445 n.26; DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J. L. & ECON. 367 (1984).

85. *See* Chazen, *supra* note 46, at 1449-50.

86. *See, e.g.*, Tanzer v. International Gen. Indus., 402 A.2d 382, 394 (1979) (on remand).

87. Note, *supra* note 5, at 905-06.

88. The possibility of significant insider gains from public issue at a high price

equities have become relatively less valuable in the market.[89] As one concerned primarily with investment or trading and not participation in management, it is a virtually complete response to the minority shareholder that he can use the money to buy an equally good but equally depressed investment.[90] On the other hand, why should the insider, whose interest is primarily in long term management rather than short term trading gains [91] be forced to accept the market's view of the relative value of his equity interest? The very fact that market conditions change and investments fall into or out of favor tends to show that an insider may validly disagree with the minority over a company's worth.[92] Indeed, there may be other markets in which equities are more valuable, such as the market for whole corporations.[93] It is no answer that the insider bargained away his privilege to deal in other markets for the liquidity

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and a freeze-out at a lower price has often been noted. *See* Tanzer v. International Gen. Indus., 402 A.2d 382, 392-93 (1979); Brudney, *supra* note 5, at 1019; Note, *supra* note 6, at 905-06. The argument was properly rejected in Kaufmann v. Lawrence, 386 F. Supp. 12, 16-17 (S.D.N.Y. 1974), *aff'd*, 514 F.2d 283 (2d Cir. 1975), where the court noted that a tender offer price of roughly half the public issue price two years earlier was attractive only *because* of market conditions.

89. For example, in litigation under the federal securities acts, it has been held that when a broker engages in excessive trading for (churns) an investor's account, the investor may recover his loss, but only to the extent it exceeds its decline in the market as a whole. The market's decline is measured by a broad based market index such as the Dow Jones Industrial Average. *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 49 n.22 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978).

90. Commentators have distinguished transactions in which the shareholder is forced to accept cash from those in which he is allowed to retain his investment. Chazen, *supra* note 46, at 1460-62; Note, *supra* note 5, at 929-30; *see also* In re Valuation of Common Stock of Libby, McNeil & Libby, 406 A.2d 54 (Me. 1979). However, if one believes in the efficient market one believes that one share of stock is as good as another. *See generally* J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-98 (1973). Thus, except that the shareholder is put to the cost of acquiring substitute investments, he should be indifferent, whether a willing seller or not, if one analyzes the issue purely in terms of market conditions. Moreover, it is well established that, through diversification, an investor can eliminate all risk except market risk without any sacrifice of return. *See generally id.* It would seem then that any bonus received from a freeze-out is pure windfall and that the investor needs little if any protection. It is argued below, however, that it is in the nature of a share of stock to be worth more as an investment than as a trading commodity and that freeze-outs are mutually beneficial because they allow extraction of the additional value unavailable in the market. Thus in analyzing freeze-outs one should not focus on the loss of value to the shareholder. The premium can be recouped by buying another issue, although there would be some cost in identifying comparable investments. Rather the law should (and often does) focus on the possibility of unjust gain to the insider. *See* note 130, *infra*. What is lost to the shareholder is the ability to get the premium in the form of cash, at best a shareholder's right only in extreme circumstances.

91. *See* Borden, *supra* note 3, at 1006-08.

92. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION 80-81 (1976).

93. *See generally* Chazen, *supra* note 46; Mirvis, *Two Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983).

of public trading. The value he perceived has since been destroyed.[94]

Finally, on a macroeconomic scale, it would seem clearly preferable to allow for the redeployment of unused capital. The fact that a company is already controlled by an investor who desires a bigger stake should not stand in the way of deal that would benefit both parties. The majority shareholder is the most likely purchaser because he knows the business and his own management capabilities. It seems foolish to insist that just because a company once goes public it must forever remain public because of *potential* conflicts of interest in the majority's purchase.[95] Not only do the shareholders lose their only chance to get out at a premium,[96] the remainder of the economy loses the use of investment funds locked in the subsidiary that cannot be taken private.[97]

Viewed in this light, a freeze-out not only may be justified but the majority may actually have a duty to carry it out. A freeze-out amounts to the declaration of an increased (one-time) dividend to those who demand it, leaving control of the company to those who believe it is optimally directed. Though there may be shareholders in the minority who agree with the majority's management strategy and would prefer to remain shareholders, the majority may be justifiably leery of allowing any minority to remain. There can be no guarantees that the disagreement will not recur.

All this is not to say that majorities cannot abuse their powers. Thus, although *Weinberger* eliminates the business purpose requirement, liberalizes the appraisal remedy, and holds that ordinarily appraisal should be the exclusive remedy in freeze-out cases, it also preserves the power of the courts of equity in cases of fraud, misrepresentation, self-dealing, waste, and overreaching.[98] Arguably, this was already the rule under *Harman*. As the court held in *Harman*, coercion is an essential element of self-dealing and thus of the cause of action at equity.[99] In distinguishing an earlier trial court opinion in *Weinberger*,[100] the *Harman* court strongly suggested that a fairly conducted vote might well justify dismissal of a plaintiff's claim without a trial,[101] though the

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94. For example, if a 100% shareholder sold 4 of his 10 shares at the market for $10 per share and froze out the public after the market price had fallen to $5, the public would have lost $20 but the parent would have lost $30 in the market value of the shares retained. The company of course would be $20 ahead in cash, after the freeze-out, though it might take some time to live down the market's opinion. To the extent that it is appropriate to think of freeze-outs more in terms of the implicit contract between management and shareholders, it may also be appropriate to think of such circumstances as these as failure of consideration.

95. *See* Johnson v. Trueblood, 629 F.2d 287 (3rd. Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

96. Chazen, *supra*, note 46, at 1449-50.

97. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1369.

98. 457 A.2d at 714.

99. Harman v. Masoneilan Int'l, 442 A.2d 487, 495-96 (Del. 1982).

100. Weinberger v. UOP, Inc., 409 A.2d 1262 (Del. Ch. 1979).

101. 442 A.2d at 495. It is ironic, to say the least, that *Weinberger* should have been used to establish this principle.

court did note that the Chancellor in *Weinberger* also held that merely giving the minority a vote was no safe harbor.[102]

There is no self-dealing when the majority does not use its control to assure that the transaction will occur, for example, when the minority is afforded a veto. Since *Harman*, it was arguable that litigation had already been confined to situations where either no vote was taken or the vote was somehow tainted. *Weinberger* uses the device of shifting the burden of proof to the plaintiffs rather than negating the existence of self-dealing. But in practice the two methods differ little. *Weinberger* reiterates and clarifies the elements of a cause of action, but the rules set down are certainly not new.

The utility of a shareholder vote to assure that the majority has set a fair price should not be underestimated. Only by putting the matter of a freeze-out to a preliminary vote can coercion be eliminated. Even in a tender offer by the parent for the minority shares there are subtle but powerful pressures that coerce a shareholder to accept less than he thinks his stock is worth. If he does not tender he may be frozen out at a still lower price.[103] Voting eliminates this problem by preserving the shareholder's option to express his opinion that the price is too low without having to forego realizing the offered price if it turns out that most shareholders think it is adequate. The problem with relying on voting, of course, is that shareholders are notorious for not taking their franchise seriously.[104] It is not clear how much of that notoriety is deserved.[105] There is no reason to believe that shareholders will not take notice once they realize that the vote in connection with a freeze-out should be treated as a decision to sell or hold at the proposed price.[106]

It bears noting that *Weinberger* does not *require* that a vote be taken. Cases may arise in which no vote is taken if, for some reason, the parent believes the shareholders would not behave rationally or if damaging disclosures unrelated to the fairness of the transaction were required to be made. The *Weinberger* court may have had such cases in mind when it suggested that the appointment of a special committee of independent directors to nego-

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102. *Id.* at n.14. Nevertheless it quickly became standard practice for the majority to call a vote of the minority in connection with a proposed freeze-out. *See* Deutsch, *Weinberger v. UOP, Analysis of a Dissent*, 6 CORP. L. REV. 29, 34 (1983). The *Weinberger* complaint was amended to allege misrepresentation in connection with the vote and was held to state a cause of action in the decision which was reversed on the merits by the Delaware Supreme Court. Weinberger v. UOP, Inc., 426 A.2d 1333 (Del Ch. 1981), *rev'd*, 457 A.2d 701 (Del. 1983).

103. *See e.g.* Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd*, 514 F.2d 283 (2d Cir. 1975).

104. *See* Weiss, *supra* note 7, at 676-77.

105. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION 37-63 (1976).

106. *See id.* at 66-68. A greater danger may be the inclination of institutional investors—often the largest shareholders in a corporation—to vote in favor of a quick profit even though they believe the investment value of the stock to be greater than the proposed price. *See id.* at 53-63; Borden, *supra* note 3, at 1015.

tiate a price will be looked upon with favor.[107]

In addition to dangling before parents the prospect of avoiding litigation, *Weinberger* increases the pressure that an informed vote be taken in every freeze-out transaction so that the majority can know how many potential appraisal-seekers there will be.[108] It would not be surprising if most freeze-outs hereafter are made dependent on a maximum number of "no" votes.[109] Assuming that there is some chance, even in fairly approved mergers, that dissenters will be awarded additional compensation, majorities will likely seek assurance that the number of shareholders seeking appraisal be kept to a minimum.[110] The majority will have a further incentive to put the matter up to a vote since only those voting "no" have a right to an appraisal.[111] Finally, the majority will likely want to leave open the option of calling off the freeze-out if the risk of having to pay a high price becomes too great.

Hazards abound here, however. Establishing any maximum number of "no" votes is some indication that there is some higher price which the majority would be willing to pay.[112] Moreover, read broadly, *Weinberger* appears to require that the majority disclose its view of the value of the subsidiary or, at the very least, the amount it is willing to pay if greater than the amount being offered.[113] It was precisely such facts which were not disclosed in *Weinberger* and which left the minority vote without force.[114]

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107. 457 A.2d at 709 & n.7; *see* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 886 (Del. 1970); Johnston v. Greene, 121 A.2d 919, 925 (Del. 1956); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971). The weight to be accorded such negotiations is unsettled, but may approach a presumption of fairness equivalent to a merger being protected by the business judgment rule. *See* text at note 81, *supra*; *see also* Chazen, *supra*, note 46, at 1440-41, 1474-77. The committee device could be used as a means of giving the minority some voice in proposing a price, thereby obviating the criticism that shareholder voting is at best an awkward substitute for negotiations.

108. The Delaware appraisal statute requires that a dissenter notify the corporation in advance of his intent to seek appraisal. DEL. CODE ANN. tit. 8, § 262(d) (1983). Thus, in fact, a vote need never be taken to determine if there will be too many dissenters.

109. The practice is not uncommon anyway. *See, e.g.*, Tanzer Economic Assocs., v. Haynie, 388 F.Supp. 365 (S.D.N.Y. 1974); Eisenberg, *supra* note 92, at 72.

110. It is argued below, however, that additional compensation should never be awarded in a fairly approved merger. *See* text at notes 186-210, *infra*.

111. DEL. CODE ANN. tit. 8, § 262(a) (1983).

112. On the other hand, recklessly foregoing the opportunity to make the transaction contingent upon a particular percentage of "no" votes, would seem to suggest that the majority would pay *any* price.

113. To a large degree such disclosure is already required inasmuch as virtually all publicly held companies are required to disclose information about future prospects and firm offers to be bought in connection with "going private" transactions. General Rules and Regulations, Securities Exchange Act of 1934, 17 C.F.R. § 240.13e-3e-100 (items 5, 8) (1983). *See* Chazen, *supra* note 46, at 1441-41, 1451-52; Tanzer Economic Assocs. v. Haynie, 388 F. Supp. 365, 366-67 (S.D.N.Y. 1974); *see also* R. JENNINGS & H. MARSH, SECURITIES REGULATION 628-30, 957-60 (5th ed. 1982).

114. 457 F.2d at 712.

It seems highly unlikely that the *Weinberger* court intended to require the majority to bare its innermost thoughts on the value of the minority interest. No clear-thinking shareholder would vote "yes" if he knew the parent was willing to pay more. But no parent would pay every last cent of the value of the minority stock either. Unless there is some profit left in the transaction, the parent will not propose it. Since no one else can, both sides stand to lose.

It can only be concluded that the holding in *Weinberger* turned on the fact that the information was obtained from sources inside the subsidiary.[115] If the parent is motivated by its own perceptions, analysis, and plans, and not by inside information obtained through its privileged position in the subsidiary, it must be presumed that disclosure is not required. Otherwise, *Weinberger* amounts to a disingenious ban on freeze-outs.

Thus it appears under *Weinberger*, the parent is free to pursue its own interest and to use its own information within the confines of fair dealing. Although the legitimacy of a majority shareholder's pursuing its own self interest may be traced back to the Delaware courts' adoption in *Singer* and subsequent cases of a competing interests analysis of fiduciary duty rather than the traditionally rigid one, the significance of *Weinberger* is that it recognizes the possibility of mutually beneficial freeze-outs, while the business purpose test may well have precluded some transactions profitable to both parties.

III. APPRAISAL AFTER *Weinberger*

Harman had already accomplished virtually as much as *Weinberger* in refining the elements of the minority's cause of action. The innovation in *Weinberger*, other than the obvious improvements in the method of appraisal, may thus appear to be that a higher price may be exacted through appraisal even though the merger has been approved by a minority vote. This is strongly suggested by the court's attitude that now that appraisal comports with real-world valuation, the dissenter has nothing to fear.[116] Moreover, one would naturally think that since a dissenter may introduce new kinds of evidence and have new kinds of values compensated, he will clearly be better off. Since the dissenter may be holding out simply because he thinks his stock is worth more than is offered, he no doubt will sometimes be correct even in the absence of fraud.

On reflection, however, it seems highly unlikely that the court intended any of this to mean that a dissenter could do better even in a fairly approved transaction. Discussing the recent amendments to the Delaware appraisal statute, the court emphasizes that fairness includes both fair price and fair dealing and that the two cannot be split apart.[117] It would seem impossible, given such an emphatic statement, for an appraiser to ignore an informed vote of the

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115. 457 F.2d at 709.
116. *See* text at note 51, *supra*.
117. 457 A.2d at 711.

minority as bearing on fairness. What would be found fair in litigation should also be found fair in appraisal.[118]

This position is further supported by the court's holding that rescissory damages may be allowed in an appraisal proceeding if appropriate.[119] Thus the court had in mind cases in which fraud is discovered in the course of appraisal. However, the equivalent of rescissory damages could be awarded simply by using the new forms of evidence recognized by the *Weinberger* court. This reinforces the conclusion that a fairly approved transaction does not call for any such award, since otherwise it is difficult to understand how such an award could be said to be discretionary.

Finally, the *Weinberger* court could not have intended for arm's length acquirers to face the possibility of having to pay dissenters more than the approved price. Nevertheless, the appraisal remedy applies to all mergers, not just to interested mergers. Whatever claim the minority may have to the gain a parent expects from a freeze-out, the dissenting shareholder in an arm's length merger certainly has none.[120]

In short, while at first the expansive notion of fairness outlined in *Weinberger* makes it appear that dissenters will now receive compensation for all sorts of value previously lost to them, fair dealing cuts both ways. If the price is fairly set, what justification can there be for changing it? By drawing so heavily on the appraisal statute for the meaning of fairness in the context of litigation, the court also insures that fairness in one context will be set by the same standards as in the other. Given the virtual identity of the two methods of proceeding after *Weinberger*, it is difficult to reach any conclusion other than that, unless grounds for litigation can be found, the appraiser will award the parent's proposed price if ratified in a fair vote of the minority shareholders. Thus, appraisal may well become the procedure of choice by plaintiffs, since they need not fear dismissal and will at the very least enjoy a cursory review of the terms of the transaction.[121]

No doubt there will be a flurry of appraisal proceedings in the near future to test the water. While it is doubtful that the Delaware court intended for appraisers freely to set new prices, it certainly appears that the liberalized appraisal proceeding was intended to be readily available to shareholders who

118. *See also* Mirvis, *supra* note 93, at 498-500; Weiss, *supra* note 7, at 671.

119. 457 A.2d at 714.

120. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1359-62.

121. This may well raise difficult procedural problems. Presumably, a finding of coercion will nullify any vote taken as in *Weinberger* itself. But if the coercion is found in an appraisal proceeding it is unclear how "yes" voters may then proceed. May they be deemed "no" voters by avoidance of the election? Must they begin a parallel action at equity? Will the availability of rescissory damages *via* appraisal and the possibility of an inconsistent result at equity create pressure for equitable relief or will collateral estoppel apply? Questions such as these have not arisen in the past since litigation has always been the preferred route when it could be supported. Regarding the peculiar procedures and pitfalls of appraisal, see generally Eisenberg, *supra* note 92, at 69-84; *see also* Weiss, *supra*, note 52, at 256-60.

simply want to keep their investments. There are compelling reasons beyond the mere definition of fairness why courts should refuse to allow dissenters any additional compensation when the merger has been fairly approved. These reasons lie in the very nature of the new forms of evidence recognized in *Weinberger.*

Weinberger allows dissenters to introduce three new forms of evidence: (1) discounted cash flows, (2) premiums paid in comparable transactions, and (3) non-speculative post-merger gains. In addition, a shareholder who dissents from a merger may also seek "rescissory damages."[122] In order to understand fully the implications of the new appraisal remedy it is necessary to understand this fourth element of potential compensation.

A. *Rescissory Damages*

Rescissory damages are the rough monetary equivalent of an award of rescission following a trial. They are calculated by determining what the plaintiff would have had if he had been allowed to keep his stock.[123] If the stock has increased in value since the freeze-out, the plaintiff gets the difference. He does not get his stock back as that would be rescission itself. He loses any unforeseeable future gains. The remedy is somewhat less harsh than rescission because the transaction is allowed to stand, but the plaintiff is awarded the benefit of the bargain, rather than being left only with his out of pocket loss at the time of the transaction.

The value of the stock under a rescissory damages formula is determined at the time of trial. As a result, it reflects upswings in the market, turns for the better in the fortunes of the company, and changes in the business wrought by the acquiring company. This is particularly significant in the context of a freeze-out since the essence of a plaintiff's case is not that he has suffered a loss, but rather that he has not enjoyed a gain. The old appraisal remedy addressed only the former.[124]

In *Weinberger*, plaintiff sought rescissory damages as had been awarded in *Lynch v. Vickers Energy Corp.*[125] In *Lynch*, the parent made a tender offer at $12 per share to the minority. The parent failed to disclose, however, that an analyst had determined that the stock was worth "significantly more" and that the parent had authorized open market purchases at up to $15 per share. The minority alleged breach of fiduciary duty and sued for damages or rescission. The chancellor conducted the equivalent of an appraisal and concluded

122. 457 A.2d at 714.

123. *See generally* 4 A. BROMBERG & L. LOWENFELS, SECURITIES FRAUD & COMMODITIES FRAUD § 9.1 (1983).

124. *See* Chazen, *supra* note 46, at 1443-47.

125. 351 A.2d 570 (Del. Ch. 1976), *rev'd,* 383 A.2d 278 (Del. 1977) (*Lynch* I), *on remand,* 402 A.2d 5 (Del Ch. 1979), *rev'd,* 429 A.2d 497 (Del. Ch. 1981) (*Lynch* II).

that $12 was a fair price at the time of the tender offer.[126]

The Delaware Supreme Court reversed, holding that, while the minority was entitled to rescission as a matter of law, rescission was impractical. Rather, the minority should be awarded the value of the stock at the time of trial.[127] The court stated that rescission is the preferable remedy when a party has been induced to contract by materially misleading representations.[128] The court noted that such a rule of damages is consistent with the notion that a fiduciary should not be allowed to profit at the expense of the principal.[129] Thus, the court held that it was not necessary for the plaintiff to show that he had been injured. He need only show that the defendant had benefited.[130]

The *Lynch* holding was criticized for confining the discretion of the chancellor.[131] Indeed, there appears to be little basis on which to distinguish *Lynch* from any case in which the stock acquired by a parent through tender offer or freeze-out appreciated in value. Certainly there is no basis for distinction in any case where the parent knew of the hidden value at the time.[132]

Weinberger overruled *Lynch* to the extent that it purported to impose a specific damage formula.[133] In other words, *Lynch* was overruled insofar as it could be interpreted to require a rescissory damages formula to be applied when unfairness was found. The *Weinberger* decision reaffirms the discretion of the chancellor to award rescissory damages in a trial and extends that discretion to appraisal proceedings.[134] Thus, whether through litigation or appraisal, the chancellor may in appropriate cases award the benefit of the bargain, the value ultimately realized by the parent.

One may think of rescissory damages as having grown out of the business purpose test set down in *Singer*. Since freeze-outs could be accomplished within the letter of the law, but were also self-interested, it fell to the courts of equity to determine whether the transaction as a whole was fair. A freeze-out differed from the traditional self-dealing transaction. For example, where a

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126. 429 A.2d at 499-500.

127. *Id.* at 501-03.

128. *Id.* at 502-03; *see also* Mansfield Hardwood Lumber Co. v. Johnson, 263 F.2d 748 (5th Cir.), *cert. denied*, 361 U.S. 885, (1959).

129. 429 A.2d at 503 n.5.

130. *Id.* at 503-04. The remedy is common in circumstances in which insider misbehavior must be deterred. *See, e.g.*, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974) (causation of damage established under Rule 10b-5 where material information not disclosed by insider-traders); Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910, 301 N.Y.S.2d 78 (1969) (corporation recovered losses avoided by insiders who traded on information obtained in fiduciary capacity).

131. 429 A.2d at 507-08 (Quillen, J., dissenting).

132. *See* Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U.L. REV. 913, 929-35 (1982); Mirvis, *supra* note 93, at 496-500.

133. 457 A.2d at 703-04.

134. *Id.* at 714.

director sells a piece of property to the corporation, the chancellor's objective would be to determine whether the transaction roughly approximated what would have happened at arm's length.[135] In such cases, self-dealing is merely a red flag that indicates that one cannot necessarily depend on the director pursuing the corporation's interest. It is nevertheless entirely possible that the transaction is in the interest of both parties.[136]

Freeze-outs were thought to be quite a different matter, at least under *Singer.* They were viewed more like a divorce, a situation in which the interests of the minority and the majority somehow had come into irreconcilable conflict. Unless the transaction were to be banned altogether, some test needed to be devised to determine whether the majority's keeping of its investment and forcing the minority to accept cash was justified. Thus, courts looked to business purpose to determine whether some higher good justified the residual unfairness implicit in the fact that the majority would never propose a transaction unless it perceived some benefit in it.[137]

Even though business purpose became easy to demonstrate, the relief available in courts of equity got ever broader. In *Tanzer*,[138] the Delaware supreme court affirmed the chancellor's refusal to grant a preliminary injunction based on his finding that a valid business purpose existed but ordered a fairness hearing anyway. Later, in *Roland International Corp. v. Najjar*,[139] the court held that a complaint requesting money damages only would suffice. The court explained this holding in *Harman*,[140] saying that the focus should be on the nature of the coercion of shareholders, rather than the damage they may have suffered. Translated, this means that the measure of damages available at law focused on the harm to plaintiffs judged by the value of what they gave up. At equity, on the other hand, the court could look at the benefit appropriated by defendants measured by the value to the defendants.[141]

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135. *See, e.g.*, Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964).
136. *See, e.g.*, Johnson v. Trueblood, 629 F.2d 287, 292-93 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).
137. *But see* Weiss, *supra* note 7, at 660-63 (argues that the purpose test was adopted primarily as an excuse to review the fairness of freeze-out mergers). In contrast, the position taken here is that the business purpose test did indeed fit the freeze-out situation for a time, but that its very application (or misapplication) altered its definition. *See* note 5, *supra* and text accompanying notes 219-20, *infra.*
138. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).
139. 407 A.2d 1032 (Del. 1979).
140. Harman v. Masoneilan Int'l, 442 A.2d 487 (Del. 1981).
141. Although it is fairly clear that a plaintiff must prove the defendant's intent in order to recover damages at law, it is not clear whether such a showing is necessary at equity to recover the benefit of the bargain from defendants. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 501 (Del. 1981) (*Lynch* II). Indeed, the Delaware court may have left the matter unresolved intentionally in order to provide a potential remedy, when necessary, for the subtle coercion often inherent in tender offers. *See* Kaufmann v. Lawrence, 386 F.Supp. 12, 16-17, *aff'd*, 514 F.2d 283 (2nd Cir. 1974). In this sense, the *Lynch* court's reliance on the existence of a fiduciary duty as a trigger for potential rescissory damages is quite accurate. *Cf.* Fischel, *supra* note 132, at 923-33;

Weinberger affirms the availability of rescissory damages in both litigation and appraisal. It clearly holds, however, that rescissory damages are an optional, not a mandatory, measure of damages.[142] No other rule would be reasonable. Rescissory damages are the value of the freeze-out to the parent. If it is determined that the freeze-out never would have occurred but for coercion or non-disclosure, any lesser measure of damage would be a parent's license to steal. Note that the mere possibility of such damages is further reason to believe that virtually all freeze-outs will now be put to a vote.

On the other hand, rescissory damages may be too harsh a remedy in some cases. *Weinberger* itself is a good example. The parent would have been willing to pay $24 per share and the minority, which overwhelmingly approved $21, would clearly have voted for the higher price. Thus, with full disclosure the transaction would have occurred. But this does not necessarily define the value the parent placed on the minority stock. It could have been that the parent's goal was a 15% return. At $24, the parent had calculated it would realize a 15.5% return.[143] The value of the stock to the parent would thus have been higher than $24 and an award of rescissory damages would presumably be based on such a higher price.[144]

The fact that rescissory damages might be excessive does not mean that the court must retreat to some sort of intrinsic worth measure like that calculated in the traditional appraisal proceeding.[145] Again, *Weinberger* is a good

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Mirvis, *supra* note 93, at 500. Indeed, while *Lynch* even as revised (and possibly *Weinberger* itself) will undoubtedly block some tender offers (and freeze-outs), the formulae for damages appear now to be as finely tuned as possible to catch only those transactions that would not have occurred had all the facts been known or would be so damaging to the fiber of corporation law that relief would otherwise increase or preserve wealth, by, for example, maintaining a higher level of confidence in the financial market in general.

142. 457 A.2d at 714.

143. *Id.* at 709.

144. In deciding whether to make a particular investment (whether in a single machine or an entire company) the essence of the analysis undertaken by a corporation is the same as that used by an individual: does the return on the investment exceed the cost of the capital to be invested? J. WESTON & E. BRIGHAM, *supra* note 71, at 291-302. The answer is often difficult to calculate for a corporation. It is difficult to tell what the corporation's cost of capital is because part of the "payment" to investors is made in the form of growth and because the risk that investors perceive simultaneously affects the amount of total dividend they demand. *Id.* at 796-801; *see also* V. BRUDNEY & M. CHIRELSTEIN, CORPORATION FINANCE: CASES AND MATERIALS 429-38 (2d ed 1979). Partly in order to cope with these difficulties of estimation, corporations typically set minimum acceptable rates of return to use internally in making investment decisions. J. WESTON & E. BRIGHAM, at 295-98. The internal rate of return of a proposed investment is calculated and if it exceeds the minimum it is given further consideration. But unless one knows what the minimum is it is impossible to tell the "value" of the investment, that is the amount of value it would add to the enterprise.

145. *See* Chazen, *supra* note 46, at 1443-44. *See generally* Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms under Delaware Law*, 2 DEL. J. CORP. L. 44 (1977); Note, *Valuation of Dissenter's Stock Under Appraisal Statutes*, 79

example. Inasmuch as the freeze-out in *Weinberger* would have been unobjectionable at $24 per share, it seems fair to presume that $24 will be the most that the parent will be required to pay when the litigation is concluded. Since this may well be less than rescissory damages, it appears that the court had in mind less severe measurements of damages too. One can only presume that the new forms of evidence to be considered in appraisal proceedings—discounted cash-flows, premiums in comparable transactions and post-merger gains—are intended to give the courts the flexibility to arrive at compromise measurements of damages.[146]

B. *A Negotiating Model*

How should the measure of damages be defined now that *Weinberger* is the law? *Weinberger* specifies the variables but provides no express formula. How is the court to know where to alight between the maximum and the minimum when the facts are less clear than those in *Weinberger* itself? Indeed, how clear are the facts in *Weinberger*? Should the trial court affirm an award of $24 or is some other measure appropriate?

There are at least some clues to the answer in the decision. *Weinberger* emphasizes fair dealing. It instructs the courts to abide by fully informed votes of minorities or to look to alternatives such as negotiations conducted by independent directors of the subsidiary. Where neither exists it requires reference to comparable transactions, accepted methods of calculation and nonspeculative gains from the transaction. In short, it appears to require the courts to reconstruct the results of arm's length "negotiations" whether by fully informed vote or by committee.[147]

In order to reconstruct the effect of such a negotiation, one must start with the bargaining positions of the two parties. From the majority's point of view, a freeze-out will not be proposed unless it is a wise investment.[148] That is, the market price the majority is willing to pay must be less than the value of the stock as perceived by the majority. If the stock is not worth something

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HARV. L. REV. 1453 (1966).

146. Of course rescissory damages, when they are appropriate, must be calculated. The new forms of evidence will be useful in that process. *See* text at note 70, *supra*.

147. That the goal of fairness and appraisal proceedings should be to replicate the outcome of arm's length negotiations is a fairly new notion. *See* Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980); Chazen, Fiedman & Fellerstein, *Premiums and Liquidation Values: Their Effect on the Fairness of an Acquisition*, 11 INST. ON SEC. REG. 143, 162-63 (Fleischer, Lipton & Stevenson, eds. 1980) (statement by Martin Lipton); Mirvis, *supra* note 93. *See generally* Chazen, *supra* note 46. "Negotiations" is broadly defined here to include shareholder ratification by fully informed vote. Many would disagree that voting can be an adequate substitute for negotiation, *see* note 107 *supra*, but it has distinct advantages over every other method for obtaining shareholder approval. *See* text at note 103, *supra*.

148. *See* Tanzer v. International Gen. Indus., 402 A.2d 382, 394 (Del. 1979).

more, the transaction will never occur; why have one's money in risky ventures rather than cash? It is presumable, then, that there is a gap between the price the majority is *willing* to pay and the majority's best guess as to the minimum price the majority would accept for the stock if it were to turn around and sell it.[149]

From the minority's point of view, its stock is clearly worth more than the market price. In the first place, the market price is undoubtedly depressed because of the majority's control. There is no potential for a take-over bid, every possibility for the parent to appropriate opportunities equally exploitable by both and a substantial chance that overreaching would be undetected.[150]

Second, even if the market price were not distorted, the minority would expect more. Market price reflects the perceptions of the most willing seller. Presumably any shareholder who thought the stock was worth no more would sell. The vast majority of stockholders must therefore believe their stock is worth more than the market price. Thus, they must be offered a premium to be induced to sell and the greater the percentage to be induced to sell the greater the premium.[151] This proposition is not merely logical. It is borne out by the fact that as shares are purchased on the open market and held out of circulation the price rises. If all shareholders believed the market price reflected full value the price would not rise. That is evident when the purchaser is an outsider, but also true when the issuer repurchases its own shares. If the corporation paid out full value the repurchase would not affect any concentration of the remaining shareholders' participations.[152]

That most shareholders believe their shares to be worth more than market price is also consistent with accepted investment theory. A rational investor puts his money into stocks when the return on stocks exceeds other investments by more than enough to compensate for the additional risk.[153] While it

149. The difference, at the very least, is the cost of making the transaction. But in most cases the difference is probably greater since one would expect investment opportunities costing less than their value to arise with some frequency (though possibly not often enough to use all available cash). Thus the majority would not likely opt for any deal with a small margin of profit, unless of course infinite amounts of cash were available. *See* note 168, *infra.*

150. V. Brudney & M. Chirelstein, Corporate Finance: Cases and Materials 689-92 (2d ed. 1979); Brudney & Chirelstein, *Fair Shares*, *supra* note 20, at 306 n.25; *see also* Chazen, *supra* note 46, at 1443-44.

151. J. Williams, The Theory of Investment Value 11-16 (1938); *see also* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1359-61.

152. *See generally* V. Brudney & M. Chirelstein, *supra* note 144, at 470-501. The reverse process, issuing new stock, also supports the proposition. It is well settled that most businesses must pay a slightly higher rate for each new dollar of financing. *See generally*, J. Weston & E. Brigham, *supra* note 71, ch. 19. Translated, this means that unless a company convinces the market that it will make a greater rate of return (or be less risky) with new capital, it will not be able to sell the new stock except at less than current prices.

153. *See* J. Weston & E. Brigham, *supra* note 71, ch. 11; *see also* note 168, *infra.*

might be argued that buyers of stock do not require the inducement of more value than they are paying for, on close analysis this reasoning is suspect. Assuming the market is efficient,[154] why would a seller ever sell? Such a view of the market may explain transactions resulting from money entering or exiting the market, but it does not explain intra-market volume. In other words, in order for the stock market to function there must be a range of values perceived by traders and potential traders.[155]

The price of a share of stock reflects the stream of dividends it will generate.[156] If the value of the dividends is fully reflected the investor would not be indifferent between taking the price and keeping the investment. One would invariably opt for the former and eliminate any further risk. Keeping the stock, however, indicates that the investor thinks the lump sum he could have if he sold would best be invested right where it is. In short, the investor thinks the dividends are worth more than the market price.[157]

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154. *See* note 160, *infra.*

155. It has been recognized by legal commentators that a fair price is within a range of values rather than any unique value. Chazen, *supra* note 46, at 1454-55; Brudney & Chirelstein, *Fair Shares*, *supra* note 20, at 316. Indeed the mechanics by which such ranges are expressed are at the very core of stock markets. In over the counter markets, market-makers publish bid and offer quotes, typically spread by a quarter to a full point. On exchanges, specialists are licensed stock by stock to maintain a limit order book recording investor's instructions to buy or sell at prices below or above the current market price. For a description of these systems, see Posner, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883, 885-96 (1981). Thus it is hardly accurate to think of the market price as a single number. It could be argued however that market price *is* an accurate measure of value since it incorporates the perceptions not only of current shareholders and traders but also of those who think the stock is overvalued by the market, that is, potential purchasers at lower prices. The problem with crediting the pessimists' perceptions, however, is that they have nothing to sell. If the goal is to replicate a negotiation, non-participants do not count. Economic theory too would seem to dictate ignoring non-owners (except for the one negotiating to purchase); just as the transaction at hand will maximize wealth (if both sides agree), the transaction in the past by which the current owner became the current owner presumably maximized wealth.

156. *See* text accompanying note 70, *supra.*

157. This assumption should be distinguished from the "bird-in-the-hand" theory that, other things being equal, investors prefer dividends. The assumption here is that other things are not equal; investors on the average think their shares are worth *more* than the supposed capitalized value of the dividends, that is, the market price. However, since investors cannot participate in such excess value (except in extraordinary situations like tender offers and freeze-outs) they must indeed prefer dividends to nothing at all unless they are convinced that the company can find investments returning more than the current payout rate. No one seems to doubt that a company which can find no investments even equal to the cost of capital should not retain any earnings. The issue is what investors prefer when the new investment exactly equals the cost of capital. Brudney & Chirelstein suggest without empirical support that this is the most common situation. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 144 at 434. If, by and large, corporations are efficiently managed that is probably a correct assumption; if significantly higher returns were generally easily available to corporations, some would show them and investors would demand them from all corporations. Such opportunities

Thus, no stock transaction would ever occur, absent external inducements (such as the investor's need for cash), unless both buyer and seller thought they were getting something worth more than what they gave up. The fact that traders pay commissions makes this all the more true.

Finally, it is logical to assume that a shareholder willing to wait to sell will insist on a higher price for the same share of stock than a shareholder who, for some reason, cannot or does not want to wait. A buyer, of course, would expect to be able to buy from the latter seller at less than full value. And anyone would be foolish to buy from anyone else. Liquidity has its price.[158]

One might argue that the focus here is on attributes of investors rather than shares of stock. That is, however, as it should be. Shares of stock are valuable only because investors want them. It is focusing too much on the share of stock itself that blinds one to the fact that the same piece of paper can have different values in different hands.[159]

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must, therefore, be scarce and, thus, often as not, one would expect corporations to decline lesser opportunities and have funds left over. *See* note 168, *infra.* Such a situation is consistent with and indeed suggested by portfolio theory. *See* note 160, *infra.*

For a sampling of the bird-in-the-hand controversy, compare Brudney, *Dividends, Discretion and Disclosure,* 66 VA. L. REV. 85 (1980) with Fischel, *The Law and Economics of Dividend Policy,* 67 VA. L. REV. 699 (1981). Fischel notes that empirical studies have so far been inconclusive on the question of whether investors have a preference for dividends. It is difficult to imagine an empirical study that would be convincing on this point since it seems improbable that one could separate the effect of pure investor preference from investor perceptions about the company's correctly choosing among all possible avenues of investment. It seems much more likely that investors will focus on longer range strategies, the talents of management and, perhaps, corporate propaganda, and that this might well lead to a preference for stable policies, that is, a preference for dividends from those who pay them and retention by those who do not. *See* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 434 (1979). This phenomenon is akin to the clientele effect first hypothesized by Miller and Modigliani in *Dividend Policy, Growth, and the Valuation of Shares,* 34 J. BUS. 411, 431 (1961). *See* J. WESTON & E. BRIGHAM, *supra* note 71, at 800-01; Fischel, *supra,* at 704-06.

158. *Cf.* J. WESTON & E. BRIGHAM, *supra* note 71, at 653. This is not particularly surprising. It has long been known that investors who buy and hold a portfolio of stocks do better over the long run than those who trade. Fama, *Random Walks in Stock Market Prices,* FIN. ANALYST J., Sept.-Oct. 1965, at 55-60. *See generally* V. BRUDNEY & M. CHIRELSTEIN *supra* note 144, at 1177-93.

159. *See* P. HUNT, C. WILLIAMS & G. DONALDSON, BASIC BUSINESS FINANCE: A TEXT 548-59 (4th ed., 1971); J. WESTON & C. BRIGHAM, *supra* note 71, at 627-33.

There are also a number of less theoretical (and less basic) reasons why investors may attach different values to the same stock. Probably the most important is taxes; investors who purchased at a price significantly different from the market price will be concerned with recognizing gains or losses for tax purposes at a time peculiar to their own situations. *See* Chazen, *supra* note 46, at 1457-59. In general, the greater the gain already imbedded in the market price of his shares, the more the shareholder will demand (the converse is true for losses). It is presumable that the length of time the average shareholder has held is correlated. *See* Fischel, *supra* note 157, at 704-06.

Efficient market theory together with portfolio theory suggest that these effects may be quite strong. The efficient market theory leads to the conclusion that most

All of this is not to say that the market is somehow inaccurate or inefficient.[160] It is only to say that trading prices and investment values differ. Trading prices are naturally lower. This fact justifies appraisal prices that differ from market prices, though the reasoning seldom appears in the decisions.[161]

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investors stand no chance of beating the market because of superior research. Thus it may be that they must be offered a significant premium in order to pay any attention to a tender offer. Portfolio theory teaches that through diversification an investor can eliminate all risk peculiar to a particular stock and thus must suffer only the risk that the market will rise or fall as a whole. If that is the case, all stocks of a particular risk level are of equal value as investments in a portfolio. Thus, factors such as tax consequences will have a greater effect than one might think from looking at stocks one at a time. Moreover, seemingly minute preferences for payout policies that minimize a shareholder's transaction costs may wax important. Note that all of these effects tend to justify the competing interests analysis of fiduciary duty and the institution of freeze-outs in that they minimize the rational investor's attachment to any particular stock and maximize his personal motivations.

160. It is generally believed, at least among theorists, that the stock market is "efficient," that is that stock prices (and indeed the prices of all capital instruments) change virtually instantaneously to reflect all available information. Probably the most important implication of this hypothesis is that the average investor (or analyst for that matter) cannot even hope to identify undervalued (or overvalued) stocks. It follows that, at a given level of return, one stock is as good as another as an investment. Portfolio theory—which is perhaps even more widely accepted—holds that through diversification one can eliminate virtually all risk of better or worse than expected returns from a particular company. Taken together the two theories indicate that a rational investor should do no more than identify the level of return and market risk he desires and buy a portfolio of stocks with such characteristics. For a concise explanation of the theories, see J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-110 (1973); Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). *See also* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 144, at 1143-1235.

Nothing about efficient market theory necessarily entails that all investors accept the same price as correct. The theory has instead to do with establishing the equilibrium between supply and demand of particular shares and, thus, *presumes* range of values. Indeed, the theory holds that prices will *move* randomly about the "correct" price. *See* J. LORIE & M. HAMILTON, *supra*, at 70-97. While the theory does eventually lead to the conclusion that the rational investor should not concern himself with the peculiarities of individual stocks, it *does not* entail either (1) that the rational investor ignore the level of the market as a whole (or even of particular risk categories) or (2) that once an offer of some sort has been made, the shareholder should not even attempt to analyze it to determine if the price is adequate. Efficient market theory seems to suggest that whenever a better than market price can be had one should take it. *See, e.g.* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175-82 (1981); *Takeover Bids, Defensive Tactics and Shareholder's Welfare*, 36 Bus. Law 1733, 1741-43 (1981). But tender offers and freeze-outs are hardly run-of-the-mill stock market transactions. They are, at the least, focal points for the market. *See* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 144, at 1191-93. Indeed, the activity of arbitrageurs in connection with such quasi-market offers implies that they pay close attention to every increment in the offered price and investors' valuations. *See id.* at 732-34.

161. *But see, e.g., In re* Valuation of Common Stock of Libby, McNeil & Libby,

Applying these principles to the matter at hand, in any fairly negotiated freeze-out that is consummated it may be presumed that there is a gap between the (higher) parent's maximum price and the (lower) minimum price demanded by the minority.[162] If this were not the case, no agreement would ever be reached. Parties bargaining at arm's length could well settle on *any* price in between the parent's maximum price and the minority's minimum price, and any such price could be said to be fair.[163] The problem with freeze-outs, of course, is that the parent is on both sides of the transaction and may

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406 A.2d 54 (Me. 1979) (trial court lowered appraiser's weighting of market price on grounds that it represented price that would be accepted by willing seller; appraiser's weighting was reinstated on appeal). Such reasoning may also explain why in one notable case dissenters obtained more by appraisal than did shareholders who sued and lost even though one judge presided over both proceedings. *Compare* David J. Greene & Co. v. Schenley Indus., 281 A.2d 30 (Del. Ch. 1971) (fairness trial; $29 per share fair) *with* Gibbons v. Schenley Indus., 339 A.2d 460 (Del. Ch. 1975) (appraisal; $33.86 found as fair value). This potential bias in favor of appraisal is replicated by the nature of the proceeding; in a fairness trial the burden is on one of the parties to prove fairness or unfairness whereas in appraisal the court is charged affirmatively to find a fair price. *See also* P. HUNT, C. WILLIAMS & G. DONALDSON, *supra* note 159, at 557-59 (distinguishing between market values and fair or intrinsic values).

For a time legal scholars leaned heavily toward limiting appraisal to situations in which there was no reliable market price. *See* Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 260-62 (1962). Indeed, the Delaware appraisal statute itself for a while applied only to corporations neither traded on a national exchange nor having 2000 shareholders. Implicit in this provision was the belief that market price is adequate compensation when the market is reliable. Since 1976, however, the exception has applied only to share-for-share exchanges and hence does not affect the remedy in the context of a freeze-out. The assumption remains subject to question even in the share-for-share exchange, however. Although the shareholder is not forced to forego investment value altogether, he may well be more optimistic about his original investment than about the one he is receiving in exchange. Undoubtedly the acquiring company is. If the shareholder elects to sell he will then incur brokerage fees and may end up worse off than if the merger had been for cash. Arguably, the Delaware court recognized such potential fairness challenges in Harman v. Masoneilan Int'l, 442 A.2d 487 (Del. 1982). *See* note 60, *supra*. A similar restriction was removed from §§ 80 and 81 of the Model Business Corporation Act. *See Changes in the Model Business Corporation Act Affecting Dissenters' Rights, A Report of the Committee on Corporate Laws*, 32 BUS. LAW. 1855, 1859-78 (1977), Conard, *Amendments of the Model Business Corporation Act Affecting Dissenters' Rights (Sections 73, 74, 80, and 81)* 33 BUS. LAW. 2587, 2592-93 (1978). The rationale for removal was that merger activity and the attendant premiums had cast doubt on the reliability of market prices generally. *See also* Brudney, *Efficient Markets and Fair Values in Parent Subsidiary Mergers*, 4 J. OF CORP. L. 63 (1978); Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholders' Rights of Appraisal*, 74 MICH. L. REV. 1023 (1976).

162. For ease this "price" is sometimes hereafter referred to as the minority's "investment value price." It should be kept in mind however that no single price is implied. Rather the value varies according to the percentage of the minority interest sought.

163. *See* Brudney & Chirelstein, *Fair Shares, supra* note 20, at 315-16 (1974).

be expected to opt for the lowest defensible fair price.[164]

One might also expect the minority to settle for less than they would in a true arm's length negotiation in order to eliminate the potential for exploitation and the attendant lessened return. However the availability of appraisal probably eliminates this effect; as long as the courts can do a credible job of calculating investment value, i.e. the price at which the median minority shareholder would willingly sell, minority shareholders can expect to receive full investment value in a freeze-out merger.[165] Indeed *only* then can they expect it, which strongly argues that investment value—and not the naturally lower market price—would be the lower limit in any negotiation.

It is helpful to view the situation graphically. The variety of potentially "fair" prices may be thought of as points along a spectrum as shown in Figure 1.

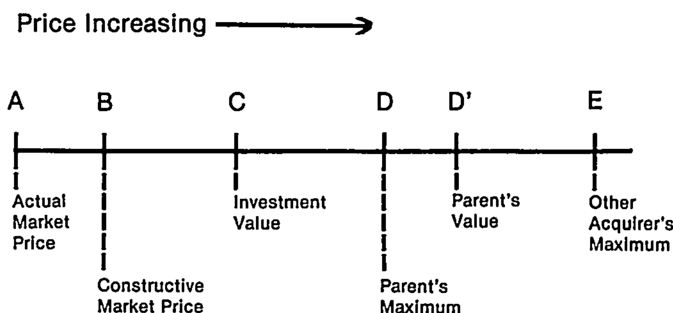

Fig. 1

Price *A*, the actual market price of the subsidiary's or minority's stock, is unrealistically low. The market has discounted it because of the danger of undetected unfair treatment, the inadequacy of remedies if it is detected perhaps, and the recognition that the subsidiary or minority will never be bid for by any one other than the parent or majority because a controlling group owns more than 50%.

Price *B*, the constructive market price, is what the price of the minority stock would be absent the depressing factors. Presumably this could be estimated by reference to other similar companies or by discounting cash flow and

164. Indeed, courts sometimes seem to conclude that they are powerless to remedy this sort of advantage-taking by parents. For example, in Levin v. Great W. Sugar Co., 406 F.2d 1112 (3d Cir.), *cert. denied*, 396 U.S. 848 (1969) the court held that the minority was entitled to a proportionate benefit from the merger, but ultimately approved the terms as "not obviously unfair." *See also* Chazen, *supra* note 46, at 1444-45.

165. The courts are quite willing to scrutinize the reliability of market prices, even though they rely on them, perhaps to excess, when they are found to be undistorted. *See* M. EISENBERG, *supra* note 92, at 70; Chazen *supra* note 46, at 1443-44; Weiss, *supra* note 7, at 662.

choosing the most pessimistic price since market price reflects the perception of the most willing seller of shares. This is the minimum "fair" price. Shareholders could never expect to get more on the market. Indeed, often as not, appraisers have relied heavily on any available evidence of undistorted market price.[166]

Price *C* is the "investment value" of the stock. To label it tells nothing of how it would be calculated. But one may be certain of its relative magnitude in any situation in which a deal can be made.

Price *D*, the parent's (or majority's) maximum, is the price that would be paid based on the parent's peculiar view of the subsidiary's prospects. In any situation in which a deal could be made, price *D* is by definition higher than price *C* since, unless there is some profit in the deal, the parent would not be interested. It may be that the parent thinks a lower interest rate is applicable in capitalizing returns than do the minority shareholders or that the parent knows that the subsidiary may be made more efficient. As *Weinberger* itself demonstrates the latter probably cannot be acted upon legally unless the knowledge comes exclusively from the parent's information about its own opportunities or the existence of public shareholders is somehow inconsistent with the plans.[167]

Price *D'*, the parent's perceived *value* is calculated using the same factors as one would use to calculate Price *D*.[168] Price *D'* would never willingly be paid since it would eliminate all profit from the transaction. However, price *D'* could be the measure of rescissory damages in an appropriate case. Though the Delaware court has not focused on the distinction between these two prices, both are implicated in the *Weinberger* decision. Price *E*, other acquirer's maximum, is the price which someone other than the parent (applying a still lower interest rate or having still better plans for the subsidiary) would

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166. The market price, if any, of the majority's shares (which is to say the price at which a controlling block of shares could be sold) is not a good indicator either since it may be inflated by the same recognitions that depress price *A*. *See* Perlman v. Feldmann, 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

167. 457 A.2d at 715.

168. The difference is that a lower rate of interest equal to the company's cost of capital is used to calculate this value. Typically, a company will establish a minimum percentage return in excess of its cost of capital to use as a "filter" to determine whether a particular project should be considered. *See* P. HUNT, C. WILLIAMS & G. DONALDSON, BASIC BUSINESS FINANCE: A TEXT 183-99 (4th ed. 1971); note 144 *supra*. Thus a company with an average cost of capital of 10% might only consider investments returning 12% or even 15% (indeed the facts of *Weinberger* suggest that the parent there was looking for a 15.5% return as a minimum, 457 A.2d at 709.). Once the project is undertaken, though, the returns will be valued by investors according to the interest rate they demand, that is, the cost of capital, assuming that the project is not so risky as to increase the cost of capital beyond the projected return. It could be argued that the parent, in fairness to the minority, should not analyze the freeze-out decision as it does other investment decisions, since it takes no additional risk. By this reasoning the parent should be willing to pay up to its full value for the remaining stock.

be willing to pay.[169]

Each of the prices other than price *C* may be found with a fair degree of accuracy. Price *C*, however, is not a unique value. It ranges all the way from the most pessimistic (price *B*) to the most optimistic (price *D*). If it is necessary to choose a single value as in an appraisal proceeding, it would seem most reasonable to choose some sort of average, either the median of all values or a weighted average. The median value (which is often but not always equal to the weighted average[170]) is the price which would induce half of the shareholders to tender.[171] In the case of an independent company with widely scattered shareholdings, it is the price for which control could be purchased.[172] Thus, this method of establishing a value for price *C* has the advantage of comporting with reality, and explains why premiums are paid in tender offers and freeze-outs.

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169. Of course, there is not always a price *E* to the right of *D* or *D'*. If the parent is doing an adequate management job, the additional risk that an outsider would face (which the parent has already mastered) would in most cases force the outsider to insist on a higher rate of return than the parent. *See* J. WESTON & E. BRIGHAM, *supra* note 71, at 362-63. Moreover, assuming the parent is acting rationally, it would sell the subsidiary to any such bidder. All this suggests that third-party sale value, which has been receiving considerable attention recently, *see, e.g.* Chazen, *supra* note 46, will only very rarely be relevant to fair price. A recent counter-example, however, was the going private offer by Norton-Simon which caused an active search for outside bidders, perhaps intentionally. Wall Street Journal, June 8, 1983, at 4, col. 2. One must be careful, however, in comparing sales of control with freeze-outs since in the former price is set by those who value their stock most highly, while in the latter price is set by those who place the lowest values on their stock. So viewed it is not surprising that an outside bidder might be willing to top the bid of an insider.

170. *See* note 175, *infra*.

171. In practice the price set by a tender offer could be depressed by various coercive elements. *See, e.g.*, Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), *aff'd*, 514 F.2d 283 (2nd Cir. 1975). The price could also be inflated by the shareholders' perception that the acquirer would better manage the company, would make more profits than current management and thus would be willing to pay more. For the present purposes of deriving price *C* or investment value (since the goal is to construct a model of fair negotiating), these distorting factors should be eliminated. The inflating factors are not necessarily an issue in the context of a freeze-out since it is current management that is the purchaser. One may think of price *C* or investment value as the price which was sought in an appraisal proceeding before *Weinberger*. It is important to remember, though, that now a different price will be sought. Assuming that *Weinberger* does require that the appraiser seek to replicate the results of fair bargaining, pre-merger investment value is a lower limit for negotiators for which they would never settle (except in the case of an arm's length acquisition if the negotiator believed that the acquiring company was going to lose money).

172. *See* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE: CASES AND MATERIALS: TEACHER'S MANUAL 108-10 (1972).

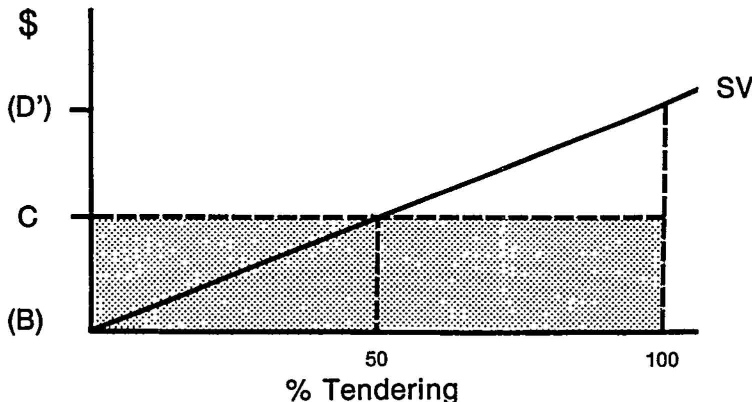

Fig. 2-1

(Note: Prices B and D' are indicated for clarification. It could be argued that the points indicated should be prices A and D though that would be less consistent with the goal of compensating shareholders for the fair value of what they gave up.)

This tender offer model of investment value is itself best understood graphically. In Figure 2-1, the shareholder valuation line (*SV*) is determined by the premium that must be offered to induce a particular percentage of shareholders to tender. Assuming that the line is a straight one, the price at which one-half will tender (*C*) when multiplied by the total quantity of shares (that is, 100%) produces a rectangle which is equal in area to the large triangle. The rectangle thus represents the total dollar premium that would be paid in a two step acquisition in which the initial tender offer brings in just enough shares to achieve control and the second step freeze-out merger is carried out at the same price.[173] Half the shareholders are under-compensated and half are over-compensated, but the total premium paid would be sufficient, if it could be distributed unequally, to satisfy all the shareholders.[174] If the merger

173. Neither *Singer* nor *Weinberger* fits this pattern precisely. In *Singer*, the tender offer price was enough to attract 84% of the shares and the soon to follow merger was at the same price. In *Weinberger*, the tender offer for 50.5% was greatly oversubscribed and the merger was at the same price, but it happened three years later when the value of the subsidiary could have changed substantially. Indeed, the market price of the subsidiary's stock was up somewhat and presumably should have been up somewhat more if not for its captive position.

174. Of course in a merger the cash cannot be distributed unequally (except to

were challenged it would arguably be unfair to the acquiring company to require it to pay any more to any shareholder, since it has already paid full value.[175]

All this argues strongly that the median price is fair. However, the median depends on the segment of the shareholder population to which an offer is being made. In the case of a freeze-out it is fair to presume that those who control the company value it most highly. The controlling shareholders are privileged to establish dividend and investment policies within a broad range to serve their personal interests: that is, they can tailor the mix between current

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the extent dissenters convince a court that they deserve more). Some view equal treatment as a central tenet of corporation law. *See, e.g.*, Brudney, *A Note on Going Private*, 61 VA. L. REV. 1028-29 (1975). And indeed in many familiar contexts, for example, dividends, voting and tender offers, equal treatment is required. *But see* Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1 (1970) (arguments for not allocating shareholder votes according to share ownership). However, unequal treatment is legally condoned both in a company's open-market repurchases of its own stock and, possibly, in a controlling shareholder's sale of his shares at a premium. Despite the requirement of equal treatment of shareholders, it is widely accepted that a company may repurchase its own shares on the market for the express purpose of eliminating those shareholders who value the company least and of raising the price available to those who do not sell. *See* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 152, at 481-82; Nathan & Sobel, *Corporate Stock Repurchases in the Context of Unsolicited Takeover Bids*, 35 BUS. LAW. 1545 (1980). By the same token, it could be argued that controlling shareholders are entitled to sell their shares for investment value plus that portion of the triangle above (see Figure 2-1) attributable to them. Such a result would be unequal but fair, assuming full disclosure. However it appears that none of the cases in which premiums have been given up have recognized this potentially justifiable (fair) element of unequal treatment. *See, e.g.*, Perlman v. Feldmann 154 F.Supp. 435 (D. Conn. 1957).

In addition, it is increasingly common in hostile take-overs for an acquirer to employ two-tier pricing, offering a higher price in a tender offer and a lower one in a subsequent merger. *See* Mirvis, *supra* note 93, at 485. The practice has obvious potential for unfairness (particularly since shareholders who receive the lower price were reluctant to tender at the higher one) and has been roundly criticized. Brudney & Chirelstein, *Fair Shares*, *supra* note 20, at 336-40. Moreover, if the plan for a lower merger price is known in advance, it will coerce some to tender who would not otherwise, thus distorting the median as a measure of fairness. Thus, even when shareholders are treated equally, (*e.g.*, by having a pro rata portion of their shares purchased at the higher price) the price may well be too low.

175. If the line is not straight, this is not true. If the line curves upward as line *SV'* in Figure 2-3, the total premium could be less than enough to satisfy all shareholders, *i.e.*, the area of the rectangle is less than the area under the curved line (such a line might well obtain in a long depressed market). By the same token, if the line curves downward, the acquirer could pay more than investment value. The upward curving line depicted in the figure offers a possible explanation and justification for management resistance to hostile tender offers.

and future income.[176] They are also in a position to avoid the risks they think most dangerous. In short, they can maximize their own value and would therefore be the last shareholders to tender.

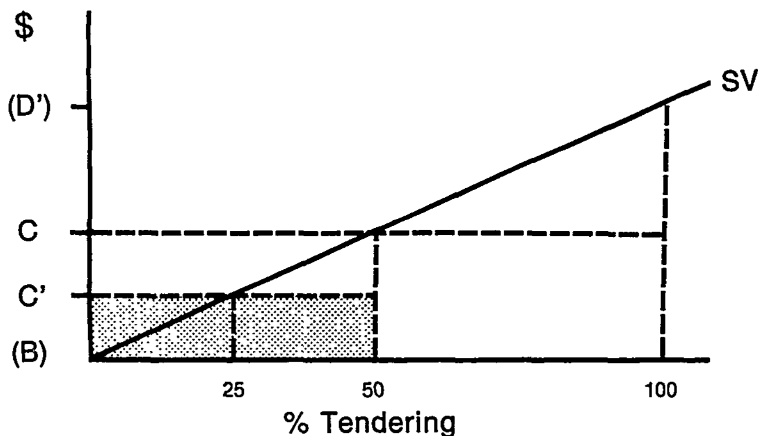

Fig. 2-2

Thus Figure 2-2 represents the situation in a freeze-out where the parent

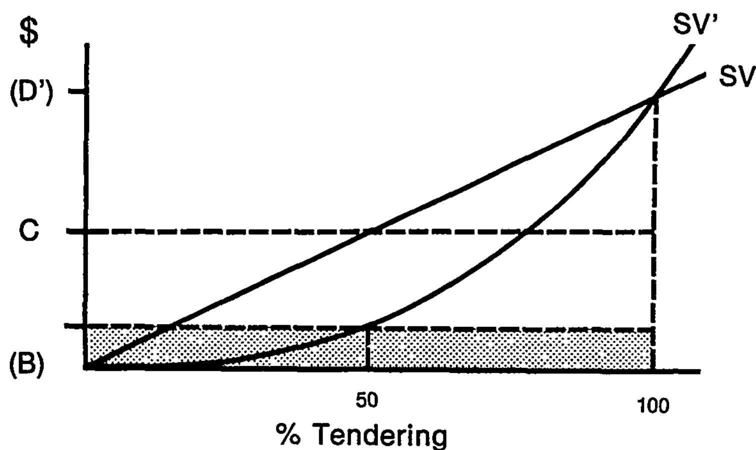

Fig. 2-3

176. *See* note 157, *supra.*

owns half the shares. The premium necessary to induce the last 50% to tender is ignored since to include it would require the parent to pay a price based in part on buying its own shares.[177] The median price demanded by the minority shareholders (C') is full compensation (that is, the area of the small rectangle equals the area of the small triangle) even though it is only half the price that would be fair if the company were being bought in an arm's length deal.[178]

In an arm's length bargaining situation the parent and the subsidiary (or minority) could reach agreement on any price falling between *C* and *D*. The precise point is a matter of the parties' relative bargaining power. Depending on the circumstances it might be that no agreement would be reached because of the subsidiary's knowledge (or suspicion) that others would be willing to pay more, for example price *E*, or indeed the parent's inability or unwillingness even to pay price *C*.

The question, however, is how does a court settle on any particular price in the negotiating range. Clearly to fall back to approving the price proposed by the parent unless it is demonstrably unfair is simply to affirm the parent's ability to set the lowest defensible fair price. That is not "entire fairness" by any standard and is certainly not what the *Weinberger* court had in mind.

Professors Brudney and Chirelstein have suggested that since the subsidiary is captive and no real bargaining can exist, the fair solution is to divide the "synergistic" gains from the merger in proportion to the values of the parties.[179] Thus, if the subsidiary were worth $5 million and the parent worth $100 million and the combined firm predicted to be worth $115 million (for whatever reason), the subsidiary's shareholders should get 5/105 of the $10 million gain. In other words, the fairest price would be a point 5/105 of the way from *C* to *D* on the graph.[180]

This method has several shortcomings. First, it is unclear that a bargaining situation cannot be approximated. Even if it cannot it may be clear in

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177. The reference here is to price *D'*, the *value* to the parent, which is to say the price the parent would demand from an outside purchaser of its stock and not to price *D* which is an internally set maximum used to determine whether an investment is a wise one. This suggests that premiums offered in successful freeze-outs would, on the average, be lower than those offered for control by an outside purchaser. Existing data are inconclusive and indeed confusing.

178. *See* R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 222-31 (1980); Chazen, *supra* note 46, at 1447-49; DeAngelo, DeAngelo & Rice, *supra* note 84. Even if the data agreed to some extent, it would be difficult to eliminate the effects of various regulations on the premiums offered (for example, the Williams Act, state takeover statutes or the business purpose doctrine). *See* Fischel, *Efficient Capital Market Theory, The Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

179. Brudney & Chirelstein, *Fair Shares*, *supra* note 20, at 313-25.

180. As presented, the formula was applied to market prices rather than "investment values" as developed here. *Id.* at 310-15. However, it does appear that Professors Brudney and Chirelstein intended the size of the gain to be based on the parent's cost of capital rather than a higher internally set rate inasmuch as they measure the gain by the full increase in market value. *Id.*

some cases that the minority would be in a better or worse negotiating position. For example, a smallish subsidiary might command something more than a proportionate amount because of numerous potential competing bidders. On the other hand, a company acquired at arm's length may bring little more than investment value if the target's negotiators either do not know the bidder's plans or do not expect the bidder to make significant changes. In short, even if synergistic gains are the only justification for freeze-out mergers, there may be good reasons why a parent negotiating at arm's length with its subsidiary would pay more or less than the proportionate share.

Second, and more important, in the context of a freeze-out effected after a long-standing parent-subsidiary relationship (which is the only situation in which the formula was proposed to be used),[181] it seems likely that any possible synergistic gains have already been achieved and would be reflected in the price of the subsidiary's stock.[182] Assuming that investment value already includes a proportionate share of achieved synergy gains, why should a parent be required to pay more than investment value at the time of a delayed freeze-out? If the merger is undertaken for other valid reasons—legitimate selfish reasons as contemplated under the competing interests approach to fiduciary duty[183]—it is not clear that gains must be shared. The rationale that synergis-

181. Professors Brudney and Chirelstein distinguish three types of freeze-out mergers. The freeze-out that is planned from the beginning as a second step in an arm's length acquisition (an "integrated two-step merger"), such as that in *Singer*, requires little regulation, they argue, because the acquirer owes no duty to the target. *See* Brudney & Chirelstein, *A Restatement, supra* note 5, at 1359-65. For that reason, and others, they argue in *A Restatement* that *Singer* was mistaken law. The freeze-out which is not planned from the time control is obtained (such as that in *Weinberger*) does require scrutiny because of the parent's fiduciary duty to the subsidiary and the potential for overreaching. *Id.* at 1370-76. Finally, they argue that the pure "going private" transaction (the freeze-out in which the parent is a mere shell formed for the purpose) should be banned because it has too little economic justification. *Id.* at 1365-70.

182. Professors Brudney and Chirelstein apparently assumed that synergistic gains were the primary and perhaps exclusive permissible motivation for interested mergers. Apparently they had in mind such effects as efficiencies of scale, reduction of risk through diversification and even increased sales or lowered expenses resulting from combined organizations. Along with such motivations should probably be included monopoly profits which, though objectionable, are no doubt often actively pursued. But, with the exception of the administrative costs attendant to maintaining two corporations (which are negligible), there is no apparent reason why most of these gains cannot be achieved and, in most cases are achieved, within a parent-subsidiary relationship. Thus, there seems to be little reason to distinguish between the freeze-out mergers between parent and subsidiary, both of which operate going businesses, and the pure going private transaction which does nothing but eliminate the public shareholders. *See* Brudney & Chirelstein, *A Restatement, supra* note 5, at 1370-72.

183. In support of their proposed formula, Professors Brudney and Chirelstein struck an analogy with a trustee who manages two separate accounts with similar objectives. Returns would in such a situation be apportioned so as to give each an equal percentage return. *See* Brudney & Chirelstein, *Fair Shares, supra* note 20, at 313-20 n.52.

tic gains arise from value that is inherent in the subsidiary simply does not apply.[184]

While synergistic gains are presumably allocable to both parties, it is clear that there are nonsynergistic gains to which the minority is not entitled. Indeed, such gains may be much more common than synergistic gains. They include those gains arising from discrepant perceptions of risk or return, differing costs of funds and opportunities belonging to the parent-majority.

Gains such as these are more akin to the sort of gains an independent acquirer perceives, and it would seem that in the absence of a good reason to preclude these wealth-increasing transactions, a parent should be as free to pursue them as an unrelated party.[185] Indeed, the parent may legitimately perceive such opportunities much sooner than outsiders and hence will increase wealth earlier.

The law does not require a parent to share its separate wealth to keep the minority happy. Indeed, the law protects the parent's right to determine investment and dividend policy within broad limits. In sum, there is no apparent reason that, simply because a subsidiary has been a captive for years, it somehow becomes entitled to opportunities presented to the parent—even those that the parent may have had at the time of acquisition—and every reason to believe the parent should be free to pursue its own interest. On the other hand, even though such gains need not be shared with the subsidiary they would figure in any negotiations and ultimately raise the price to the majority by some indeterminate amount.

The formula proposed in *Fair Shares* could be used to determine, arbitrarily, the outcome of such negotiations, but it is not clearly so difficult to assess the bargaining positions of the two parties that an inflexible rule is required. Moreover there will be situations in which using the formula will preclude a deal that otherwise would be made.[186] The law should thus allow for

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There is, however, an important difference between trustees and corporate managers: a trustee is strictly forbidden from profiting from his position, a corporate manager is not. *See* Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). Ironically, if the analogy were correct the parent would have a considerably stronger motivation to get rid of the minority.

184. *Cf.* Brudney & Chirelstein, *Fair Shares, supra* note 20, at 307-16, 325-30.

185. *See generally* Easterbrook & Fischel, *supra* note 160.

186. *See* Brudney & Chirelstein, *Fair Shares, supra* note 20, at 313-25. Note that under the *Fair Shares* formula the parent is still generously treated: it gets both its proportionate share of the gain and part of the subsidiary's share (equal to its percentage ownership). Thus, in a drastic case in which the parent and subsidiary are the same size and the parent owns a bare controlling interest, the parent gets ¾ of the gain even under the formula. Nonetheless the ¼ that goes to the minority may make a difference. If it does, the parent probably faces limited investment opportunities and would probably be doing the minority a considerable favor by effecting a freeze-out, even at investment value. *See* note 157, *supra*. On the other hand, why should the parent, no matter what its condition, forego any profit it can in fairness make? The parent already owns its shares. The monetary issue to be addressed is how is the gain attributable to the minority stake to be divided.

remedies based on a broad range of factors including synergistic gains, if any. *Weinberger* appears to do precisely that. By allowing the courts to take cognizance of any generally accepted method of valuation *Weinberger* provides a means for calculating the range within which the parties would have negotiated. Reference to premiums in comparable transactions and post-merger gains should allow the courts to approximate the point within the range on which the parties would likely settle.

C. *Appraisal in the Fairly Approved Merger*

While rescissory damages are presumably available only when a merger has been coerced, reference to cash flow, premiums and post-merger gains can produce comparable results whether or not there is coercion. The flexibility inherent in the *Weinberger* approach thus will make it that much easier for dissenters to make out credible cases for additional compensation even in fairly approved mergers. It seems likely that cases will arise in which a dissenter will be able to prove that the acquisition was more valuable than the majority of the minority thought even though they were fully informed. One might expect such a result fully half the time. Indeed, the tender offer model assumes that half the minority values the stock at a price in excess of the minimum, that is, investment value. The question is whether that means that a dissenter will be able to obtain additional compensation even in a fairly approved merger.

Moreover, since the price that the parent is willing to pay for a subsidiary's cash flow ultimately depends on the parent's cost of capital, another parent with a lower cost of capital might be willing to pay more.[187] Since the court expressly approved evidence of premiums paid in comparable transactions, the question arises whether the range of acceptable prices should be regarded as the parent's range or a broader one (that is, segment *CD* or segment *CE* on Figure 1). If the latter, there may even be instances in which additional compensation is assessed against a parent in such amount as to render the transaction uneconomic. Whatever sort of relief may now be appropriate against a parent who coerces a freeze-out, it is difficult to believe that the *Weinberger* court intended such a drastic fate to befall the parent who fairly obtains the minority's blessing. Such a result would be inconsistent with the notion of negotiation that is implicit in the *Weinberger* decision.

Finally, if appraisal now allows for a bonus payment to dissenters even in fairly approved mergers, at least some shareholders will be inclined to vote "no" even if they think the price is fair, since by voting "no" they may be able

187. This may well be a rare situation since an outsider would likely insist on a higher return because of the greater risk it perceives as an unknowledgeable outsider. *See* note 169, *supra*. On the other hand, a court might choose to ignore this impediment on the theory that the minority should not be penalized because of the identity of its parent. The question, again, is should one focus on the gain to the parent or the loss to the minority. *See* notes 130, 141, *supra*.

to exact a higher price through appraisal without much risk of being awarded a lower one.[188] Such a result would be utterly inconsistent with *Weinberger's* stress on shareholder voting. Moreover, management, in order to assure that the transaction would be approved by ever more sophisticated shareholders and to assure that the number of appraisal seekers would be minimized, would likely increase the premium offered over the average market premium. Thus, the average itself would creep upward. Since there is no effective ceiling on the premium short of the maximum price consistent with a good investment for the parent,[189] it is likely that soon parents would be offering nearly that price. It is extremely unlikely that the *Weinberger* court intended minorities eventually to inherit the greater part of the benefits of freeze-outs.[190] That would effectively ban them even though the court apparently made freeze-outs easier

188. The risk is that enough shareholders would vote "no" to stop a transaction that they actually would have considered desirable. Hence, after a close loss, it would not be irrational for the parent to hold a second vote on the same terms. The appraisal statute discourages such behavior to some extent since it requres a shareholder to inform the corporation in advance of his intent to seek appraisal. DEL. CODE ANN. tit. 8, § 262(d) (1983). If shareholders become adept at this, the notification process would, practically speaking, become the vote itself. Of course, any shareholder who seeks appraisal must be willing to wait for his money. Delaware courts, however, take a flexible approach to awarding interest after appraisal and the loss, particularly now in light of *Weinberger*, may be minimal. *See* Lynch v. Vickers Energy Corp. 429 A.2d 497, 506 (Del. 1981) (*Lynch II*).

189. *See* note 168, *supra*.

190. *See* note 186, *supra*. One could argue that there is nothing wrong with allowing minorities to exact as much of the profit as they can as long as the transaction still occurs. Distribution of the profit is a matter of indifference, the argument would continue, and therefore policies like allowing an appraisal bonus may be adopted if they are desirable for other reasons. One would conclude, then, that there is nothing inconsistent between an appraisal bonus and the *Weinberger* regime. However, it is vital to insure that the majority is not disfavored. Two themes that pervade the economically oriented writing on corporations are (1) that transactions are motivated by the mutual desires of the parties to maximize their individual wealth and (2) that in a free market, like the stock market, such transactions lead to a state of equilibrium in which it is impossible to make a profit. Note that while the two themes are closely connected, they are also in conflict. If profit making were impossible because of efficient pricing then transactions would never occur. *See* J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 98 (1973); Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 14 (1982).

This is not the place to pursue cosmic details, but it seems reasonable that in this system of thinking about economic behavior, one must leave room for a prime mover of sorts, one who determines to apply physical assets to a project hitherto not divulged to the market and therefore not reflected in the price he pays for it. Otherwise, activity would cease. Since only majorities are in a position to do such things (only one "person" can be), it is crucial that they be left some margin—both of profit and for error. Minorities are, after all, passive investors and rarely, if ever, are they in a position to initiate any innovative action. To allow the possibility—in a fairly negotiated transaction—of minorities gaining a very large proportion of the benefits would not put an end to freeze-outs but it would tip the balance in the wrong direction.

to accomplish legally by its increased reliance on voting and elimination of the business purpose test. It is still less likely that the court intended for targets in arm's length mergers to enjoy such a windfall.[191] It must be concluded, therefore, that the court did not intend the possibility of gain through appraisal in a fairly approved transaction.[192] At the very least, it is clear that, if *Weinberger* is interpreted to mean that additional compensation may be available to dissenters even in fairly approved mergers, it will ultimately discourage freezeouts even though a safe-harbor procedure has been devised and the business purpose test has been eliminated.[193]

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191. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1359-62.

192. Bizarre issues would no doubt creep up in those few mergers that were still effected despite such an interpretation of *Weinberger*. Shareholders of parents might be induced to bring law suits alleging that they had been unfairly treated by a minority which managed to exact too high a price. And minority shareholders who were not frozen-out might begin to demand to be when premiums had been bid up. They could argue that, but for the subsidiary's captive position, it could have been sold to a parent who would pay more than current investment value and that, therefore, the current parent had breached its fiduciary duty by keeping for itself a subsidiary that would have been more valuable in another parent's hands. This could create problems for a majority that does not have the cash or credit necessary and might even lead to serious consideration whether a parent company has a duty to sell a subsidiary to another parent who may be in the position to pay the going premium. One could of course make that sort of argument under the current state of the law anyway.

It has been observed that perhaps the worst fate that can befall a shareholder is to be "frozen-in" to an investment in a depressed subsidiary. *See* Borden, *supra* note 3, at 1003; *see also* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1369. It has become fairly common for individual shareholders to demand that an issuer repurchase their shares at a premium. The practice, called "greenmail" by some, was recently reviewed by the SEC's advisory committee on tender offer rules which recommended that issuer repurchases in excess of 15% be approved by stockholder vote. *See Excerpts from Final Report of SEC Advisory Committee on Tender Offers*, [July—Dec.] SEC REG. & L. REP. (BNA) No. 28, at 1375, 1380 (July 15, 1983); *see also* Tobin & Maiwurm, *Beachhead Acquisitions: Creating Waves in the Marketplace and Uncertainty in the Regulatory Framework*, 38 BUS. LAW. 419, 440-45 (1983). *See generally* Israels, *Limitations on the Corporate Purchase of Its Own Shares* 22 SW. L.J. 755 (1968); Nathan & Sobel, *supra* note 174. On reflection, it is somewhat surprising that whole groups of shareholders have not joined in such demands, particularly when a large individual shareholder threatens to coerce favored treatment for himself.

Of course, everyone cannot expect to have his subsidiary owned by the single most efficient parent and to make the highest return available anywhere in the market merely because one set of managers has shown it can be done. To impose such a duty on corporate managers would seemingly run counter to the business judgment rule, practically speaking, in that it would amount to a duty to succeed rather than a duty to give one's best efforts. However, if the great majority of parents operate at or close to the risk-efficient frontier, as has been suggested, that defense is considerably weakened. *See* note 160, *supra*. In any event, one could not make out a case unless a bid had actually been made for a subsidiary by another parent (though such bids might be encouraged under the new regime), and it would be extremely difficult to disprove any reasons that the existing parent might give for not accepting such a bid. *Cf.* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1371.

193. Of course, only if the market is perceived as rising, on balance, would it be

This scenario might be regarded as somewhat fancifull but for the fact that the *Weinberger* court, in addition to liberalizing the kind of evidence that can be introduced in an appraisal proceeding, also held that the appraisal statute's exclusion of post-merger gains was to be limited to speculative and pro forma results of the combination. This appears to mean that any foreseeable gains in cash flow which result from efficiency or synergy from the merger are compensible to dissenters.

It could be argued that the *Weinberger* court has contravened the express terms of the appraisal statute in this aspect of the holding. The statute clearly says that dissenters are entitled only to pre-merger value.[194] It could also be questioned whether the simple addition of the word "fair" to the appraisal statute could possibly have been intended to add whole new categories of value to appraisal awards.[195] Yet it seems unrealistic ever to have held that all gains were post-merger gains.[196] Clearly part of the value of the company being acquired is its value to potential acquirers.[197] Again, often a shareholder buys at least in part because he thinks some sort of offer might be made for the company. In short, even given the current language of the appraisal statute, it appears wrong for all of the gain to go to either side, but the proportion in which it should be shared is a matter peculiar to each case.

Nevertheless, the essence of the court's holding is unmistakeable. As such it necessitates a rule against appraisal bonuses in fairly approved mergers since it is easy to imagine that, unchecked, the new appraisal could turn some profitable mergers into money losers. For example, suppose a cash-poor parent with a barely controlling interest and an especially good idea developed within its own planning department proposed a freeze-out, at a price based on the subsidiary's prospects in the subsidiary's current business without the benefit of the innovation. Suppose further that during the course of an appraisal it becomes clear that the new strategy promises to be quite successful though it has not yet started generating much cash. The dissenting shareholders are awarded their proportionate share of provable post-merger gains, in this case fully half of the gain, but the parent, struggling perhaps to pay off the freeze-out as well as to fund the innovative business, still does not have that much free cash.

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necessary continually to increase premiums. In a falling market, premiums would presumably begin to fall also, though they would remain higher than otherwise. It is easy to see how an appraisal bonus affects the cost of a freeze-out merger, but even apparently non-monetary impediments, like the business purpose rule, raise the price. Though this effect has not been demonstrated in connection with the business purpose doctrine itself, it has been suggested that, in tender offers, defensive maneuvers and take-over laws may account for greater premiums than would otherwise obtain. *See generally* Easterbrook & Fischel, *supra* note 160; Fischel, *supra* note 178.

194. DEL. CODE ANN. tit. 8, § 262(h) (1983).

195. 457 A.2d at 713-14.

196. *See, e.g.*, Tanzer v. International Gen. Indus., 402 A.2d 382 (Del. Ch. 1979).

197. Brudney & Chirelstein, *Fair Shares*, *supra* note 20, at 306.

There are only two alternatives. The parent corporation itself could seek to undo the transaction, or it could sell the now wholly-owned subsidiary to someone else, hopefully getting something approaching the value it perceived. But if the parent succeeded at the former the subsidiary's minority shareholders would have a strong argument for sale to an alternative parent company; the existing parent would in essence have admitted its inability to match the price a cash rich company would have paid.[198]

Clearly it is absurd to think that the court meant for dissenters to be awarded 100% of post-merger gains. Such a rule would even more strongly incline everyone to vote "no" than the mere chance at an appraisal bonus on pre-merger values as calculated with reference to cash flow and premiums. Moreover, such a rule would amount to an effective ban on mergers since there would be insufficient gain left for the acquirer. Indeed, the effect of awarding post merger gains after the fact and in the absence of coercion, is worse than precluding a merger altogether by forcing up premiums, since it operates unpredictably and therefore discourages more mergers than would actually be affected after the appraisal process was finished. It seems much more likely that the court had in mind a sharing of post-merger gains and was indicating, again, that appraisers should look for assurances that the proportions of sharing were reached through fair means. After all, in negotiation, only a portion of post-merger gain could be commanded by the minority, but clearly even the weakest negotiator could command some of it.

It is possible that the court decided to allow compensation for post-merger gains in order to provide some realistic prospect of relief in cases in which the range of possible prices (measured in advance of the transaction as in the example) is narrower than usual. In other words, in some cases post-merger gains would provide a source of additional awards to minority shareholders when necessary to punish coercion by the majority.

Still, it seems more likely that the court was simply giving a further example of the new approach to appraisal. In a true negotiation, the target com-

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198. This scenario is not at all far-fetched. In Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) (*Lynch II*), the Delaware Supreme Court reinstated a claim for rescissory damages based upon a parent's failure to disclose in a tender offer that it was willing to pay more in open market purchases. The court instructed that on remand the amount awarded should reflect the value of the stock at the time of trial, four years after the tender offer. The tender offer had drawn in more than 72% of the 46.5% minority shares at $12 per share. The supreme court instructed, however, that on remand the range of $15 to $41.40 should be considered, the former being the price the parent was willing to pay and the latter being the price argued for by the plaintiffs which included post-merger gains.

Consider the parent's options if the maximum price were awarded and for some reason it could not pay. To undo the transaction would mean forcing the long-gone minority to take back their shares. It is unlikely that any court would ever order that and few shareholders would voluntarily accept such shares if by refusing they would get cash instead. There seems to be no choice but to sell the subsidiary to someone who has the cash.

pany would not settle for investment value. Knowing that the merger would not be proposed unless the acquirer expected to make money, the target could command some of the gain up front.[199] Looking at premiums in comparable transactions provides one kind of evidence of where the parties would agree. However, the premiums in comparable transactions emanate from the same source, the expectation of gain after the merger. Looking directly to post-merger gains then is simply a more specific inquiry of the same sort. It is no reason to believe that the court intended for appraisers to rework mergers exhibiting fair dealing, that is, the attributes of arm's length negotiating.[200]

These speculations may be quite disturbing to a parent that is found to have coerced a minority vote. When a vote is fairly solicited, however, there are good reasons to believe that appraisals should not diverge significantly, if at all, from the price approved by the minority vote. Nevertheless, aside from the court's virtual insistence that appraisal and fairness results now be identical and the wisdom of a policy against any divergence, the impression lingers that, in the court's finally accepting real evidence of value, a shareholder may do better than ever before in appraisal. It is dissenters, after all, who undertake appraisal and presumably would prefer to remain investors even under new management. Moreover, the dissenter is entitled to an appraisal whether or not there is actionable unfairness.

It is at least arguable that the appraisal price may justifiably differ from the fairness trial price. It has in the past. A fairness hearing may be aimed only at determining the price at which the transaction would occur under arm's length bargaining. With the new evidence allowable, one might well argue that the courts have finally recognized that the dissenter is at least entitled to the monetary equivalent of keeping his stock, that is the value of the subsidiary to the parent (price *D*' on Figure 1). The facts in *Weinberger* itself suggest this result.

Consider a perfectly fair arm's length merger. Some shareholders will

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199. In terms of Figure 2-1, text *supra* at notes 173-75, shareholders' beliefs that the acquirer would reap gains from changes in the business would have the effect of moving the entire shareholder value line vertically, unless, of course, the value line already reflects information of that sort as the efficient market hypothesis suggests it would. In short, post-merger gains add nothing to the calculation which is not reflected in the other two factors *unless* the parent has managed to keep something secret and perhaps only if the secret is a significant innovation or discovery. *See, e.g.*, Lynch v. Vickers Energy Co., 429 A.2d 497 (Del. 1981) (*Lynch II*) (discovery of North Sea oil). But it is precisely in such circumstances one must be most careful not to disfavor the parent. To the extent that *Weinberger* limits additional compensation to situations in which coercion is shown it will not discourage economic growth.

200. Admittedly, a minority which is in the unfortunate position of having the subsidiary controlled by a relatively inefficient parent will probably settle for less than it would if the subsidiary were an independent company. It is in this situation alone (which is in many ways parallel to an innocently conceived tender offer—such as that in *Lynch*—that works out *too* well for the parent) that one may want to reserve some power to grant additional compensation. However, in such a case it is quite likely that a fairly credible case of nondisclosure could be developed.

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think their stock is worth more than the price paid. Appraisal entitles them to the *stock's* value, not the value at which they would deal (which may be unrealistically high), and not the market price or the intrinsic or investment value. Rather, if the argument is correct, the dissenter is presumably now entitled to the value of the stock to the acquiring corporation, less whatever merger gains continue to be excludable. If the dissenters are correct, why should they be done out of their investment by the ignorant majority of the minority? While one may argue that in the case of an arm's length one-step or integrated two-step merger, the coercion of majority rule may be justified as necessary to accomplishing any deal at all, in the case of a freeze-out merger, it is not, since the majority is already in control and will probably go ahead with its plans anyway.[201]

While these arguments have some merit they should not prevail. In the first place, the dissenter is in effect asking for rescissory damages when he demands full post-merger gains. *Weinberger* clearly holds that rescissory damages are awardable only when there has been coercion.

Secondly, the essence of the dissenter's argument is that he should not be required to give up his stock over his objection, since he is entitled to every bit of measurable benefit attached to it. But this argument ignores the fact that the dissenter is being forced to yield only in order to achieve a much larger, mutually beneficial transaction. No one seems to question the propriety of forcing the dissenter to sell in an arm's length transaction when the bidder insists on 100% ownership. Majority rule in such a case, while mildly coercive,[202] is necessary to overcome the impossibility of negotiating with hundreds of individuals. But there is really no more justification for a freeze-out in connection with an arm's length merger than there is for the pure going private transaction.[203] The potential detriment of having a minority is the same for an arm's length acquirer as for one who is already a parent.

There is no reason why the parent should be denied the ability, with appropriate safeguards, to pursue the same opportunities available to an independent acquirer. Indeed, perhaps the parent should have somewhat more freedom to do so since it may already have suffered damage from the existence of the minority.

Finally, the value the parent places on the subsidiary could never be achieved in arm's length bargaining.[204] There must be some differential remaining to motivate the transaction from the acquirer's point of view. Thus, assuming one agrees that freeze-outs are justifiable, the most anyone could ever realize is the amount the parent is willing to pay rather than value to the

201. In addition, one could argue that the minority shareholder should be rewarded for having held on to his shares in a captive company, with its depressed value, since if things had not worked out well for the parent, the minority shareholder likely would have been stuck forever.

202. *See* Brudney & Chirelstein, *A Restatement*, *supra* note 5, at 1359-61.

203. *See* note 181, *supra*.

204. *See* text at notes 148-49, *supra*.

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parent.[205]

Inevitably, however, one must grapple again with the possibility that another bidder might be willing to pay more.[206] Still, in any negotiation there comes a time to stop talking and make a deal. Though it is always possible that a better deal will be made, at some point the cost of making it exceeds the additional gain. The benefits of facilitating the consummation of mergers beneficial to both parties would seem in the end far to exceed the cost of an occasional instance in which a subsidiary could have been sold as a whole to another parent.

If one accepts the thesis that Delaware has substituted a negotiation model for a rigid rule or formula, it would seem likely that the narrow exceptions for speculative gain will ultimately come to refer to that segment of the range of values lying between the investment value price C plus an appropriate but indeterminate premium and the acquirer's maximum price. In one sense that is precisely what speculative means: that portion of value perceived by the buyer but not perceived by the seller. The appraisal statute still says that the dissenter is entitled to pre-merger value.[207] Much as one might believe that appraisal should afford full value, the statute does not allow it. The dissenter still loses something.

There is a sense in which it is unfair to the majority to say that full value should be available to the minority. There will always be something between the fair dealing price and the maximum. If appraisal were to be interpreted to entitle the minority to the maximum, it would be senseless for anyone ever to vote in favor of a merger. One would vote "no" to protect one's individual appraisal rights in hopes that others would vote yes and take the cash. Whether one thinks the court intended to substitute a negotiating model or not, surely it did not intend to inject that sort of artificial incentive into the voting process the process which, after all, is essential to eliminating coercion in freeze-outs.[208]

Here then is the strongest argument of all that *Weinberger* should not be interpreted to allow additional compensation to shareholders dissenting from fairly approved mergers. Since the decision applies to all appraisals, the potential for additional compensation amounts to something akin to the old common law right of a shareholder to veto the transaction, or to hold out for more, in a

205. *See* note 168, *supra.* Neither is such a bonus necessary in a freeze-out in order to compensate the minority for waiting for its money since the time control was acquired by the majority. Under *Weinberger*, the minority shareholder will be compensated according to the value of the subsidiary in the hands of the parent. That is, the investment value of the minority's stock should already include any efforts at better management and "negotiations" will start from there. Thus, there is no sense in which the minority will have been strung along never to realize any of the greater gains that supposedly justified the original transaction.

206. *See* note 147, *supra.*

207. *See* notes 197-198, *supra.*

208. *See* text at note 103, *supra.*

situation that requires some admittedly artificial device to "negotiate" a transaction beneficial to both sides. Appraisal rights were, after all, the quid pro quo for denying hold-up rights to individual shareholders. They recognize the need to allow for wholesale transfers of assets without the sort of impediments one finds in partnerships.[209]

The upshot of all of this is that *Weinberger* must be viewed as holding that, if a freeze-out is coerced, the court, whether in litigation or appraisal, will be free to set an alternate price for the transaction from within the range of acceptable prices. It should not be read as otherwise authorizing divergent prices to be set by appraisal. This suggests that appraisal might become obsolete. However, litigation is certainly more time consuming and expensive. Appraisal should thus be retained in the interest of judicial economy, but some sort of penalty for instituting frivolous proceedings should be added to compensate for the fact that an appraisal proceeding is not subject to summary dismissal. Perhaps unjustified appraisal proceedings should result in a lesser valuation for dissenters than the ratified price. Bringing an unjustified appraisal proceeding could be viewed as unfair dealing by a minority justifying something like rescissory damages being assessed against them.

In summary, *Weinberger* requires that identical notions of fairness be applied both in appraisal and in proceedings at equity. If the same standard of fairness must necessarily apply in both forums then the appraiser must be without authority to set another price when a court would be powerless to do so, including situations in which it appears that for some reason (other than coercion) the minority's approval was irrational.[210]

IV. THE BROADER IMPLICATIONS OF *Weinberger*

The minority vote under *Weinberger* provides substantial assurance against fairness challenges both in court and by appraisal and thus now assumes real importance. Very few transactions can be expected to be undertaken without a vote. Note, however, that since proxies must therefore be solicited, it appears that the Delaware court has insured that a federal cause of action will exist in virtually every case in which Delaware itself would recognize a cause of action.[211] Under *TSC Industries v. Northway, Inc.*,[212] few if

209. It is standard in partnerships for unanimity to be required in any decision affecting the scope of the partnership business. *See* UNIF. PARTNERSHIP ACT § 18(h), 6 U.L.A. 213 (1969). Numerous cases describe the horrors of partners' inability to agree when such proposals are at issue. *See, e.g.*, Summers v. Dooley, 94 Idaho 87, 481 P.2d 318 (1971).

210. *See, e.g.*, Barrett v. Denver Tramway Corp., 53 F.Supp. 198 (D. Del. 1943), *aff'd*, 146 F.2d 701 (3d Cir. 1944).

211. Proxy solicitation is, of course, governed by § 14 of the Securities Exchange Act. Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78(n) (1982). A private right of action is recognized for violations and, notably, plaintiffs need not prove reliance on any misrepresentation or omission and may not need to prove anything more than negligence on the part of the defendant. *See* Mills v. Electric Auto-Lite Co., 396 U.S. 375

any proxy solicitation cases in which a parent owned a majority of stock would have presented an issue under federal law since the minority's vote would have been unnecessary to accomplish the transaction. Now every such vote in connection with freeze-outs of Delaware subsidiaries is certainly an important though perhaps not "essential" link in the process.[213]

Weinberger also casts doubt on the meaning of *Santa Fe Industries v. Green*[214] in which the United States Supreme Court held that a Delaware freeze-out effected by short-form merger, which required no vote, did not state a cause of action for fraud under federal law. The Court held that federal law prohibits deception. Coercion with full disclosure, though it might amount to the same thing as deception, is not fraud within the meaning of Rule 10b-5.[215] The court further held that the essential issue in *Santa Fe*, fairness, was a matter traditionally left to state law.

Now, under *Weinberger*, the Delaware Supreme Court has not only effectively required a vote and outlawed coercion, it has also transmuted the traditional standard of fairness into a matter of full disclosure.[216] There is, therefore, every reason to expect the federal courts to become heavily involved in freeze-out litigation once again, which means, of course, that the federal courts will have much to say about the interpretation and application of *Weinberger*, particularly in connection with the standard of materiality to be applied in assessing the adequacy of disclosure.

What is much less clear is the effect *Weinberger* will have on other areas of Delaware corporation law. The court declared that in connection with freeze-out mergers the business purpose requirement should "no longer be of any force or effect."[217] While it is easy enough to limit this pronouncement to freeze-out mergers, it seems natural to think that the business purpose doc-

(1970); J. I. Case Co. v. Borak, 377 U.S. 426 (1964); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281 (2d Cir. 1973).

212. 426 U.S. 438 (1976).

213. 426 U.S. at 499. However, in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 n.7 (1970), the Supreme Court did leave open the possibility of recognizing a causal connection between the vote and accomplishing the transaction even though the management controls a sufficient number of shares to insure approval "if the management finds it necessary for [other] legal or practical reasons to solicit proxies from minority shareholders."

214. 430 U.S. 462 (1977).

215. 430 U.S. at 476.

216. There had been some effort after *Santa Fe* to revive a cause of action for coercion under Rule 10b-5, on a theory that failure to disclose the potential illegality of a transaction and the availability of relief under state law violates federal law. *See* Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977). *Weinberger* eliminates the need for that sort of reasoning, at least in Delaware. *See also* Weiss, *supra* note 52, at 260-61.

217. *See, e.g.,* Sinclair Oil Co. v. Levien, 280 A.2d 717 (Del. 1971); Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964); Condec Corp. v. Lunkenheimer, 230 A.2d 769 (Del. Ch. 1968); *See also* Johnson v. Trueblood, 629 F.2d 287 (1980), *cert. denied*, 450 U.S. 999 (1981). Moreover, *Singer* had been followed in several other states, most faithfully in Hawaii.

trine will be questioned in other areas of its application. Delaware courts have resorted to a business purpose test or a closely related formulation to determine the propriety of a corporation's repurchasing its own shares at a premium from a dissident shareholder, defensive tactics in connection with takeover attempts, the use of corporate funds to wage proxy battles and the declaration of dividends allegedly motivated by the majority shareholder's need for cash. In general, the courts have recognized in these cases that corporate actions undertaken without a valid business purpose are not protected by the business judgment rule. In other words, lack of business purpose is grounds for challenging the exercise of discretion by directors and officers just as is self-dealing.[218]

Weinberger raises the question whether the courts of Delaware will continue to recognize this basis for challenging corporate action in other contexts. One could argue that the business purpose test, as finally developed in the *Singer* line of cases, differed from the recognized approach. Indeed, the *Weinberger* court suggests this.[219] In the other applications of the test, it has been up to plaintiffs to prove a lack of business purpose, a standard so difficult as to be qualitatively different from that adopted in *Singer*. However, this mode of distinguishing *Weinberger* from other business purpose cases leaves open the possibility that in some obscure (and presumably drastic) situations the traditional business purpose exception may indeed apply to freeze-out mergers.

The better view, however, would seem to be that when a transaction involves an alteration in shareholder rights as between the existing majority and minority, business purpose is an inappropriate standard. That should be obvious enough anyway; such internal conflict should be resolved with a clear view that it is just that—internal conflict which stems primarily from *competing* personal motivations. Business purpose remains an effective concept in situations in which the majority uses corporate resources for arguably self-interested ends without affording the minority an opportunity to cash out.

This distinction may well illustrate a fundamental shift in corporation law. It encompasses the recognition that shareholders may be more interested in the potential for liquidating an investment than they are in the ability occasionally to exercise control or simply to feel a proprietary interest in their shares. This is hardly revolutionary doctrine.[220] However, its embodiment in *Weinberger* may mean that minority shareholders—indeed all outsider shareholders—will benefit, not from an increased ability to resist mergers and keep their investments or gain windfall appraisal awards, but rather from the more frequent and more predictable use of freeze-outs allowed by the safe-harbor procedure outlined in *Weinberger*. It is indeed ironic that such a result should

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218. *See generally* Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

219. 457 A.2d at 715.

220. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

come of a campaign that all along appeared to be one to protect the traditional property rights of the common shareholder.

The ultimate question now is whether minority shareholders can be depended on to take seriously the voting process that is critical to the noncoercive freeze-out.[221] If not, the *Weinberger* procedure simply gives insiders one more advantage. One must presume, however, that shareholders will quickly realize that their vote in connection with a freeze-out should be treated just like a decision to buy or sell their stock. Indeed, inasmuch as each shareholder will receive a proxy statement for the vote, it should be more convenient to make this investment decision intelligently and rationally than it ever is otherwise. In short, there is really very little reason to worry.

V. CONCLUSION

Professors Brudney and Chirelstein have suggested that *Singer* was in part motivated by the late Professor William Cary's criticism that Delaware corporation law is far too lax.[222] While they disagreed with the holding in *Singer* they applauded the court's concern and expressed the hope that *Singer* would be the law only temporarily until the competing rights of majority and minority shareholders had been sorted out. *Weinberger* may well signal that resolution has been achieved.

Whether *Weinberger* represents a new trend in Delaware is unclear. On the one hand, *Weinberger* may ultimately mean that the courts will scrutinize disclosure in connection with mergers more closely than ever. One could thus view the decision as an extension of the Delaware court's new willingness to substitute its own judgment for that of corporate boards.[223] On the other hand, *Weinberger* clearly embodies a hands-off attitude, at least when a matter may be voted on.

As has been argued here, the latter course makes far more sense if one believes that even mergers negotiated in conflict of interest may be beneficial to both majority and minority if one realizes that there is no reason to believe a single fair price exists. Nevertheless, the voting process could serve as easily as a rationale for the courts to pass on the merits of mergers as it could a reason not to scrutinize them. That is, the fairness of the vote could become as

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221. *See generally* M. EISENBERG, THE STRUCTURE OF THE CORPORATION (1976); Manning, *The Shareholders Appraisal Remedy: An Essay for Frank Coker,* 72 YALE L.J. 223 (1962); Manning, Book Review, 67 YALE L.J. 1477 (1962) (reviewing J. LININGSTON, THE AMERICAN STOCKHOLDER 1958)); Ratner, *The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote,"* 56 CORNELL L. REV. 1 (1970); Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered,* 77 COLUM. L. REV. 388 (1977).

222. Brudney & Chirelstein, *A Restatement, supra* note 5, at 1354 n.2; *see also* Cary, *Federalism and Corporate Law: Reflections Upon Delaware,* 83 YALE L.J. 663 (1974).

223. *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981). *See generally* Fischel, *supra* note 132.

much of a morass as did business purpose if the courts are bent on continuing to review the merits of mergers. However, *Weinberger's* repeal of the business purpose test must be viewed as a strong indication of a genuine change in policy rather than as a mere shift of focus from business purpose to disclosure as a means of determining fairness. It is therefore crucial to understand the virtue of reliance on the voting process. It affords the only non-coercive way of negotiating a mutually beneficial transaction yet devised, and it leads to monetary results that comport with a coherent view of the competing interests of the majority and the minority. Such benefits should not lightly be foregone in favor of expensive, time-consuming and unpredictable substantive review.