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# Share Valuation— A Chance for Financial Literacy

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## INTRODUCTION

Sovereign attitudes about the exact amount of protection to be accorded the rights and expectations of individual shareholders in a corporation have changed over the decades, yet are still in a state of flux. Early in the corporate era, traditional individualistic notions about the immutability of contract rights and the continuity of property rights governed official attitudes about share ownership. This approach soon proved to be too rigid to serve legitimate corporate institutional purposes. Individualistic rights therefore began to give way to institutional rights to facilitate corporate exploitation of business opportunities and to achieve financial advantages.[1]

Corporate charter amendments have long been allowed which add to or change the original corporate purposes or alter and restructure the existing power and economic relationships among the shareholders.[2] Various notice, procedural and voting mechanisms were devised to accomplish these fundamental changes and at the same time to protect the interests of the individual shareholders. Ultimately, the courts had to identify the outer limits of the propriety of these maneuvers. The concept of "vested rights" served to do this initially[3] as did restrictive statutory interpretation.[4] In the states attracting businesses wishing to incorporate,

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1. *See* Lattin, *Minority & Dissenting Shareholders' Rights in Fundamental Changes*, 23 LAW & CONTEMP. PROBS. 307, 308-10 (1958). *See also* Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROBS. 283 (1958); Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of* Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 1 (1983).

2. *See* Gibson, *supra* note 1, at 291-92.

3. *See* Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U.L. REV. 624, 627-31 (1981).

4. Bowman v. Armour & Co., 17 Ill. 2d 43, 160 N.E.2d 753 (1959) (holding that



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the scales were increasingly balanced in favor of corporate need and institutional flexibility. More recently, complete and permanent separation of shareholders from their corporation against their desires has been allowed.[5]

While the individual shareholders no longer can depend on the form and permanency of their relationship to their corporation, it is recognized that in a squeeze-out, the ousted shareholders must be properly compensated for the interests which they are being forced to surrender. Several decades ago, the Delaware court adopted a set of influential guidelines, called "the Delaware block rule," for valuing these shares.[6] Originally, the rule was applied to merger situations in which the departing shareholders accepted the appraised value of their shares rather than receive an interest in the merged (and changed) corporation.[7] More recently, the block rule has been extended in Delaware to coercive situations in which minority departure was not a matter of choice. The recent case of *Weinberger v. UOP, Inc.*,[8] prompted the Delaware court to rethink its share appraisal rules.

## I. PAST VALUATION METHODS

In the past, the court in applying the block rule for appraising shares generally relied on a weighted average of several value factors which it recognized as elements of value inherent in the shares. Usually recognized were "earnings" and "net assets," and less frequently, "market price" and dividends."[9]

As used in the accounting sense, asset book value often served as a starting point for valuing assets of the corporation. However, the courts did not use that figure alone to determine asset book value.[10] Delaware courts took a broader view of asset value than did accountants and considered it only an integral part of the go-

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the Illinois corporation statute did not permit a recapitalization by charter amendment which converted preferred stock to debt securities).

5. *See* Weiss, *supra* note 3, at 632-57; Gibson, *supra* note 1, at 286.

6. *See, e.g., In Re General Realty & Utilities Corp.*, 29 Del. Ch. 480, 52 A.2d 6 (1947).

7. *See* Weiss, *supra* note 1, at 12-25.

8. 457 A.2d 701 (Del. 1983) [hereinafter *UOP*]. The Court of Chancery report appears at 426 A.2d 1333 (Del. Ch. 1981) [hereinafter *Weinberger*].

9. *See In re* Jacques Coe & Co. v. Minneapolis-Moline Co., 31 Del. Ch. 368, 75 A.2d 244 (1950); Tri-Continental Corp. v. Battye, 31 Del. Ch. 101, 66 A.2d 910 (1949), *rev'd* 31 Del. Ch. 523, 74 A.2d 71 (1950); General Realty & Utilities Corp., 29 Del. Ch. 480, 52 A.2d 6 (1947). *See also* a list of selected block rule cases in V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE—CASES AND MATERIALS 579-80 (2d ed. 1979); Banks, *A Selective Inquiry into Judicial Stock Valuation*, 6 IND. L. REV. 19 (1972); Banks, *Measuring the Value of Corporate Stock*, 11 CAL. W.L. REV. 1 (1974).

10. *See* Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1457 (1966).

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ing concern's value of which the minority shareholder was being deprived. For example, contrary to generally accepted accounting principles, one court permitted the addition of a subjectively determined amount of "goodwill" to the assets.[11] In another, a court allowed a reduction for the obsolescence of a balance sheet item but declined to allow additions for construction in progress and leasehold improvements.[12] In yet another, a court permitted a write-up of all the assets to their estimated replacement values less depreciation.[13]

Delaware courts thus showed little concern for assets as measured by the accountant and no reluctance to make adjustments in the figures especially if these alterations corrected an apparent understatement traceable to generally accepted accounting principles or if they occurred due to the unique nature of the business. Furthermore, these courts seem to have favored replacement value rather than liquidation value.[14]

Delaware courts also refused to view corporate assets as having value only because of the income they can be expected to produce.[15] Rather, they insisted on considering the assets and corporate earnings as separate components of the worth of a going concern. Consideration of two (or more) value elements poses the problem of how to combine them into a single value figure. To reach such a figure, a weighted average of the factors was traditionally employed.

Invariably, earnings were a second value component of major importance to the block rule. Here, generally accepted accounting principles seemed more important, or at least the courts appeared

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11. Jacques Coe & Co. v. Minneapolis-Moline Co., 31 Del. Ch. 368, 75 A.2d 244 (1950).

12. Application of Delaware Racing Ass'n, 42 Del. Ch. 406, 213 A.2d 203 (1965). Generally accepted accounting principles usually permit deductions for obsolescence as well as depreciation; permit the listing of construction in progress on the balance sheet; and, though the leasehold may or may not appear as an asset, allow the listing of leasehold improvements. W. MEIGS, C. JOHNSON & R. MEIGS, ACCOUNTING, THE BASIS FOR BUSINESS DECISIONS 405, 442 (4th ed. 1977).

13. Adams v. R.C. Williams & Co., 39 Del. Ch. 406, 158 A.2d 797 (1960). Generally accepted accounting principles still generally eschew "write-ups" and favor historical costs. T. FIFLIS, H. KRIPKE & P. FOSTER, ACCOUNTING FOR BUSINESS LAWYERS 79-80 (3d ed. 1984). The courts seemed to have devised their own approaches to adjustments without systematic reference to financial practices of analysis.

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

15. *See* Felder v. Anderson, Clayton & Co., 39 Del. Ch. 76, 159 A.2d 278 (1960), where the court said it was improper to use one value factor (earnings) to measure another value factor (assets) and adhered to its reconstruction of net assets as reproduction cost less depreciation. *But see* Sporborg v. City Specialty Stores, Inc., 35 Del. Ch. 560, 123 A.2d 121 (1956), where the court allowed capitalization of certain corporate rental property at six percent to determine its asset value. *Compare* this with Justice Holmes' dictum that the business worth of property rests upon "the expectation of income from it . . . ." Galveston, Harrisburg & San Antonio Ry. Co. v. Texas, 210 U.S. 217, 226 (1908).

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less willing to tinker with them. However, this pattern may be on the verge of a major change in view of the criteria which were found permissible in *UOP*.[16]

The block rule traditionally computed the value of a corporation by first averaging past years' earnings (often five years of earnings). This average was then multiplied by an appropriate figure that would produce the value of a future stream of income that exactly duplicated the value of the past average of earnings. Rather unrealistically, this assumed that the past would be duplicated in the future for an indefinite period. Until *UOP*, Delaware courts always refused to project actual dollar amounts that were expected to be earned in the future based on an estimation of the future prospects of the company; however, the courts never hesitated to take unadjusted past dollars and project their continuation into perpetuity.

The formula for the present worth of a perpetuity can be stated as $V = E(M)$, where V = value, E = earnings and M = an appropriate factor (or multiplier) that expresses the extent to which the value or a going concern should exceed its earnings. For example, an investment that generates $1 in earnings and which is worth ten times that amount should be valued at, and hence sell for ten times $1, or $10. This is the so-called price-earnings ratio known to the equity investor and by which the relation of earnings to price of a share is expressed to aid in determining the appropriateness of the share price currently demanded by the market. For example, a share selling at twenty times earnings may be more "expensive" than one selling at twenty-five times earnings regardless of the dollar amounts. It also is another way of stating that if one earns $1 per year on a $10 investment, the return amounts to 10% per year. A feature of the foregoing is its failure to address the matter of time and its implicit assumption that the current relationship between price and earnings will continue indefinitely.

Thus far, the two block rule cornerstones had been a *net asset value*, which is an accountant's book value per share rewritten to please the court, and an *earnings value*, which is a court-derived average of accounting earnings for recent years multiplied by an appropriate factor pursuant to the formula $V = E(M)$. The two *values* were combined by use of a weighted average, for example, 60%-40%, 80%-20%, etc., as the court found to be fair under the

16. Even earnings calculated according to generally accepted accounting principles may imply an objectivity that is illusory. For example, the choice between "LIFO" and "FIFO" inventory pricing methods may dramatically affect the level of reported earnings, yet in both instances the method chosen need not always match the order of the outflow of the physical inventory. J. COX, FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW: CASES AND MATERIALS 308-13 (1980).

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circumstances of each case, to produce the earnings' multiplier. Of course, a field day for the advocates and their experts is inherent in such a rule as it invites endless debate about selecting the appropriate weights to ascribe to the variables.

Less light than heat had been generated in early block cases by intractable judicial adherence to the so-called Dewing tables[17] through which an early and celebrated financial writer cautioned against using multiples in excess of ten. Earlier cases, for example, used multipliers of seven or eight[18] and six to eight.[19] A breakthrough occurred in 1965 when the court allowed a factor of fourteen.[20] The court there found compelling the fact that the company was holding certain assets for later sale which had depressed earnings of recent years such that earnings were considered unrepresentative of the company's worth.[21] In subsequent years, the rigid adherence to the Dewing maximum seems to have disappeared. For example, in another case, the court found no difficulty with the use of a multiplier of 16.1 possibly because of the higher price-earnings ratios that had come to be known in the market by that time.[22]

Two other valuation elements also figured into the block rule: dividends and price. Thus, as many as four variables had to be factored in to reach a weighted average of values. However, especially in closely held firms, there may be no dividends and price may either be suspect or may arise with insufficient regularity to warrant its use. Even for publicly held and traded shares, market price is a suspect element. The market may be too thin or be subject to external influences which deflect price below intrinsic value and, in the case of squeeze-outs, the controlling parties may be taking advantage of circumstances which have not yet been assim-

17. 1 A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 390-91 (5th ed. 1953).

18. Cottrell v. Pawcatuck Co., 36 Del. Ch. 169, 128 A.2d 225 (1956).

19. Sporborg v. City Specialty Stores Inc., 35 Del. Ch. 560, 123 A.2d 121 (1956). Another case rejected a multiplier of 15.2 and relied instead on the figure resulting from ten times earnings, specifically noting the ceiling in the Dewing table. Application of Delaware Racing Ass'n, 42 Del. Ch. 406, 416, 213 A.2d 203, 213 (1965).

20. Swanton v. State Guar. Corp., 42 Del. Ch. 477, 215 A.2d 242 (1965).

21. The court apparently was not satisfied that an average of past earnings would adequately represent future expectations. Rather than predict the future through estimation, the court chose to continue to rely on historical experience and calculate the expected value of the company by increasing the Dewing Multiplier above its limits.

22. Francis I. DuPont & Co. v. Universal City Studios, Inc., 312 A.2d 344 (Del. Ch. 1973) *aff'd*, 334 A.2d 216 (1975). Though use of the Dewing tables may have declined in recent years, reliance on them can be found in Securities Indus. Assoc. v. Board of Govenors of the Fed. Reserve Sys., 468 U.S. 137, 165 (1984); Board of Trade of Chicago v. SEC, 677 F.2d 1137, 1156 (7th Cir. 1982), *reh'g denied*, May 27, 1982; Banco Nacional de Cuba v. Chase Manhatten Bank, 505 F. Supp. 412, 463 (S.D.N.Y. 1980); Eiberger v. Sony Corp. of America, 459 F. Supp. 1276, 1279 (S.D.N.Y. 1978) *aff'd* 622 F.2d 1068 (1980).

ilated into the public price.[23] Thus, quite often, the four part block rule dwindled to three or to two components, with earnings and assets as the ever-present variables.[24] *Weinberger v. UOP, Inc.*, involving a two step freeze-out, provided the Delaware court with the opportunity to abandon one substantive rule, to insist on "fair" procedures which protect minority shareholders and to relax the mechanical rigidities of the block rule.

## II. The Case

In the early 1970's, Signal Companies, Inc., a diversified, technically based operating company, had accumulated surplus cash from the sale of a subsidiary. In 1974, it approached the management of UOP, Inc., a diversified industrial company whose stock was listed on the New York Stock Exchange, and arranged to acquire control of UOP by buying 1,500,000 shares of unissued UOP stock and making a public tender offer at $21 a share for the necessary balance. Although the tender offer was greatly oversubscribed, Signal took only enough to attain 50.5% control of UOP. Signal initially elected six members of the UOP board of directors, but when UOP's president retired in 1975, he was replaced by a Signal senior executive who also became a member of the boards of both companies.

In 1977, Signal was still looking for investment opportunities. Since UOP again seemed the most attractive option, management determined that UOP would be a good investment at any price up to $24 a share. Signal's board of directors decided to acquire all of UOP's shares by way of a cash-out merger at between $20 and $21 a share. When informed of the plan and price, UOP's president could find no objection, but did express concern about the possible departure of key shop personnel and the need to protect key employees' stock options.

On February 28, 1978, Signal's management was authorized by its executive committee to negotiate with UOP about a merger so that the Signal board could consider the matter at its March 6 meeting. Lehman Brothers, which had acted as investment banker to UOP for many years and had one of its partners on the UOP board, was retained to render a fairness opinion as to the price offered for the minority stock. After doing a quick study, Lehman Brothers advised both boards on Monday, March 6, that $21 would be a fair price for UOP shares.

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23. *See* Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023 (1976).

24. *See* table of selected Delaware cases in Comment, *supra* note 10, at 1469.

Signal's board unanimously voted to proceed with the merger at that price. After being provided incomplete information about the proposition, the UOP outside board members, that is, those who were not Signal nominees, also approved the proposed merger.

Signal first informed shareholders of UOP of its action on March 7. Finally, on May 26 at the UOP annual shareholders meeting, the merger was approved by 51.9% of the total minority shares outstanding. Counting Signal's shares, the proposal passed with a 76.2% majority. Only 2.2% of the shares voted against the merger. By the terms of the agreement, the merger took place on May 26, and each share of UOP stock in the hands of minority shareholders automatically converted into a right to receive $21 cash.

In a class action brought on behalf of the minority shareholders, the plaintiff attacked the validity of the merger, seeking to set it aside or asking for damages in the alternative. The plaintiff contended that Signal unfairly used its majority status to cash out the minority at an unfair price and for no proper business purpose, but rather only to rid itself of the minority. The plaintiff also claimed that Signal used its majority control of the UOP board and management to disseminate false and incomplete information about the transaction. The plaintiff further asserted that the UOP board breached its fiduciary duty by failing to require an independent appraisal of the UOP shares before agreeing to the merger terms. Finally, the plaintiff alleged that in reaching the cash-out price per share, the board failed to take into account the value of substantial assets owned by UOP.[25]

At the trial, the chancellor found that there was a proper business purpose for the merger between UOP and Signal, citing the advantages which the UOP "investment" would have for Signal.[26] He also found there had been no misrepresentation or improper failure to disclose relevant information to the minority. Thus, he ruled that there had been no breach of a fiduciary duty.

Finally, the chancellor concluded that it had not been shown that the $21 buy-out price was inadequate. In reaching this conclusion, he analyzed the testimony of the valuation expert called by the plaintiff. After first expressing doubts about the persuasiveness of the expert's discounted cash flow analysis, the chancellor ruled that giving consideration to that sort of evidence about value was not permitted under the Delaware block rule. Block rule testimony had been presented by the defendants' experts to justify the $21 price. The chancellor noted that fairness to the minority did

25. Weinberger v. UOP, Inc., 426 A.2d 1333, 1341-42 (Del. Ch. 1981).
26. *Id.* at 1348-50.

not require that the majority disclose the highest price it was willing to pay for the shares.[27]

The Delaware Supreme Court reversed the chancellor's decision and ruled that the merger had been conducted unfairly because the information that Signal furnished to the outside directors and the shareholders was incomplete in material ways.[28] The court further found that public representations made about the merger and the way it was accomplished were misleading. The court abandoned its recently adopted requirement that minority squeeze-out decisions must be supported by some sort of business purpose,[29] preferring a requirement that a cash-out be conducted with "entire fairness" to the minority.[30] According to the court, entire fairness requires that a fair procedure be used to accomplish the squeeze-out and that the price offered to the departing shareholders be a fair one.

The court first found that Signal had not used fair procedures in taking over UOP. In addressing the latter requirement, the court claimed that it was merely applying a rule which had long been on the books. However, it adopted an approach which permitted more flexibility in ascertaining the value of shares. In doing this, the court did not repeal the long-standing block rule, but merely expanded the permissible techniques and elements that may be used in determining value.[31] The court recognized that certain post-merger elements of value could be considered.[32] Consequently, it remanded the case for a determination by the chancellor of the fair cash-out price of the UOP shares.[33]

## III. Commentary of the Case

### *A. The Business Purpose Doctrine*

Before its decision in *Weinberger v. UOP, Inc.*, the Delaware Supreme Court seemingly had been genuinely concerned about protecting minority interests in a takeover situation. Stung perhaps by the criticisms of the late professor William Cary and others,[34] the court first attempted to curtail the elimination of minority interests in a public corporation to those situations in which

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27. *Id.* at 1358-59.
28. Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983).
29. *Id.* at 715.
30. *Id.* at 711.
31. *Id.* at 712-13.
32. *Id.* at 713.
33. *Id.* at 715.
34. *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978).

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there was a legitimate "business purpose" to be furthered by the action.[35] The court thus approached the problem substantively and formulated a policy which assumed that a "business interest" would always outweigh the interests of a minority shareholder group. Once again, the age-old balancing act between majority and minority interests had been rung down in favor of the minority, but this time it was done in a way purported to protect the minority against arbitrary or capricious freeze-outs. The court never had much of an opportunity to refine this approach, however: As was warned by some commentators,[36] the rule proved to be unworkable because the concept of "business purpose" was a nebulous one at best and became increasingly rarefied in practice. Perhaps more important to the court, the requirement proved to be a standing invitation for litigation about the existence and validity of the "business purpose" in any particular case.[37] When it first adopted the *Singer* rule of substantive protection, the court perhaps did not feel any necessity to question its well-established block rule for valuing shareholder interests, even though it had attracted criticism.[38] As such, the court saw no reason to explore alternative valuation methods which might have led to fairer dollar awards.The rejection of the substantive rule of *Singer* by the court in *UOP* brought matters back to the original focus: How should the legitimate, but conflicting, interests of the two shareholder groups best be accommodated as a matter of law? *UOP* opted first for a procedural rule of full and fair disclosure which is hardly novel, even for Delaware. The facts of *UOP* fairly cried for the application (if not the invention) of such a rule. In its essentials, the court in *UOP* required that the majority and its management must first make full and fair disclosure about the factors it has taken into account in fixing the value of the securities it seeks to buy, including the maximum amount it is willing to pay. The disclosure must be made to any independent faction on the board and/or to the minority security holders as a class so that some

35. *See* Roland International Corp. v. Najjar, 407 A.2d 1032 (Del. 1979) (business purpose applied to a short form merger); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977); Tanzer v. International Gen. Indus. Inc., 379 A.2d 1121 (Del. 1977).

36. The rule survived for only six years. *See* Brudney & Chirelstein, *supra* note 34, for a pungent criticism of the rule. At least while the *Singer* rule was in effect, it could be said that minority shareholders had a protected interest in the form of their investment which, however, was subject to being counterbalanced by an overpowering business interest of the controllers. Toward the end of the life of the *Singer* rule, it did not take much of a business interest to tip the balance in favor of the majority.

37. *See* Berger & Allingham, *A New Light on Cash-Out Mergers*, Weinberger Eclipses Singer, 39 Bus. Law 1 (1983).

38. *See* Weiss, supra note 3; Brudney, *Efficient Markets and Fair Values in Parent Subsidiary Mergers*, 4 J. Corp. L. 63 (1978).

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sort of informed independent judgement can be exercised about the proposition. In the end, of course, this rule concerns only the adequacy of the proposed price.[39]

Majority controllers of public corporations understandably are inclined to prefer freezing out minority interests as quickly and inexpensively as possible. The Delaware court continues to indulge the first part of this majority preference as a matter of policy.[40] Whether they can do it as inexpensively as before remains to be seen.

### *B. The Valuation Rules*

The second aspect of *UOP*, the new valuation rules, reflect a significant departure from precedent despite the fact that the court stated that it was merely returning to original principles.[41]

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39. This aspect of the case has attracted an immense amount of analysis and commentary in the law journals. Most of the writers approve of the direction of the case but seem uncertain about how the disclosure rules are to be implemented. *See* Berger & Allingham, *supra* note 37; Deutsch, Weinberger v. UOP*: Analysis of a Dissent*, 6 CORP. L. REV. 29 (1983); Herzel & Colling, *Squeeze-Out Mergers in Delaware—The Delaware Supreme Court Decision in* Weinberger v. UOP, Inc., 7 CORP. L. REV. 195 (1984); Herzel & Colling, *Establishing Procedural Fairness in Squeeze-Out Mergers After* Weinberger v. UOP, 39 BUS. LAW 1 (1983); Payson & Inskip, Weinberger v. UOP, Inc.: *Its Practical Significance in the Planning and Defense of Cash-Out Mergers*, 8 DEL. J. CORP. L. 83 (1983); Prickett & Hanrahan, Weinberger v. UOP*: Delaware's Effort to Preserve A Level Playing Field for Cash-Out Mergers*, 8 DEL. J. CORP. L. 59 (1983); Steinberg & Lindahl, *The New Law of Squeeze-Out Mergers*, 62 WASH. U.L.Q. 415 (1984); Weiss, *The Law of Take Out Mergers:* Weinberger v UOP, Inc. *Ushers in Phase Six*, 4 CARDOZO L. REV. 245 (1983); Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of* Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 1 (1983); Note, Weinberger v. UOP, Inc.*: Fairness Renewed In Delaware*, 4 J. LAW & COMM. 169 (1984); Note, *Corporation Law*—Weinberger v. UOP, Inc.*: Delaware Reevaluates State-Law Limitations on Take Out Mergers*, 62 N.C.L. REV. 812 (1984); Note, *Delaware's Solution to the Problem of the Minority Stockholder in a Cash-Out Merger*—Weinberger v. UOP, Inc., *457 A.2d 701 (Del. Ch. 1983)*, 11 N. KY. L. REV. 575 (1984); Note, *Achieving Fairness in Corporate Cash Mergers:* Weinberger v. UOP, 16 CONN. L. REV. 95 (1983); Note, *The Standard of Care Required of An Investment Banker to Minority Shareholders in A Cash-Out Merger:* Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 98 (1983); Note, *Price and Purpose: The Two Faces of Fairness in* Weinberger v. UOP, Inc., 13 MEM. ST. U.L. REV. 384 (1983); Note, *Reappraising Minority Shareholders Protection in Freezeout Mergers:* Weinberger v. UOP, Inc., 58 ST. JOHN'S L. REV. 144 (1983); Note, *A Cash-Out Breakthrough in Delaware Judicial Merger Regulation*, Weinberger v. UOP, Inc., 37 SW. L.J. 823 (1983); Note, *Corporations—Mergers—Delaware Redefines "Entire Fairness" Test for Cash-Out Mergers and Suggests More Liberal Appraisal Remedy*, 28 VILL. L. REV. 1049 (1983); Note, *Minority Shareholders & Cash-Out Mergers: The Delaware Court Offers Plaintiffs Greater Protection and A Procedural Dilemma*, 59 WASH. L. REV. 119 (1983); Note, *Delaware Corporation Law:* Weinberger v. UOP, Inc.*—A Limitation on* Singer *Fairness Standards?*, 42 U. PITT. L. REV. 915 (1981).

40. The *UOP* court said that it was returning to Stauffer v. Standard Brands, Inc., 41 Del. Ch. 7, 187 A.2d 78 (1962), and David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971), which mandates "a shareholder's recourse to be the basic remedy of an appraisal." *UOP*, 457 A.2d at 715.

41. This seemingly basic principle is that "[f]air price obviously requires considera-

This change is now beginning to generate commentary.[42] Some of it merely describes in technical detail the various valuation techniques that might be used by professional financial analysts and which *UOP* now makes available to augment the old block rule considerations.[43] Other commentators have tried to distill a general rule from the case. The author of one thoughtful article reads the case as assuring that the minority shareholder will receive a price equivalent to, but no more than, an amount that which would be produced by an arm's length negotiation.[44]

Arm's length seems consistent with one of the underlying assumptions of financial analysts. They are accustomed to providing valuation assistance and advice to potentially willing buyers or sellers whom, they presume, have the freedom to close a deal with an equally free counterpart or to walk away from it. If the Delaware court views the minority squeeze-out situation based on this assumption, it will be dealing in fiction. In the economic power politics of a public corporation, equal bargaining capacity cannot be mustered by the minority, no matter how full and fair the information it receives. Legally or politically, it will never be in an effective position to walk away from an offer and avoid the buyout altogether. The only thing the minority can "bargain" about is the price of its ultimate departure. Individually or collectively, it is in no position to effectively protect its interests within the available time frame. The minority has no legitimate agency to look after its interests. The corporate electoral process does not provide an adequate forum in which the minority can exercise the judgments that must be made or in which it can mediate the conflicts that will naturally exist among its members. Any analysis which is based on the assumption of minority free bargaining really is not a satisfactory way to value the property interests at stake or even to find the outer limits of those values.[45]

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tion of all relevant factors involving the value of a company." *UOP*, 457 A.2d at 713. In support of this proposition, the court cited the old case of Tri-Continental Corp. v. Battye, 31 Del. Ch. 101, 66 A.2d 910 (1949) *rev'd*, 74 A.2d 71 (1950).

42. *See* Booth, *The New Law of Freeze-Out Mergers*, 49 MO. L. REV. 517 (1984); Comment, *Valuation in the Context of Share Appraisal*, 34 EMORY L.J. 117 (1985); Note, *"Fair Value" Determinations in Corporate "Freeze-Outs" and in Security and Exchange Act Suits: Weinberger, Other, and Better Methods*, 19 VAL. U.L. REV. 985 (1985).

43. *See* Comment, *supra* note 42.

44. *See* Booth, *supra* note 42.

45. Individually or collectively, the minority shareholders stand in a much different position than does the typical client of a financial expert. The expert can advise his typical client about the value of a particular share at a particular time, knowing the client's objectives and his ability to cope with the risks involved. To allow an *ad hoc* minority splinter group composed of neutral members of a board of directors to make critical decisions on behalf of the minority is not an adequate substitute. The splinter group has no recognized legal status to do such things and the individuals are not necessarily selected for expertise

### 1. The UOP Financial Expert's Approach

Under the *UOP* cash-out criteria, the court now allows use of a "discounted cash flow" approach, presumably representative of a criterion that might be applied in the investment world.[46] In examining the UOP expert's version of the "cash flow" method, it should be remembered that it is but one of several criteria that may exist and that its sole preoccupation with cash may or may not coincide with other investment analysts' overall methods of assigning value to a company.

UOP's expert began by selecting a base year and starting with the historical accounting data for that year. As is typical of "cash flow" approaches, the analyst attempted to some extent to undo the work of the accountant. The accrual accountant prefers to convert incoming and outgoing cash into accounting "earnings" that are considered as more truly representative of the financial condition of the company. For example, earnings may be affected dramatically by showing the write-off of the cash purchase of a plant not in the first year of its life, but rather by spreading the price evenly over the large number of future years during which the plant will be used. On the other hand, the cash flow analysis prefers to take these equal and annual deductions for the "depreciation" of the plant and lump them back together in the year or years of the original cash purchase.

Without judging the propriety of what he did, UOP's expert selected two accounting items (depreciation and deferred taxes), labeled them Sources of Cash and added them back to UOP's 1977 income. His selection criteria for the two are not explained in the reported case, but a fair assumption is that the items in part represented relatively large sums that involved the outflow of cash in some year or years other than 1977. These so-called cash flows from operations were probably but a few of many items that did not involve a 1977 cash disbursement but that may, nevertheless, have provoked a 1977 accounting deduction.[47] Thus, the question arises as to how many additional adjustments of this sort might be made to convert the accountant's figures to a true and complete cash inflow. The *UOP* decision offers little help on this point.

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in their particular field.

46. Some authors have gone so far as to state that "[d]ifferent users will be interested in different values, but security analysts will want to value the firm at the present value of future cash flows." Page & Hooper, *Financial Statements for Security Analysts*, 35 FIN. ANALYSTS J. 50, 55 (1979).

47. Such deductions might have also included amortization and deferred compensation.

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UOP's expert turned next to cash outflows, or uses of cash and selected two large ones: long-term debt payments and additions of plant and equipment. These two items differ somewhat from the cash sources discussed above not only because of the direction of the flow of cash (one pair in and the other pair out), but also because the two are found in different parts of the company's financial statements. For example, cash spent for plant and equipment directly influences the assets (cash and plant) found in the balance sheet while payments on the long term debt affect an asset (cash) and a liability (debt), both of which are found in the balance sheet. On the other hand, depreciation and deferred taxes constitute non-cash expenses and reduce earnings in the income statement for the year in question.[48]

Cash analysis is not concerned with annual "earnings" in the accounting sense which was the starting point for the Delaware courts in block cases. Instead, UOP's expert began by constructing the amount of "cash" that would be needed by the company during a business year. Having found the major cash sources for 1977 and the major cash uses for 1977, the analyst subtracted the latter from the former to reveal an excess of cash that presumably could have been removed without impairing operations for the year.[49] Other cash items of an extraordinary nature and certain excess liquidity were found, but their full role in the process presumably would require resort to the full report of the expert. For reasons not fully explained in the reported case, once he located the excess or "free" cash for 1977, the expert selected two capitalization rates. He divided the excess cash by each rate to determine present values, then added the aforementioned extraordinary items and excess liquidity and divided this sum by the number of outstanding shares which produced a range of values. This part of the process obviously cries out for further explanation than that afforded in the chancery court's opinion.

UOP's expert did not stop with 1977 for which he had historical data on which to rely, but proceeded specifically to project cash flow figures for 1978 through 1982. The result was a dollar amount that constituted the present value of the company which furnished a per share figure for the value fairness test. By endorsing this approach, the Delaware court approved projecting value

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48. Not all financial analysts would necessarily follow this approach. Some, perhaps, might limit cash adjustments to those that affect merely the earnings figure listed on the income statement.

49. One author describes cash flow as "the difference between inflows and outflows. More specifically, the cash flow from a firm is its earnings less investments necessary to maintain the firm . . . ." J. FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT 282 (3d ed. 1980).

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on the basis of future contingencies and thereby departed from the block approach. The court did impose a precautionary outer limit for projections by excluding those of a "speculative" variety.[50] It remains for future litigation to refine this speculative concept.

*a. Source and Use of Funds Statement.* The outline of the expert's analysis is based on what accountants usually call a Source and Use of Funds Statement, or a Statement of Changes in Financial Position, or a similarly named statement, that generally appears as a part of a corporate annual report.[51] Recognizing that the accrual based balance sheet and income statement may reflect little about the actual inflow and outflow of cash during any period, a source and use of funds statement provides supplementary information by partially converting the accounting figures back to cash figures. For example, a list of "sources of funds" or "sources of cash" might also include cash collected for the year's credit sales. Such sources of cash might include "deferred salaries" and "deferred taxes" and many other items that, although listed as accounting expenditures, did not require the use of cash in the year in question. Conversely, sources of cash might also be expanded to include items that did not affect the accounting income for the year in question but most certainly did affect the contents of the corporate till. Examples of this are funds raised by both short and long term borrowing, funds raised by new stock issues and funds raised by sales of fixed assets.

By the same token, "uses of funds" or "uses of cash" may be shown by adjusting the financial statement to reveal some of the many items that require cash outlays which accrual accounting might properly omit as expenses in the income statement and/or changes in the balance sheet, including expenditures on a new plant, dividends paid and payments on debt. The difficulty is that there are so many such items that to pursue all of them would be

50. *UOP*, 457 A.2d at 713.

51. For a thorough discussion of the mechanics of the source and use of funds approach, *see* D. LIPSKY & D. LIPTON, A STUDENT'S GUIDE TO ACCOUNTING FOR LAWYERS 153-71 (1985). For further discussion of the method and adjustments as well as illustrations of its use in practice (at least in determining creditworthiness), *see* the latest version of Robert Morris Associates Uniform Credit Analysis manual and an example of source and use of fund statements in 1985 West Point—Pepperell, Inc. Ann. Rep. 21. The general task of transforming a source and use of funds statement into a valuation device is formidable. For example, the sources and uses to be omitted must be determined, for even in these days of sophisticated data processing equipment, to include them all could become unwieldy and the estimation period still must be selected. Estimating in perpetuity impeaches itself, although estimation for much more than six months or so is hardly error-free. Yet questions still arise: Might managerial data affect the expert's projection? Might the use of end-of-year estimates rather than during the year (each day, each week) be legitimized on the ground that the latter are too speculative? For a discussion of management as a source of information, *see* Page & Hooper, *supra* note 46, at 50.

a ponderous task. Another problem is that the source and use of funds statement really is a one year picture, reliance on which again raises the question of what will happen in the future. For example, shall an indefinite continuation of the past be assumed or shall one actually project or estimate these many transactions as they are reasonably expected to occur in year two, year three, year twenty-three, or any other year?

Delaware courts have always recognized the time value of money as have investors. Thus, a dollar today is worth more than a dollar ten years from now, even ignoring inflation, and the borrower well knows that interest is the charge required by the lender to compensate for this time differential. In any analysis such as discounted cash flow, time must be addressed. The future values must be projected to obtain the proper estimate for each year and then the entire stream of cash must be discounted back to the present at some rate to obtain its present value. This is quite an undertaking, not only because of the invariably subjective task of selecting capitalization rates, but also because of the high level of inaccuracy inherent in projecting the precise time of cash flow.

For example, it does make a difference to an employee whether his salary is received at the end of the present calendar year or monthly throughout the same calendar year. Thus, theoretically, one should project not merely the year during which a new plant will be paid for, or the year during which a new common issue will be sold, or the year during which salaries will be paid, but rather the precise day within the year. Further, this should be true not only for the projections for next year, but for the tenth, the twentieth, the thirtieth year. Is it important to do so? In theory, yes. Is it necessary? No, because distant errors may be masked by using high capitalization rates thus producing a lower present value for the distant guess. Is the concept of any worth? Yes, just as the nonexistent perfect circle, it stands as a theoretical reference against which actual practice can be refined. The investment analyst's search for "value" is futile, of course, should absolute accuracy be a requirement; but imprecision is no cure.

For the above reasons, a source and use of funds statement usually explains but one year in a corporate life. Yet, a "discounted cash flow model," however truncated, must always expand the one year into a more acceptable future period unless corporate liquidation is imminent. Purely in the interests of expediency, the process must always omit certain of the myriad of less significant cash items.

UOP's expert seemed to have based his model on an extension of the source and use of funds approach. He also appeared to have used six years, to have applied and discounted three "sources" and

two "uses" and to have relied on "end of year" figures, all of which the court did not dispute.

2. Problems With Generally Accepted Financial Criteria

In its opinion remanding the case, the Delaware Supreme Court indicated that the chancellor should not have rejected the UOP expert's cash flow evidence of the valuation of the shares since "the standard 'Delaware block' or weighted average method . . . shall no longer exclusively control such proceedings. We believe that a more liberal approach must include any techniques or methods which are generally considered acceptable in the financial community . . . ."[52]

The court's search for generally accepted valuation standards seems to result from analogous reliance on generally accepted accounting principles in financial reporting cases. While the search for such principles itself is not always easy, the potential applicability of competing rules to a given situation can be a most frustrating, if not impossible, task.[53] It would seem that at this stage of the development of the financial art, a search for and the application of generally accepted financial criteria might be almost impossible to accomplish since the number of such maxims vary directly with the number of available financial experts.

It is not clear how widely the specific approach of UOP's expert is used in financial practice. It is minimally discussed in the financial literature. The Delaware court will ultimately have to determine whether its new rule will have the effect of allowing any and all financial experts to bring in various and sundry approaches "for what they are worth" or if the profession itself will have to devise authoritative principles applicable to common valuation situations.

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52. *UOP*, 457 A.2d at 712-13.

53. Exegesis of generally accepted accounting principles can bewildering: The *cost* principle, in which assets are written down but not up, is based on the *consistency* principle, which might be thought to conflict with the *cost* principle. But, *consistency* apparently has a temporal connotation and urges that the same practice generally be followed each year. Opponents of the *cost* principle might suggest that the *consistency* principle requires that one do the wrong thing on a regular basis. The *objectivity* principle bases accounting on exchange transactions and guards against subjectivity. That is, the cost of a building should be its original price and not an estimate of the cost of its replacement. Yet the *matching* principle, by which an asset's expenses should be matched with its revenues in the same period in which the latter are earned, opens the door to choices. Among depreciation methods, the subjectivity inherent in selecting the depreciation method to be used can, depending on the method, cause earnings to be higher (straight-line depreciation) or lower (accelerated depreciation). For an extended discussion of this topic, *see* J. Cox, *supra* note 16, at 63-70.

### 3. The Dividend Valuation Model

Another form of the discounted cash flow process apparently in use in the investment world is the so-called Dividend Valuation Model, often referred to as the Gordon Model.[54] If the *UOP* opinion is read literally, this theory might be permitted in valuing a corporation. A key difference between an expert using the dividend model and the approach of UOP's expert is the perspective of each. The UOP-type expert generally takes an insider's view of the corporation and, in one form or another, nets corporate cash outflows which might include "dividends" as but one of the many corporate cash outflows. Conversely, the dividend valuation model expert takes the shareholder's view of the corporation and considers the present value of only the outflowing dividends discounted at an appropriate capitalization rate.

The dividend model has been discussed extensively by many authors;[55] however, a brief review is helpful to contrast this theory with the approach of UOP's expert. In its search for new criteria and in its opening of the door to those generally used in financial practice, Delaware courts must understand that the two approaches to discounted cash flow are quite different and that knowledge of their mechanics is essential to their appropriate application.

The dividend model may be represented as $P = D1/(k\text{-}g)$ where P = the present value of the common shares, D1 = the dividend expected to be paid in the first year, k = the appropriate rate of capitalization at which all future dividends expected from the share can be reduced to a single present value, and g = the con-

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> Discounting the future stream of cash flows to shareholders is the most widely accepted method of stock valuation. The cash flows consist of dividends plus the proceeds from sale of the stock. The selling price, however, reflects the next buyer's expectations . . . about future dividends. Thus, the value of a share reflects projected dividends to current and all future shareholders.

Rappaport, *The Affordable Dividend Approach to Equity Valuation*, 42 FIN. ANALYSTS J. 52 (1986). Though M.J. Gordon and later writers have made overwhelming contributions toward its development and refinement, J.B. Williams, an early financial writer, also did much toward synthesizing and adding to even earlier proponents of the cash model. *See* J. FRANCIS, *supra* note 49, at 265. *See generally* M. GORDON, THE INVESTMENT, FINANCING AND VALUATION OF THE CORPORATION (1962); J. WILLIAMS, THE THEORY OF INVESTMENT VALUE (1938).

55. *See* R. KOLB, INVESTMENTS 244-63 (1986); J. COHEN, E. ZINBARG & A. ZEIKEL, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 384-400 (4th ed. 1982); Hawkins, *Toward an Old Theory of Equity Valuation*, 33 FIN. ANALYSTS J. 48-49 (1977); Comment, *supra* note 42, at 127-33. One author notes that the "most commonly used approach to valuing common stock is to find the present value of expected future dividends." R. RADCLIFFE, INVESTMENT: CONCEPTS, ANALYSIS, AND STRATEGY 287 (1982). Another states that the dividend model has become "standard fare" for most segments of the investments industry. Rappaport, *supra* note 54, at 52.

stant growth rate at which future annual dividends can be expected to increase.[56] The classic assumptions of the model are that dividends will be paid in perpetuity, that dividends alone give value to a stock, from which it follows that a stock that will pay no dividends can never acquire a value, and that dividends will grow at a constant rate. (Alternative growth assumptions can be applied, such as different growth rates for different periods, which can be a formidable job indeed.[57])

Some critics are troubled by the notion that dividend payments make up the only value element of a share. (To some degree, a similar criticism may be leveled at the preoccupation of UOP's expert with net incoming cash as a single fountainhead of value.) This assumption states that one who buys a stock does so only for the cash to be paid him while owner and that this cash invariably takes the form of a dividend. Further, if a stockholder decides to sell, the buyer will be of a similar mind and pay for a stream of perpetual dividends. Should this second stockholder decide to sell, the third buyer will pay for dividends in perpetuity and so on. The result of the assumption is that the discounted present values of an endless series of finite streams when added together will be the same as the present value of an infinite stream. Thus, forever is forever, whether expressed as a perpetuity or as a series of finite periods added together in perpetuity.[58]

Whether or not the assumptions of the dividend model are proper, similar to the model of UOP's expert, the theory does deal with cash, does involve projecting and discounting and is said to be in common use in institutional investment decision making.[59] However, one model deals with cash flowing out to the stockholder while the other deals with cash flowing into the company. The use by UOP's expert of a shortened version of the latter and the court's approval of it seem to reflect a preference. Irrespective of the discounted cash flow model that Delaware courts may finally adopt or integrate into their valuation criteria, it is imperative that the major differences between the model of UOP's expert and the dividend model be known, for the two models take significantly different positions in their calculations of "cash."

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56. Brudney, *supra* note 38, at 74-75; FRANCIS, *supra* note 49, at 265-68.

57. R. KOLB, *supra* note 55, at 249-53.

58. *See* H. PHILLIPS & J. RITCHIE JR., INVESTMENT ANALYSIS & PORTFOLIO SELECTION 150-53, 154-56, 157-60 (2d ed. 1983).

59. R. RADCLIFFE, *supra* note 55, at 287; Rappaport, *supra* note 54, at 52.

4. Other Valuation Approaches

At best, the valuation process, whether applied to an individual stock or the whole enterprise, is a semi-sophisticated, demi-professional guessing game. In the investment world, toward which Delaware courts are seeming now to turn, the best valuation approach is the one that works. Yet this can only be known in retrospect. To expect more from financial analysis is to expect too much. Though a book on how to become rich in the market may sell well, it likely will not deliver on its implied promise, for the ultimate key to investment success would sell, if at all, for a price well beyond affordability.

*Fundamental* analysis[60] has many forms, all of which hold that a stock may have underlying value that differs from its price at any particular time. This notion permeates the investment community and seems to have its uses in legal valuation in quests for "fair" value, going concern value and the like. The block approach essentially was a method by which to measure underlying stock value, irrespective of its price. Not surprisingly, the various discounted cash flow models are but extensions of the approach of the fundamentalist.

Thus, the fundamentalist will presuppose that price and value may be unequal and that as a result, some shares are overvalued and others are undervalued. In fact, though financial modernists may argue that the price of a stock is equal to its value, the die-hard fundamentalist may argue that price can *never* equal value. That is, the underlying value as stated in terms of the present worth of all future expectations from the stock must be *thought* by the buyer to be higher than the stock's price and that underlying value must be *thought* by the seller to be lower than the price, or there would never be a motive to buy or sell. If all participants in a market thought that they were merely swapping dollars or shares of equal value, the exchange would be without gain or loss and, absent nontraditional financial motives, there would be no sale.

The problem is that fundamentalist buyers and sellers differ on their opinions as to value and as to the methods by which their opinions should be formulated. Buyers and sellers may use the

60. "All investors need not agree about the proper value of a security. Forecasts of future propects will differ between investors when they hold different information about the security." R. RADCLIFFE, *supra* note 55, at 282. Some celebrated fundamentalists seemed to emphasize asset value and minimize the algebra. *See, e.g.*, Graham, *The Future of Common Stocks*, 30 FIN. ANALYSTS J. 20 (1974). Other writers devote much space to economic and industry analysis as well as financial statement (including ratio analysis) examination. H. PHILLIPS & J. RITCHIE JR., *supra* note 58, at 422-513.

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dividend model and still arrive at different values for the stock merely by using different capitalization rates. These capitalization rates might result from differences in the degree of risk each is willing to undertake or differences as to the degree of risk that each perceives to be inherent in the shares. Many fundamentalists, however, may eschew the dividend model and base their decision on a host of characteristics, arranged according to their individual preferences for value factors chosen from among the myriad available to them. Such factors may include book value, earning per share, operating expense ratios, corporate liquidity or ratios of debt to equity. Analysts who have done this over time and with success may be less than willing to share their secrets. Thus, in selecting from methods used in the investment world, Delaware courts must realize that the choices are infinite.

In contrast, the so-called *technical* analysts[61] purport to have no interest in stock value but are concerned only with price direction. For example, the technicians read patterns in the rising and falling of stock prices and rely on the predictive nature that they feel these price patterns may contain. Thus, if a pattern indicates an expected price rise, the stock may become a buy candidate. The technicians seem to follow a minority approach and come regularly under fire for those who adhere to the *efficient market* hypothesis.[62] Depending on the degrees to which its followers claim that it exists, this theory adheres to the belief that the market price is generally equal to value because all relevant information affecting price is instantaneously incorporated in it; a less severe viewpoint is that information is assimilated in the market price with sufficient rapidity that the fundamentalists will be unable to make their decisions in time sufficient to produce a success record that is higher than merely buying the stock at its market price.[63]Thus far, Delaware courts appear to have emphasized a form of fundamental approach and seem to be willing to add to it. In doing so, a caveat is necessary: Reliance on the lore of the technicians and of the theoreticians who dwell in the world of the efficient market hypothesis could well produce an irrelevant complexity and merely increase the difficulty of formulating new Delaware

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61. J. COHEN, E. ZINBARG & A. ZEIKEL, *supra* note 55, at 294-335.

62. B. BRANCH, INVESTMENTS: A PRACTICAL APPROACH 332 (1985).

63. Some "suggest that earnings per share follow a random walk. . . . What it simply means is that generally a security analyst will not significantly improve his ability to forecast . . . by studying historical earnings." J. FRANCIS, *supra* note 49, at 340. Though the buzz words "random walk" appear to have merged somewhat into "efficient market," virtually all analysts seem to attribute at least some level of efficiency to the stock market and its ability to include information about the stock in its price with at least some degree of speed. B. BRANCH, *supra* note 62, at 138, 141. For a clear and readable treatment of this theory, *see* B. MALKIEL, A RANDOM WALK DOWN WALL STREET (4th ed. 1985).

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cash-out standards.

### C. *The Arm's Length Model for Valuation*

A footnote in the *UOP* case makes reference to arm's length bargaining;[64] yet arm's length bargaining may also be relevant to value as argued by one commentator.[65] He hypothesized that the outer limits of the bargain should be fixed at the greatest price which the majority would be willing to pay. The lower theoretical limit presumably would be the price below which the minority would be unwilling to sell. The "fair value" of the shares should lie somewhere in between these figures and the "modern valuation methods" now permitted by *UOP* could be applied to extrapolate that value.[66]

There seem to be two fallacies in this approach. First, this approach still does not come to grips with the problem of identifying the minimum elements of value inherent in the minority shares which the court as a matter of policy should protect. Second, the upper limit is at best an artificial one that plays into the hands of the majority which already has most, if not all, of the advantages. From its perspective, the *UOP* majority in searching for a "good investment" had determined what rate of return it must have, what costs and risks it would accept and its other requirements. It then looked for an investment that satisfied these expectations. It valued the benefits it expected to derive from that investment and calculated the highest price it could pay and still make a profit given its investment assumptions.

In a true arm's length model, there is nothing to guarantee that either party to the negotiation will be able to realize its expectations. Certainly, the Delaware court could not have intended that the upper investment value of the UOP stock as determined by the management of Signal, which had to act as a fiduciary, be used in such a way that it would also fix the upper level of appraisal value which the minority should receive. Because Signal owed a fiduciary duty to the minority shareholders, the court insisted that all value information be disclosed to be used by the minority in exercising its judgement whether to accept or reject the "deal." The minority should be able to compare that price with an even higher price if available and then reject the majority's "offer" if it wishes. The disclosure of one bargainer's top price to the other one is of itself inconsistent with the arm's length

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64. *UOP*, 457 A.2d at 709.
65. Booth, *supra* note 42, at 542-57.
66. *Id.* at 527-31, 535-36.

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hypothesis which puts a premium on secrecy. In any event, the attempt to construct a specific value of shares by use of the arm's length model is chimerical. It cannot produce dollar and cents results since the bargain price which truly free negotiators would have agreed on can never be artificially constructed. Indeed, an artificially created value relies on the unwarranted assumption that the parties would have arrived at a mutually agreed price. The power dynamics permitted under Delaware merger law assures the majority that a "deal" will be struck—the stock will be sold, but the price will have to be ascertained some other way than by an artificial bargaining construct.

The arm's length ideal has a certain logical or rhetorical appeal, but it proves useless as a practical way for ascertaining value. In the context of *UOP*, it is simply a rationalization for allowing the minority shareholder to have some sort of final say in the matter. The minority shareholder is being forced out of the corporation at the behest of the powerful and better informed management which has chosen the time and manner of the exchange and over which the minority shareholder has no control and little option. Even though the shareholder is given an opportunity to vote on the matter, the opportunity for ever exercising an "informed" judgement about the "fairness" of the offering price in minimal at best. All this reflects the fact that the displaced shareholder is not really in an "arm's length" situation, but really is in the midst of an unfriendly power play by which the stronger majority can legally use its control to force the minority to make a choice between taking what at first blush may seem to be an attractive price for its shares and remaining as a vulnerable minority.[67]

Thus, freeze-out transference is clearly different from a truly voluntary transaction. Therefore, the use of the valuation techniques which investment analysts normally would use in making judgment about value for trading or investing are not appropriate. Analysts' techniques are designed to provide the best possible insights about value at any particular moment so that the owner or potential investor can best decide whether to accept or walk away from the "opportunity" at hand. In contrast, the minority shareholder realistically does not have the option to refuse a squeeze-out, making normal analytical tools inapplicable. Unless a valuation system is adapted to the involuntary nature of the freeze-out situation which properly values the interests which should be protected as a matter of policy and unless such a method is sensitive to the peculiarities of each squeeze-out situation, the valuation

67. *See* Brudney, *supra* note 38.

system will be inadequate no matter how well it may perform in other contexts.

To be useful in the freeze-out context, a valuation system must satisfy at least three criteria: (1) every interest in the stock having value should be considered using an appropriate, acceptable method; (2) in calculating total value, no interest should be counted more than once; and (3) compensation should be made for any costs and/or added risk factors which are imposed by the transaction.[68]

## IV. The Elements of Value

It is much too simplistic to uncritically merge conventional valuation models into freeze-out fairness law. Initially, the elements of value to be protected must be identified. Some of the value elements of shares of stock that have been identified by the Delaware court include:

ASSETS

EARNINGS

DIVIDENDS

PRICE

POST-MERGER VALUES

TRANSACTIONAL COSTS[69]

But even after the general elements of value have been listed, the elements that need protection in any given freeze-out situation still must be specified. If more than one element has been identified, then the values of multiple elements will have to be assimilated into one single final valuation figure[70] unless these values are mutually exclusive and thus can be directly added together.

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68. Financial analysts seem committed to the idea that any investment opportunity can be reduced to an ascertainable dollar figure and that any investment is as good as the next one if it provides the same investment return. *See* Booth, *supra* note 42, at 532 (citing J. Lorie & M. Hamilton, The Stock Market: Theories and Evidence 70-98 (1973)). This approach depends heavily on the "efficient market" which is now seriously questioned for purposes of determining the real value of shares. *See* Brudney, *supra* note 38. This attitude of fungibility of investment seems to be the underlying rationale of the cash freeze-out. But even if the value being offered truly represents the intrinsic value of the shares being given up, the shareholder is faced with the expenses and risk of finding a substitute, and hopefully equivalent, investment. So, in addition to whatever the "true value" of his shares, the minority shareholder should be allowed an additional award to cover the transactional expenses and opportunity risks to which he will be exposed. *UOP*, 457 A.2d at 713.

69. Note, *supra* note 10. The concept of "post-merger values" was first recognized in the *UOP* case where the court also mentioned transactional costs.

70. Note, *supra* note 10, at 1468-71.

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The blending or weighing of values was perhaps the most distressing aspect of the old Delaware approach. The court was required to first identify which of the four elements were to be considered in a particular case, then identify the predominate ones and finally weigh them proportionately.[71] The court's way of identifying the elements to be valued had a factual, if pragmatic, basis, but the weighing process was never satisfactorily explained and appeared to have been highly subjective.[72] A master or an appraiser initially exercised his judgment about the appropriate weighing, then the chancellor would reweigh the elements and, in important cases, the Delaware Supreme Court also calculated a value on appeal, selecting either the figure of the appraiser or of the chancellor or averaging their difference.[73]

The result of all this was very imprecise and was subject to significant swings in value depending on which element was given the most weight. The discounting factor, which was subjective in nature, also had an influencing, levering effect.[74] The process amounted to an exercise of disinterested good faith, but relied on blind discretion which was founded on an artificially narrow basis of fact. The Delaware court seems to hope that the new *UOP* approach of opening up the process to include additional elements contributing to value will somehow make it fairer. This may well be the case, but the process really will not be any easier nor any more predictable.

In its application of the block rule, the Delaware court has persistently mentioned assets, earning, dividends and price as the pertinent elements of value of shares in appraisal situations. More often than not, the court focused its attention on the first two factors. As it was in the *UOP* case, price was often ignored or not found to be decisive because it was suspect or nonexistent.[75] Dividends would seem to be only a subset of earnings and, for most purposes, will not merit separate treatment. With respect to earnings, cash flow analysis can take several forms. The method used by UOP's expert seemed to account for the earnings value by using earnings as the focal point of his analysis. He first made adjustments to transform them to cash earnings, but then continued

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71. Seldom, if ever, would other elements be explicitly identified; however, in the "adjustment" process, other elements would be taken into account.

72. *See* Brudney, *supra* note 38.

73. For examples of this process, *see* Francis I. DuPont & Co. v. Universal City Studios, Inc., 312 A.2d 344 (Del. Ch. 1973); Application of Delaware Racing Ass'n, 42 Del. Ch. 406, 213 A.2d 203 (1965).

74. *See* Francis I. DuPont & Co. v. Universal City Studios, Inc., 312 A.2d 344 (Del. Ch. 1975); Schaeffer, *The Fallacy of Weighing Asset Value and Earnings Value in Appraisals of Corporate Stock*, 55 CALIF. L. REV. 1031 (1982).

75. *See* Brudney, *supra* note 38.

with calculations of other cash flows which were not limited to those which directly affected earnings. Instead, he also included other cash flows which had broad impacts on the entire financial structure of the firm.

The assets of a corporation are the physical and intangible property interests which are owned by the corporate entity and in which a shareholder would have an ultimate claim.[76] In some instances, the full value of the corporation's property can be ascertained by a cash flow analysis, particularly if all those assets are being directly devoted to the generation of the relevant corporate cash flow that should be measured.[77] In other instances, some of the corporation's assets must be valued differently if they are not presently generating any cash flow to the company.[78]

## CONCLUSION

The *UOP* case raises more problems than it settles, but in the long run its approach should prove beneficial. However, much development and refinement remains for the courts. *UOP* has broken the rigidities of the old block rule by

1. Permitting the use of modern stock valuation practices;
2. Allowing the use of expert estimations about future financial prospects of the company (in contrast to the blind projection of past averaging as done under the block rule);
3. Creating the means for refining the elements of value of shares while distinguishing the means of actually valuing them;

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76. Conventionally, the shareholders' interests in a corporation are described as their right to exercise their claim to management or control and their right to assets if and when the corporation is liquidated. In a large national corporation, the average shareholder has little or no interest in control and, in any event, the opportunities for asserting any effective control are minuscule. "Control" as an element of value in the minority squeeze-out situation has also been rejected because realistically the majority has already bought and attained control of the corporation. However, as long as the Delaware courts accept as part of fair procedure the power of the minority group to reject the proposition or if the courts will allow the minority's interest to be priced by the disinterested faction of the board, then the minority arguably has a new or residual "control" value (or "nuisance" value perhaps) and logically should be taken into account in considering merger plans.

77. The corporation may have assets that are "redundant," that is, those which are not integrated into the economic operations of the company. These assets may have a potential for generating a cash flow or they may only have a potential for an eventual sale. Nevertheless, they have a "current value" which must be accounted for to the minority shareholder who will be permanently separated from this value. The Delaware court has recognized this particular type of asset (*see* Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980) and Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 793, 93 A.2d 107 (1952)), but it has never developed a satisfactory way of assimilating that value into the total package.

78. The value of these kinds of assets can be determined by application of conventional property appraisal methods for similar property. The distinction between operating and non-operating assets has been recognized for estate and gift purposes.

4. Explicitly recognizing the legitimacy of crediting future values connected with the accomplishments or expectations of the merger;
5. Opening the door to compensation for transactional losses; and
6. Providing the potentiality for eliminating the subjective weighing of multiple value elements.

However, *UOP* provides little or no guidance concerning
1. Identifying the relevant elements of value which must be considered in various circumstances;
2. Identifying the accepted valuation practices that are appropriate for use in various situations and how they should be used or modified in particular cases;
3. Identifying the relevant economic stream to be measured in various circumstances and specifying the time length for such measures;
4. Selecting the appropriate capitalization rate that should be used in various routines and subroutines; and
5. Identifying the circumstances in which elements of the block rule should not be used, or used alone or used in conjunction with other valuation techniques.

The old block rule had the virtue of simplicity. The total range of elements to be valued was restricted and very often only two were deemed important in a given case. The process of choosing the elements to be considered always invited legal debate, but it also produced judicial principles of ascertaining the relevance and importance of the short list of elements as these items appeared in various situations. These principles should continue to be useful even in the expanded scope of *UOP* and they may prove helpful in refining any new elements of value which may appear in the future.

Emphasis on one or more elements of a corporation's economic flow has been in fashion at one time or another. Some analysts have concentrated on the dividend stream, others on the earnings stream. Still others, like the expert in *UOP*, have concentrated on the "cash flow." There is as little agreement among financial professionals about the proper definition of any particular stream as there is about which one or ones will best reflect the corporations's worth. Post-*UOP* litigation may produce some guidance about which are not useful in the squeeze-out situation. Certainly, the length of any stream to be measured will have to be fixed. Some arbitrary and simple rule may have to be adopted based on the facts of that case, such as the average of five years back and/or five years forward. Information that is much older than five years may not be relevant to a current valuation effort and any projection beyond five years is liable to be just a pure guess. An infinite

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projection of the stream clearly is not appropriate. Such an assumption is unrealistic from the perspective of the owner and its use would tend to produce unjustifiably skewed values. In the final analysis, the best rule might well be to use the most recent year of experience and project it for five years as did UOP's expert.

Financial projection under the block rule and modern financial practice requires a capitalization rate for determining the value of the stream under consideration. Slight shifts in the rate cause vast swings in the final value figure. There is probably little that courts can do themselves to make this selection process a more precise one. As under the block rule, eventually the courts will have to temper the professional estimates of the expert witness with their own common sense.

There is one particular area of the *UOP* approach which has the potential to vastly improve the current dilemma faced in valuing a corporation. Weighing the elements to reach a final value figure was highly subjective and unprincipled. The introduction of competing modern techniques of value analysis may finally lead the Delaware law to a formula or series of formulae which would permit identification of the discreet elements of value which could be combined into a single figure without going through a subjective weighing process.

Delaware has always shown a preference for earnings and assets as elements of value. Adhering to the block rule would forego the new avenues opened by the *UOP* rule. One way to integrate the positive attributes of both the block rule method and the *UOP* approach would be a valuation system which combines the active elements of the enterprise, the modern valuation techniques of *UOP*, rather than the highly subjective weighing approach, and any identifiable property not currently contributing to the economic stream of the firm valued according to conventional liquidation techniques.

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