LEGAL STANDARD OF FAIRNESS OF MERGER TERMS UNDER DELAWARE LAW

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INTRODUCTION

IT IS PROBABLY AXIOMATIC that when a board of directors considers a proposal to merge or otherwise combine the corporation with a second company, the board's principal consideration should be the fairness of the proposed merger terms to the stockholders of their corporation.

Whether such board consideration of the fairness of a proposed merger is subject to judicial scrutiny, and if so when and of what nature, are of course different questions. However, it now seems clear that the corporate law of many states, including that of Delaware, permits judicial scrutiny of the fairness of proposed merger terms in situations in which one of the constituent corporations to the merger controls or dominates the second corporation and the legal challenge is mounted prior to consummation of the transaction.[1] Judicial scrutiny is presumably considered appropriate in these circumstances because of the possibility that the proposed merger terms may not have arisen from the kind of arm's-length dealing that, in the normal functioning of the market place, is likely to produce a fair price.

The purpose of this article is to summarize the fairness doctrine and to analyze the financial and economic aspects of that doctrine as they have evolved under the law of Delaware, particularly in the context of mergers involving controlling and controlled companies.

APPLICABLE LEGAL STANDARDS UNDER DELAWARE LAW

Under most circumstances, a board of directors enjoys the benefits of the "business judgment" rule in Delaware. Its actions are presumed reasonable and a plaintiff must bear a heavy burden of

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1. Although the focus of this article is on state law, it should be noted that there is also an emerging body of federal law which may be moving in the direction of establishing a rule that "unfair" mergers may be challenged in federal court as being fraudulent or deceptive and hence actionable under Rule 10b-5.

showing lack of any business purpose, amounting to actual or constructive fraud, before a court will interfere with decisions reached by the board.[2] The "business judgment" rule is normally applicable to stockholder challenges to the fairness of mergers under Delaware law, with the result that a court will ordinarily not substitute its judgment for that of the boards of directors of the constituent corporations, who are presumed to have reached their bargain in good faith through arm's-length negotiation, unless the terms of the merger are so patently unfair as to shock the conscience of the court. The "business judgment" rule is especially applicable when stockholders challenge mergers which have already been consummated, alleging that the merger terms have made inadequate provision for the stockholders of the merged corporation. Even in situations in which one of the constituent corporations was controlled by the other, the stockholders' right of appraisal is felt to supply an adequate remedy at law for post-merger disputes which can reasonably be characterized as involving only the issue of value.[3]

There is, however, a general exception to the "business judgment" rule for situations involving self-dealing or similar conflicts of interest.[4] In the context of challenges to the fairness of merger terms, made prior to completion of the transaction, this exception may apply when one of the constituent corporations to the merger controls or dominates the other constituent corporation and there is some element of or potential for self-dealing in the transaction. In such a situation a Delaware court generally will not defer to the business judgment of the directors, nor will it accept as conclusive an independent opinion procured by those directors that the merger terms are fair and reasonable. Rather the court will examine *de novo* the terms of the merger to determine whether they are "intrinsically fair."

> [W]hen the persons, be they stockholders or directors, who control the making of a transaction and the fixing of its terms, are

2. *See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 722 (Del. 1971); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).

3. Singer v. Magnavox, Civ. Action No. 4929, October 26, 1976 (Del. Ch.); David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30, 36 (Del. Ch. 1971) [hereinafter cited as *Schenley*]. The judicial reluctance to interfere with a consummated transaction is, of course, not absolute. "[I]t has long been the settled law of this state that a merger may be set aside as fraudulent where the terms offered herein are so unfair to minority stockholders as to be shocking to the conscience of the courts." Stauffer v. Standard Brands, Inc., 178 A.2d 311 (Del. Ch.), *aff'd*, 187 A.2d 78 (Del. 1962). *See also, e.g.,* Cole v. National Cash Credit Ass'n, 156 A. 183, 188 (Del. Ch. 1931) ("The inadequacy must be so gross as to conclude that it was due not to an honest error of judgment but rather to bad faith, or to a reckless indifference to the rights of others interested.").

4. *See, e.g.,* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

> on both sides, then the presumption and deference to sound business judgment are no longer present. Intrinsic fairness, tested by all relevant standards, is then the criterion.[5]

Although the Delaware courts do not normally articulate the concept as such, the "intrinsic fairness" doctrine appears to be an attempt to use the process of an independent judicial review of the terms of the challenged merger as a substitute for the arm's-length negotiation that the courts presume to have been absent in situations involving controlling and controlled corporations.

Stated most simply, the "intrinsic fairness" doctrine holds that in a merger involving a controlling and a controlled corporation, the controlling corporation:

> (a) has the burden of proof, (b) to show that the transaction is fair, (c) after careful review by the court.[6]

Of these three elements of the "intrinsic fairness doctrine," the first and last involve procedural matters which are relevant in litigations invoking the doctrine and, as such, are beyond the purview of this article.[7] The substantive element of the doctrine — "that the transaction is fair" — can be analyzed as subsuming two separate concepts: fair dealing and fair price.

The concept of fair dealing examines the relationships between the parties. Deciding whether there has been fair dealing on the part of a controlling corporation involves consideration of the facts and circumstances surrounding the preparation, presentation and negotiation and stockholder approval of the proposed merger terms. For

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5. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430 (Del. Ch. 1968) [hereinafter cited as *Dunhill*]. The legal standards of the "business judgment" rule and the "intrinsic fairness" test might be viewed as two extremes on a continuum. The Delaware courts have formulated some intermediate positions. Thus, for example, if a transaction has been done in haste, a court may scrutinize the terms carefully even though granting some weight to business judgment. Gimbel v. Signal Companies, Inc., 316 A.2d 599 (Del. Ch.), *aff'd*, 316 A.2d 619 (Del. 1974). Similarly, there may be judicial scrutiny if the directors "can be said to have passed an unintelligent and unadvised judgment." Mitchell v. Highland Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933).

6. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 431 (Del. Ch. 1968). *See also* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952) [hereinafter cited as *Sterling*].

7. As suggested by the foregoing quotation, under the "business judgment" rule, the person challenging the transaction has the burden of proof to demonstrate unfairness and the court will exercise restraint in the sense that it will not lightly second-guess or interfere with the bargain arrived at by the parties. Under the "intrinsic fairness" doctrine, however, the burden of proof shifts to the defender of the transaction, and the court will display little hesitancy in examining the substance of the transaction in an effort to reach an independent judgment as to the merits. *Cf.* Harriman v. E.I. duPont deNemours & Co., 411 F. Supp. 133 (D. Del. 1975) [hereinafter cited as *Harriman*].

example, in order to avoid a claim that the controlling corporation has unilaterally dictated the terms of the merger or otherwise sought unfair advantage from its control position, it is common practice for the controlled corporation to appoint an independent negotiating committee composed of board members who are not affiliated with the other corporation, to charge that committee with the explicit function of representing the public stockholders and to have the independent negotiating committee retain independent investment bankers and legal counsel to assist in the negotiation and evaluation of proposed merger terms.[8]

Although the issue of fair dealing is often an important factor in judicial determination of "intrinsic fairness" of a proposed merger, the case law concerning this aspect of "intrinsic fairness" is beyond the scope of this article. Suffice it to say that, to the extent a court believes there has been fair dealing in the determination in the course of determining and obtaining stockholder approval of proposed merger terms, it should be more ready to accept the bargain struck by the parties and less willing to substitute its own judgment. Indeed, several Delaware cases suggest that if adequate procedures are utilized to neutralize the control position of the controlling corporation and prevent it from exercising its dominance and power over the controlled corporation (thereby effectively restoring an arm's-length bargaining situation), the court may, at least as a practical matter, revert to something more like the "business judgment" rule and may not be as ready to overturn the merger agreement unless its terms are so shockingly unfair from an economic point of view as to border on fraud.[9]

The second substantive aspect of the "intrinsic fairness" doctrine, and usually the more important, is that of fairness of price — *i.e.*, the economic and financial aspects of the proposed merger terms. Stated most simply, the question is whether the stockholders of the controlled corporation are receiving the "substantial equivalent in

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8. The issue of fair dealing may also encompass conduct prior to the merger — *e.g.*, has the controlling corporation used its dominance to the detriment of the controlled corporation and thereby reduced the economic value of the controlled corporation's stock. Alternatively, this aspect of fairness may be analyzed as going to fairness of price, since such pre-merger conduct may be alleged to have artificially affected the relative values being contributed to the combined enterprise resulting from the merger. *See* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 429-30 (Del. Ch. 1968); *cf.* Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374 (2d Cir. 1974).

9. Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971); Kaplan v. Centrex Corp., 284 A.2d 119 (Del. Ch. 1971). *Compare* Harriman, (independent committee appointed; merger found fair under Delaware law) *with* Collins v. Securities and Exchange Comm'n, 532 F.2d 584 (8th Cir. 1976) (independence of committee questioned; same merger found *not* reasonable and fair under Investment Company Act).

value" for their stock in the controlled corporation.[10] In a cash merger, the question of course relates solely to the value or range of value of the controlled corporation's stock.[11] In other mergers, the question analytically involves a valuation both of the stock of the controlled corporation being surrendered and of the stock (or other securities) of the controlling corporation being issued in exchange. In either type of merger, however, the question of fairness of price is essentially one of valuation.[12]

THE CONCEPT OF FAIR PRICE OR FAIR VALUE

The concept of fair price (or, as it is sometimes formulated, fair value), in the context of an evaluation of the fairness of a proposed merger, represents a determination which is economic or financial in character. Although the Delaware courts have not fully explained the nature of the economic or financial determination which is to be made, it appears from a reading of the cases that the basic principle is to determine what might be characterized as an idealized (or "inherent" or "true") fair value — *i.e.,* the price or price range at which a rational willing buyer and a rational willing seller would exchange the stock or other security in question in an arm's-length transaction, assuming that each had knowledge of all the relevant facts concerning not only the security in question and the issuer, but also other comparable securities and issuers.[13]

Given this conceptualized approach to the determination of fair value, it is easier in many ways to identify what the concept is not, rather than what it is. For example, as the cases make clear, the fair

10. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110–14 (Del. 1952).

11. *See* text at notes 56–57 *infra.*

12. The valuation of securities being issued or extinguished in a merger is also relevant to situations other than those involving application of the "intrinsic fairness" doctrine under Delaware law. The question of valuation may arise under the "business judgment" rule in the determination of whether proposed merger terms are so unfair as to warrant judicial intervention. The most common forum for the valuation of securities in a merger context is, of course, appraisal proceedings. Indeed, the Delaware decisions involving appraisals form one of the major sources of learning concerning the methods of valuation of securities for purposes of pre-merger challenges to the fairness of a proposed merger, and the Delaware Supreme Court has stated that the same valuation factors used in appraisal cases are to be used in cases involving the "intrinsic fairness" doctrine. Poole v. N.V. Deli Maatschappij, 224 A.2d 260, 263 (Del. 1966); 243 A.2d 69 (Del. 1968).

13. As such, the concept of fair price seems to assume that it is meaningful to attempt to ascertain such an abstract, "inherent" or "true" value, divorced from the perspective and perceptions of actual less than rational and fully informed buyers or sellers and divorced from the idiosyncrasies and influences of a less than rational marketplace for securities. Whether this assumption accords with rational economic and financial analysis — *i.e.,* whether it makes sense to seek fair value in the abstract — is obviously another matter, and one which is not here addressed.

value of a security is not simply its current or historical market value, nor is it simply a capitalization of historical or projected earnings per share, nor is it simply the equivalent of the asset values underlying the security. Rather, as the lower court opinion in one leading case explains:

> All revelant value of figures of both corporations may be examined and compared in order to arrive at a decision as to the fairness of the [merger] plan. Thus, while not determinative, the value of each corporation for various purposes, *e.g.*, going concern value, book value, net asset value, market value is pertinent to the issue presented.[14]

Although as the foregoing quotation suggests, the basic instruction of the Delaware cases is that a value determination should take into account all revelant facts and circumstances, the Delaware courts have identified certain principal factors or categories of analysis that should be analyzed and given due weight in arriving at a valuation of securities in the context of a determination of fair value. These factors are customarily discussed under the three principal categories of market value, earnings value and net asset value.

The next sections of this article discuss these principal factors in more detail. It should be emphasized, however, that the following discussion, as the case law on which it is based, is largely illustrative in nature. As stated above, the overriding principle of the law is that all factors relevant to a determination of fair price in a particular situation should be examined and given appropriate weight. Thus, the fact that in a given case a particular factor is viewed as being more or less important does not necessarily imply that it will or should have the same relative impact in another factual setting.

It should also be noted that there is no suggestion in the case law that all of the possible factors, consideration and comparisons must be favorable to the party seeking to establish the fairness of the merger. The courts do recognize, at least implicitly, that the determination of fair price requires a large degree of balancing and judgment and that there may be a range within which fairness can be found. Moreover, given the mandate to examine all relevant considerations, it would be unreasonable to expect that all valuation methods would produce a uniform result. Nor would it be appropriate or equitable to

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14. Sterling v. Mayflower Hotel Corp., 89 A.2d 862, 867 (Del. Ch. 1952). *See also* Poole v. N.V. Deli Maatschappij, 224 A.2d 260, 263 (Del. 1966): "The general rule is that in determining the actual value of stock, consideration should be given to the various relevant factors of value including earnings, dividends, market price, assets, and any other pertinent factors on a 'going concern' basis."

establish as a matter of law that stockholders of a controlled corporation are entitled to receive consideration equal to the largest amount that can be produced by application of any particular valuation procedure.[15]

MARKET VALUE

Market value is the price at which a stock trades, or would trade, in a representative market.[16] Several threshold judgments are inherent in a determination of market value, including selecting a time period over which the trading history will be examined, and ascertaining whether and to what effect extraneous factors have affected market prices.

There is no legally-required period over which to examine market price. Where no distortions or possible distortions in market prices are perceived, quite recent market prices may serve as the basis for a market value figure. For example, in *Harriman v. E. I. du Pont de Nemours & Co.*[16a] both the investment bankers, in preparing their fairness opinions in connection with a merger, and the court, in subsequent judicial review of the merger, averaged the daily closing price or closing bid for the stocks in question during the week preceding the merger announcement to determine the market prices of those stocks. Similarly, market price in one reported appraisal proceeding was determined by finding the average price for the six months preceding the tender offer that eventually resulted in a plan of merger.[17]

Where market prices are or may be distorted or affected by extranous conditions, longer time spans are often examined. Thus, the court *in David J. Greene & Co. v. Schenley Indus., Inc.*[17a] in refusing to enjoin a merger claimed to be unfair in part on the basis of a market price analysis, noted that the average market price of the controlled corporation's stock for the 18 months prior to the merger

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15. *See, e.g.,* Bastian v. Bourns, 256 A.2d 680 (Del. Ch. 1969) (share-for-share merger approved even though the controlled corporation showed higher earnings than the controlling corporation over the past five years; shareholders in controlled corporation unsuccessfully argued that, using a capitalization of earnings basis, they were entitled to more than one share in the exchange); Muschel v. Western Union Corp., 310 A.2d 904 (Del. Ch. 1973) (pro forma dilution in controlling corporation's earnings per share not conclusive on the issue of overpayment).

16. In appraisal value cases, Delaware courts require, if no market exists, a consideration of "reconstructed market value." *See, e.g.,* Application of Delaware Racing Ass'n, 213 A.2d 203, 211 (Del. 1965) (two years before trial, major shareholder offered to purchase outstanding shares of $1530; *held,* appraiser could conclude market value $1530).

16a. 411 F. Supp. 133 (D. Del. 1975).

17. *In re* Olivietti Underwood Corp., 246 A.2d 800 (Del. Ch. 1968).

17a. 281 A.2d 30 (Del. Ch. 1971).

approximately the consideration to be paid for the stock. Higher market prices in the preceding two-year period were explained as due to competing tender offers and were therefore not taken as good evidence of market value. This conclusion was reinforced by an examination of the market prices for six years preceding the tender offers, during which the stock's price (allowing for normal appreciation) approximated the merger price.[18]

The problem of identifying distortions or possible distortions in the public market place may go beyond selecting the appropriate time frame for consideration of market prices. Such factors may relate to the depth of the market itself, and thus to its reliability as a criterion in the process of determining fair value. In *David J. Greene & Co. v. Dunhill Int'l Inc.*,[18a] for example, the market in a controlled corporation's stock was thin and sporadic due to the large holdings of the controlling corporation, and the stock's trading price was not regarded as strong evidence of its market value.[19]

A second type of distortion which courts have identified as a reason for ignoring or discounting market value is the external pressure on a stock caused by buying campaigns on the part of others seeking to gain control of the target company. In *Sterling v. Mayflower Hotel Corp.*,[19a] *Hilton*, the controlling corporation, had owned a majority of Mayflower for six years. It had continued to make purchases of Mayflower stock during this period, and its desire to effect a merger was presumably well known. All parties conceded that Mayflower's market price was "higher than would be justified in a free and normal market uninfluenced by Hilton's desire to acquire [Mayflower stock] and its policy of continued buying,"[20] and Mayflower's market price was accorded no significance in the determination of the value of Mayflower stock. In *Schenley*, shareholders of Schenley, a controlled corporation, sued to enjoin a merger in 1971 on the grounds of unfairness. They argued the consideration offered by the controlling corporation was far lower than Schenley's 1968 market price. The court rejected the claim of underpricing, finding that in 1968 Schenley's price had been distorted by competing takeover bids.

Assuming a representative public market exists in the stock being valued, and giving due consideration to the nature of that market, its

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18. *Cf. Sterling* (market price for two years preceding trial noted, but concededly distorted; no further examination).

18a. 249 A.2d 427 (Del. Ch. 1968).

19. In fact *Dunhill* states that in such a situation "market value" as such may play no part in overall value determination.

19a. 93 A.2d 107 (Del. 1952).

20. Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952).

liquidity and any other actual or possible market distortions, it can be said that, in general, market price is probably the most important factor in determining fair value. This is because market price presumably represents what a willing seller would ask and a willing buyer would pay for the stock; it is thus viewed as being the most objective and ascertainable guide to "true" or "inherent" value.[21] Thus, while Delaware courts say with some degree of regularity that market value is not the only factor to consider in assessing whether or not the terms of a merger are fair,[22] the situations in which factors other than market price are given more weight are almost always those in which a representative market does not exist, because of lack of depth or other external factors.[23]

EARNINGS VALUE

Earnings value represents an attempt to capitalize the earnings stream of a company on a basis independent of the market for that company's stock. Traditional earnings value analysis begins by determining an appropriate earnings base and capitalizing such figure by selection of an appropriate price/earnings multiplier based on current data.

With regard to the earnings base figure, many cases conclude (or assume) that it should represent an historical average. Five years is considered the proper period over which to average earnings.[24] Extraordinary circumstances may warrant the use of figures for a shorter period,[25] but for the most part courts are not receptive to arguments that business uncertainties or management changes justify the use of either a longer or a shorter period. In one appraisal rights case, for example, the appraiser used earnings for two years only, citing instability in the coffee market as reason for omitting the three preceding years. The court held the omission unjustified, as there was no evidence that such market instability might not recur.[26] In another appraisal case, shareholders of Olivetti unsuccessfully urged

21. *See, e.g., Schenley* where the court relied heavily on the stock's trading history on the New York Stock Exchange to support its denial of an injunction.

22. The case most often cited as precedent for this rule, Chicago Corp v. Munds, 172 A. 452 (Del. Ch. 1934), was an appraisal rights case decided in the depression, when market prices were drastically depressed.

23. *See, e.g., Sterling* and *Dunhill.*

24. Universal City Studios, Inc. v. Francis I. duPont & Co., 334 A.2d 216 (Del. 1975).

25. *See, e.g.,* Stryker & Brown v. Bon Ami, Civ. No. 1945 (Del. Ch. March 16, 1975) (unreported; *reprinted in* PLI THIRD ANNUAL INST. ON SEC. REG. 573 (1972)) (shareholders of controlled corporation sought to enjoin merger; court examined consolidated balance sheet and income statement for just one year, finding the past separate histories of the companies not comparable).

26. Adams v. R.C. Williams & Co., 158 A.2d 797 (Del. Ch. 1960).

averaging of earnings for 13 years. For the five years preceding merger, Olivetti had been a controlled corporation and had shown annual losses. But in the eight years preceding acquisition of control, Olivetti had average earnings of $2.00 per share. Nevertheless, the court held the fact of prior profitable operation alone was not a reason for averaging 13 years.[27]

Although Delaware law is clearly weighted toward the use of an historical average to arrive at an earnings base figure, there is some support for also taking into account projected earnings, particularly if doing so would enhance the value of the stock of the controlled corporation. For example, in *Harriman* the major issue was the valuation of duPont stock held by Christiana, a closed-end investment company. As a relatively small part of its assets, Christiana owned 100% of the stock of a Wilmington newspaper. In assessing the fairness of the terms of proposed merger between Christiana and duPont, the court accepted in its entirety a valuation of the newspaper made by "a leading newspaper broker and recognized authority on the valuation of privately-held newspapers."[28] While the expert examined earnings over the last several years, his valuation involved multiples of gross revenues and projected net earnings, the latter higher than they had been in the past. The expert, the court noted, "concluded that a prospective purchaser would emphasize the potential, rather than actual earnings and revenues . . . particularly in view of operating inefficiencies he deemed readily remediable."[29] That projected earnings may be taken into account in determining earnings value is also suggested by another recent case, *Muschel v. Western Union Corp.*,[30] in which shareholders of the acquiring corporation sued to enjoin a merger, alleging overpayment and offering as proof pro forma dilution in earnings per share. The acquiring corporation offered and the court seemingly accepted five-year projected earnings for the combined operation which, it was argued, more than offset the initial dilution.

Some cases state that the earnings base figures may omit extraordinary items, although they do not clearly indicate whether the term is identical with the accounting concept. There is, however, some suggestion that items must be truly extraordinary if they are to

27. *In re* Olivetti Underwood Corp., 246 A.2d 800 (Del. Ch. 1968).

28. Harriman v. E. I. du Pont de Nemours & Co., 411 F. Supp. 133, 148 (D. Del. 1975).

29. *Id. See also* Universal City Studios, Inc., *supra* note 24, at 218 (appraisal; proper valuation "necessitates not only the Court's examination of historical earnings but also a perusal of the corporation's stability and future prospects as of the date of merger").

30. 310 A.2d 904 (Del. Ch. 1973).

be omitted from the earnings base figure. Thus, in *Gibbons v. Schenley Industries, Inc.*,[31] the Court approved the appraiser's inclusion of the gain from a sale of real estate in his computation of Schenley's average earnings, but excluded the capital gain from Schenley's sale of Buckingham Corporation, which held the exclusive franchise to market Cutty Sark:

> The record reveals that the Buckingham sale was not only a sale of a major branch of Schenley's business but on a scale many times larger than past extraordinary sales of assets. Thus, the appraiser listed extraordinary earnings from three previous sales occurring in 1964, 1965, and 1967 in which the earnings per share averaged $.36 on a non-diluted basis. Earnings per share on the Buckingham sale were $8.99 on a non-diluted basis, almost twenty-five times larger. They will be excluded from the averaging of earnings over the period in question. . . .[32]

On the other hand, in *Dunhill* plaintiffs challenging merger terms as inadequate argued that the earnings base figure should be increased to offset losses which Spalding regularly showed in its U.K. operations "because management's announced policy is to eliminate those losses."[33] While the court agreed in principle that past earnings might require adjustment, it characterized the argument as "based upon the most general of management objectives" and took "earnings as they are, and not as the parties would like them to be."[34]

As noted above, traditional earnings value analysis also requires selection of an appropriate current price/earnings multiplier to apply to the selected earnings base or bases. This selection is customarily made on the basis of a comparative analysis, in which the corporation is measured against similar companies with regard to price/earnings ratios, earnings per share, yields, percentage growth in sales and dividends, profit margins and such other figures and ratios as may be relevant to its particular type of business. An average current price/earnings ratio for the group is computed as of a date as close as practicable to the valuation date and the corporation in question is assigned a higher or lower multiplier depending on its performance as compared with that of the group.[35]

Even if it is assumed that the earnings base figure should be limited to an historical average, it seems clear that the selection

31. 339 A.2d 460 (Del. Ch. 1975).
32. Gibbons v. Schenley Industries, Inc., 339 A.2d 460 (Del. Ch. 1975).
33. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 433–34 (Del. Ch. 1968).
34. *Id.* at 434.
35. Alternatively, a range of current price/earnings ratios for the comparative group may be determined, and the corporation in question positioned within this range based on its comparative performance within the group.

of the proper price/earnings multiplier need not and probably should not be limited to a consideration of historical data. For example, in an appraisal case dealing with the valuation of a motion picture company's stock, guaranteed revenues over the four years after merger from contracts with television networks supported the appraiser's choice of a multiplier,[36] thereby indicating that favorable projections may warrant a higher multiplier than that which would be assigned solely on the basis of an historical average. Similarly, a reasonably foreseeable decline in future earnings may justify selection of a relatively low price/earnings multiplier. In *Schenley* the multiplier took into account a court-ordered divestiture by Schenley of a corporation which sold scotch whiskey. After divestiture, Schenley could continue to sell its major product, a large line of blended whiskies, but could offer only one brand of scotch. The court noted that Schenley's scotch market share would be reduced and, as blended whisky sales were generally declining, a decrease in earnings was probable. In addition, the choice of multiplier in *Schenley* did not reflect a recent increase in earnings due to a reduction in overhead; the court approved the adjustment, noting that the reduction in overhead "cannot be expected to recur annually."[37]

It is most important, when making a comparative analysis for the purpose of choosing a price/earnings multiplier, that the companies selected for comparison be similar as to products and risks of the business and represent a fair cross-section of the industry. In *Dunhill,* Spalding, an athletic equipment manufacturer, was compared by independent financial analysts with twelve other companies. Only three companies were across-the-board competitors; other competed with Spalding only to a limited degree, and others did not compete with Spalding at all, but were in the "broad recreational and leisure time field." The last group included companies which manufactured bicycles, boats, firearms and playing cards. Spalding's performance was below average within the group of twelve, a factor urged on the court by the controlling corporation to justify a low multiplier and, ultimately, the merger terms themselves. The court found that Spalding compared very favorably with the three companies that were direct competitors and only slightly less well with companies with which it competed to a limited degree. The poorly chosen comparison group was a clear factor in the court's decision to enjoin the merger.

36. Francis I. duPont & Co. v. Universal City Studios, 312 A.2d 344, 349–50 (Del. Ch. 1973); *aff'd,* 334 A.2d 216, 220 (Del. 1975).

37. David J. Greene & Co. v. Schenley Industries, Inc., 281 A.2d 30, 34–35 (Del. Ch. 1971).

Although the Delaware cases do not speak to the question, an earnings value analysis might also appropriately include methodologies in addition to or varying from the classic, if somewhat stylized, analysis described above, provided of course that such methodologies are appropriate and relevant to the basic issue of assessing the earnings power of a particular corporation. For example, a total yield approach, looking to dividends and capital appreciation in market value, either on the basis of historical figures or on the basis of projections, may in some cases be considered appropriate and desirable. In this regard, as is the case for all aspects of the determination of fair price, the key elements are that all factors bearing on the determination may be considered and that the relevancy and weight of such factors is not pre-ordained but depends upon all of the facts and circumstances of the particular case.

NET ASSET VALUE

The "net asset value"[38] component in stock valuation represents a judgment as to the value of a company's underlying net assets. While the basic concept of net asset value is relatively straightforward, the calculation of the figure, as well as its relevance, is less certain.

The first question is the standard which should be used in valuing net assets. A recent Delaware Supreme Court case establishes that "fair market value" of the assets is sought:

> Obviously, going-concern asset value is comparatively an ethereal concept, and the appraisal thereof is a highly speculative and conjectural process. We are satisfied that fair market value, so well formulated in the law of eminent domain, furnishes a more concrete and workable rule for appraisers, lawyers, and judges.[39]

By "fair market value," the Delaware courts mean the price that would be agreed upon by a willing seller and a willing buyer under usual and ordinary circumstances, after consideration of all available uses and purposes of the assets in question — in effect, a "highest and best" use concept. Given this definition of fair market value, it is not surprising that the cases reject asset valuations which assume distress sale circumstances or forced liquidations of the nature that might be encountered in bankruptcy.[40]

38. The term "net asset value" in this context should not be confused with the use of the term to represent book value. Book value is generally felt to be of little relevance in valuing stock. *See Sterling.* Book values, however, are sometimes taken into account, particularly in comparative per share analyses of equity mergers. *See* text *infra* at note 51.

39. Poole v. N.V. Deli Maatschappij, 243 A.2d 67 (Del. 1968).

40. *Id.* at 70; Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 112–14 (Del. 1952).

Whether fair market value is to be determined on the assumption of an orderly disposition of each individual asset or on the assumption of sale of self-contained segments or of the entire business appears to be a matter of judgment. In one case, the court accepted an expert's conclusion that tobacco field holdings could most expediently be valued on the basis of an orderly sale over five years. The estimated total revenues from the sales were then discounted back to their present worth as of the date of merger.[41] In *Harriman,* on the other hand, the court accepted without question an expert's valuation of a newspaper on the basis of its sale as a whole on a going concern basis.[42]

Another question with regard to net asset value relates to the manner of determining fair market value. In situations in which no independent market exists for the type of assets in question and in which the assets have not been or cannot practicably be subjected to formal independent appraisal,[43] various accounting figures are sometimes urged as evidence of fair market value. Replacement values are almost universally felt to be too high to be any proof of what fair market value would be. The artificial figure representing depreciated reproduction costs, commonly used for insurance purposes, often appears in the cases.[44] This may be due to the expense and difficulty of presenting other proof of fair market value. A depreciated reproduction cost figure is often a middle ground between replacement cost and book value.[45] But there is no indication that depreciated reproduction cost is the only relevant figure or, in fact, is required to be examined in each and every case.[46] Indeed, at least one recent Dela-

41. Poole v. N.. Deli Maatschappij, 243 A.2d 67 (Del. 1968).

42. Harriman v. E.I. du Pont de Nemours & Co., 411 F. Supp. 133 (D. Del. 1975).

43. Sterling, *supra* note 6, at 115, may be said to stand for the proposition that an investment banker is not required to conduct or obtain a formal appraisal.

44. *See, e.g.,* Heller v. Munsingwear, 98 A.2d 774 (Del. Ch. 1953); Root v. York Corp., 50 A.2d 52 (Del. Ch. 1946). Use of reproduction costs may become even more widespread, as under recently adopted amendments to Regulation S-X, the Securities and Exchange Commission now requires companies whose combined inventories and gross property aggregate more than $100 million and amount to 10 percent or more of their total assets to disclose in financial statements "the current cost of replacing inventories and productive capaity and the amount of cost of sales and depreciation if they had been computed on the basis of replacement costs." *See* Securities Act Release No. 5695 (March 23, 1976).

45. *But see* Root v. York Corp., 45 F. Supp. 436 (D. Del. 1942), in which preferred stockholders of an ice machinery company unsuccessfully sought an injunction in federal court against merger of their corporation on the grounds the terms were unfair. The court noted that while it had received evidence of book value and evidence of depreciated reproduction cost, it had received no evidence of "fair market value" — so it split the difference.

46. At least from a conceptual viewpoint, use of reproduction costs or depreciated reproduction costs to establish a net asset value would seem to imply use of the same measure in determining an earnings value. Otherwise, stockholders of the com-

ware case suggests strongly that depreciated reproduction costs may be irrelevant to a determination of net asset value.[47]

A third question is the role, if any, that earnings (historical or projected) play in determining net asset values under Delaware law. At least from an economic or financial viewpoint (particularly for an industrial enterprise) the fair market value of an asset is determined largely by the contribution it can make to the future earnings of the buyer. Thus the valuation process for an asset typically consists of analysis of its actual or potential earning power.[48] It was presumably for this reason that the parties to the proposed merger in *Harriman,* as well as the court, accepted an asset valuation of a newspaper business owned by Christiana based largely, if not entirely, on the capitalization of the enterprise's projected earnings.[49]

Recent leading Delaware valuation cases, however, take the unequivocal position that it is improper to take into account earnings power as a component of asset valuation, such component being relevant solely to a calculation of earnings value rather than net asset value. The Delaware Supreme Court has thus stated:

> Any allowance for earning power of the assets or value of the business, deemed necessary under the circumstances of a given case, is best left to the court's consideration of earnings as an independent element of stock value, and to the court's exercise of the weighting function.[50]

The foregoing discussion of the net asset value factor, particularly the refusal to allow any role to earnings values in arriving at a determination of asset values, leads to the larger question of the relevance and importance of net asset value in the determination of the fair value of a stock. This question was addressed in *Sterling,* one of the very first Delaware cases invoking the "intrinsic fairness" doctrine. The principal contention of the complaining stockholders of the controlled corporation was that they were entitled on the merger to receive securities of the controlling corporation with a market value

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pany whose shares are being valued will receive the best of both worlds: a high asset value component with an earnings value premised on lower book values of inventory and fixed plant and equipment.

47. Poole v. N.V. Maatschappij, 243 A.2d 67 (Del 1968).

48. As Justice Holmes said, "the commercial value of property consists in the expectation of income from it." Galveston, Harrisburg & San Antonio Ry. Co. v. Texas, 210 U.S. 217, 226 (1908). Such analysis is especially pertinent when there is no recognized market for the asset or for the type of asset involved.

49. It should be noted, however, that this valuation method premised on a capitalization of earnings was not questioned by the parties.

50. Poole v. N.V. Maatschappij, 243 A.2d 67 (Del. 1968).

equal to the liquidating value of their stock in the controlled corporation. The Delaware Supreme Court emphatically rejected this position:

> If plaintiffs' contention should be accepted it would follow that upon every merger of a subsidiary into its parent corporation that involves a conversion of the subsidiary's shares into shares of the parent, the market value of the parent stock issued to the stockholders of the subsidiary must equal the liquidating [*i.e.*, net asset value] value of the subsidiary's stock. On its face this proposition is unsound, since it attempts to equate two different standards of value. In the case of many industrial corporations, and also in the instant case, there is a substantial gap between the market value and the liquidating value of the stock; and to apply to the merger of such corporations the proposition advanced by plaintiffs would be to bestow upon the stockholder of the subsidiary something which he did not have before the merger and could not obtain — the liquidating value of his stock.[51]

The upshot of these difficulties with the concept of net asset value is that this factor is usually accorded significantly less weight than those of market value and earnings value in arriving at a determination of fair value.[52] This position, and some of the reasons for it, were summarized by the Delaware Supreme Court in *Sterling*:

> As we have already held, net asset value is one of the factors to be considered in determining the fairness of a plan of merger. But the requirement that consideration be given to all relevant factors entering into the determination of value does not mean that any one factor is in every case important or that it must be given a definite weight in the evaluation . . . . The relevant importance of several tests of value depends on the circumstances. Thus, in some cases net asset value may be quite important. . . . But in the case at bar it is of much less importance than the factors analysed in the [investment banker's] report. We are dealing here with corporations engaged in the hotel business, whose capital is invested largely in fixed assets. The shares of such corporations are worth, from the viewpoint of an investor, what they can earn and pay. A comparison of net asset values may have some weight, but it is of much less importance than demon-

51. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 111 (Del. 1952). *See also Poole*, in which the Delaware Supreme Court emphasized that, in determining the fair or true value of stock, plaintiffs were not entitled to an amount equal to the liquidating value of the corporation's assets without regard to market values and earnings values.

52. A different result may obtain in instances where substantially all of the assets of the controlled corporation are relatively liquid and there is a readily ascertainable market for such assets — *e.g.*, where the corporation in question is an investment company. In such a situation the uncertainties inherent in finding an appropriate measure of value for the assets, as well as the uncertainties involved in the process of liquidation itself, are not present and it may be possible to speak realistically about liquidation as a meaningful alternative to merger. *See, e.g., Harriman.*

> strated capacity of the corporation to earn money and pay dividends. In *Allied Chemical & Dye Corp. v. Steel and Tube Co. of America,* 14 Del. Ch. 64, 122 A. 142, Chancellor Wolcott, dealing with the relative importance of replacement costs and earning power as standards of value in connection with industrial property, expressed the view that earning power is by far the more important.[53]

More recently, the Court of Chancery concluded, in the context of the Schenley stock appraisal, that "asset value has little or no meaning in arriving at a determination as to the intrinsic value of the shares of corporate stock in issue." The court stated:

> [T]he investing and trading public, in reaching a judgment as to the value of corporate shares, gives consideration to corporate assets only insofar as they disclose a capability of generating earnings, a judgment exercised here, and I am satisfied that there is no possible means of arriving at an approximation of the value of Schenley's assets as generators of earnings as of the time here in issue, when Schenley had an overvalued inventory, containing a number of unpopular brands and most of its twenty-nine distilleries and related plants were closed down. Accordingly, an appraisal of its assets as of such time would not, in my opinion, have served as a basis for reliance by a would-be investor in Schenley stock as of the time immediately prior to the merger here in issue, and will be given no weight here.[54]

COMPARATIVE PER SHARE ANALYSIS

Although rarely examined specifically in the Delaware case law, an important dimension of an investigation of fair price is the nature of the consideration being received by stockholders of the controlled corporation. In many mergers, this consideration takes the form of equity securities (often common stock) of the surviving corporation. In such cases, an evaluation of fairness of price probably neither can nor should end with isolated examinations of each of the two stocks involved (*i.e.,* the stock of the controlled corporation being surrendered and the stock of the controlling corporation being issued in the merger exchange). Rather, because the securities involved in the exchange are comparable in nature (that is to say, they admit of the same modes of analysis) and because the stockholders of the controlled corporation will continue to have an equity participation in the combined enterprise, a comparative per share analysis should be made, including examination of the two securities, of the contribution

53. *See* note 48 and accompanying text *supra.*
54. Gibbons v. Schenley Indus., Inc., 339 A.2d 460, 472-73 (Del. Ch. 1975).

being made by each constituent corporation to the combined entity and of the pro forma combined effects of the merger. This type of comparative analysis typically includes a review of per share data (such as market, earnings and asset values) for each stock on an historical basis and on a pro forma combined basis, in each case taking into account the proposed exchange ratio. If properly conducted, such a comparative per share analysis should offer considerable insight into the comparative values of the two securities and the relative contributions being made by each of the constituent corporations to the combined enterprise, as well as the ultimate question to be decided — whether the proposed exchange ratio fairly reflects such comparative values and relative contributions.

The desirability of using such a comparative analysis method as part of the valuation of the fairness of a merger involving a stock-for-stock exchange was emphasized in *Sterling*. There, as noted above,[55] plaintiffs' principal argument was that they were entitled to receive stock of the controlled corporation with a value equal to that of the net assets underlying their stock in the controlled corporation. The Delaware Supreme Court, in rejecting this argument, stated that the proper issue to be resolved was one of comparative values and comparative contributions to the combined enterprise, and in fact relied in large part on a comparative per share analysis based on a report prepared by a financial advisor to the controlling corporation, which included comparative average earnings, dividends, book values and market prices per share.[56]

The polar extreme to a merger involving solely an exchange of equity securities is, of course, a merger in which the stockholders of the controlling corporation receive only cash; the middle range involves virtually infinite combinations of forms of consideration including straight debt, convertible securities and straight preferred stocks. Except in situations where the form of consideration is predominantly equity in nature,

55. *See* text at note 51 *supra*.

56. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 111–13 (Del. 1952). *Cf.* Cole v. National Cash Credit Ass'n, 156 A. 183 (Del. Ch. 1931), extensively referred to in *Sterling*. *Cole* addressed the issue of net asset valuation, rather than overall analytic standards in a stock-for-stock merger, but strongly suggests consideration of compartive contributions in such mergers. In *Cole*, preferred shareholders of National Cash Credit Ass'n, one of the constitutent corporations in a three-way merger, sought to enjoin the merger, claiming their corporation's assets had been undervalued in determining exchange ratios. Thus, they argued, the value of the assets underlying their shares would decline were the merger to be effected. Although the court did not find undervaluation on the facts, it characterized the issue as:

> whether or not they as stockholders in one of the constituents are to receive in exchange for their present holdings, stock which has a value commensurate with the asset contribution which their company is making to the common pool.

Id. at 187.

the two premises underlying a comparative evaluation method — comparability of the security being surrendered with that being received and continuing equity participation in the combined enterprise — are usually missing. Accordingly, in such non-equity mergers it often will not be feasible or appropriate to conduct an extensive comparative evaluation. For example, if the merger terms contemplate an exchange of stock in the controlled corporation for straight debt of the controlling corporation, what is there to compare beside yield figures, such as dividends versus interest rate?[57] It certainly does not seem particularly meaningful to compare historical and pro forma earnings values, since earnings value is not directly relevant to an evaluation of a fixed income security (except, of course, in its more general aspect as a component of creditworthiness). The same, of course, is true of asset values.

That an extensive comparative analysis need not be made in such non-equity mergers is also supported (at least by negative inference) by the Delaware case law. Without exception, the cases discussing comparative per share values involve equity mergers, whereas no mention of such analysis can be found in the cases dealing with non-equity mergers. These considerations lead to the conclusion that the detailed comparative analysis of the securities involved in the merger exchange or of relative contributions to the merged enterprise is not required under Delaware law for non-equity mergers and that in such non-equity mergers the inquiry should focus principally on establishing the independent (*i.e.*, non-comparative) fair value of the consideration being surrendered versus the independent fair value of the consideration being received.

VALUATION OF DEBT, PREFERRED STOCK AND CONVERTIBLE SECURITIES

As suggested by the foregoing discussion of comparative per share analysis, in the vast preponderance of Delaware cases involving the issue of fair price in merger situations and securities valuation in general, the securities in question have been common stocks. In part this reflects the prevailing pattern of using common stock of the surviving company as the currency for merger exchanges, but it also no doubt reflects the assumptions of many potentially dissident stockholders that, as it is relatively easy to value such other forms of securities, their

57. In *Schenley,* minority shareholders were offered debentures and a small amount of cash for their stock. The court, in determining the fairness of the terms, compared the yield to the stockholder from his present stock dividend with the yield from interest on the debenture. No other comparisons were made by the court and one assumes that none were offered by the parties.

value is not an appealing issue for litigation. Whatever the reason, the result has been that the Delaware case law is relatively undeveloped regarding particular methods for valuing other securities, such as straight debt, straight preferred stock and convertible securities.

Within the financial community, however, relatively standard financial practices have evolved for the valuation of fixed income and convertible securities. These practices apparently underlie the valuations found in the few Delaware cases dealing with such securities.[58] These cases suggest that straight debt and straight preferred stock should be valued by comparing their yield with the yield on similar securities of other comparable companies of the same level of creditworthiness, as well as by reviewing the market value for the security in question and similar issues.[59]

Convertible securities, as a general rule, should not be valued below the stock into which they are convertible. Thus, for example, in *Gibbons v. Schenley*[60] the controlled corporation argued in an appraisal proceeding that holders of convertible preferred stock were entitled to not more than the liquidation value of their shares. By the terms of the certificate of incorporation, however, the preferred was convertible into 9/10 of a share of common, and the court insisted upon a higher valuation based on that conversion ratio. With the underlying common stock value as a floor figure, the valuation of convertible securities would then rest on a comparative yield, creditworthiness and market price analysis similar to that involved in a straight debt or straight preferred stock valuation.

In some circumstances, a convertible security may be viewed as the equivalent of common stock. *Dunhill* involved a valuation of a preferred stock which was convertible into 1.6 shares of common stock. The court considered the relatively short call protection (6 months) on the preferred and the higher dividends paid on the preferred as compared with the dividend on 1.6 common shares, and concluded that:

> should the merger be consummated, there would be good reason for Dunhill to redeem the new preferred . . . and so eliminate the . . . dividend. Since the higher yield on the proposed pre-

58. This is not surprising, considering both the precept of the Delaware law that all *relevant* considerations to a determination of value should be taken into account and given due weight, and the weight often given to expert opinion regarding the methodology to be followed in securities valuation.

59. In *Schenley*, an expert valued the straight debenture involved in the merger at 70% of face value. he court considering the history of another debenture issue of the company's took an 80% figure.

60. 339 A.2d 460, 473 (Del. Ch. 1975). In *Schenley*, an earlier challenge to the merger on the grounds of unfairness, the 9/10 ratio was stipulated.

> ferred vis-à-vis the Dunhill common is assured for a relatively short time only, it is reasonable to conclude that one share will be substantially equal in value to the 1.6 shares of Dunhill common.[61]

This approach of valuing a convertible security as a common stock equivalent would also seem appropriate for cases where it was expressly designed as such (*e.g.,* a convertible preferred stock convertible on a one-for-one basis and bearing the same dividend and vote as the underlying common stock) or traded as such because the underlying common stock price exceeded the conversion ratio.

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61. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 432 (Del. Ch. 1968).