because the market has already discounted the stock price to reflect the minority's inability to protect itself.

As earlier noted, the empirical evidence suggests that, as insiders approach *de facto* control, the value of the public shares seems to decline.[225] Thus, the market value of the publicly held shares just prior to a merger does not represent a neutral, unbiased estimate of corporate value. Indeed, it requires perversely circular reasoning to use a price, that is affected by the existence of a controlling shareholder, to determine what the minority should receive if they dissent from a transaction dictated by that controlling shareholder.

D. *The Case Against Proportionate Value*

Some economists argue that the appraisal remedy should award the minority only the market value of their shares prior to the time that the new controlling shareholder made its investment.[226] Focusing particularly on "going private" transactions, where former managers effect a leveraged buyout that "freezes out" the public shares, Hermalin and Schwartz argue that "investment will be suboptimal unless the appraisal price is set to allow the majority to capture, on the margin, the value that its investment yields."[227] Their concern is basically that potential controlling shareholders will not undertake sufficient efforts to identify companies that they can improve through their efforts, unless they can capture all the returns from these efforts.[228]

This analysis works, however, only by ignoring alternative and more realistic scenarios under which controlling shareholders seek to exploit the private benefits of control. Professors Hermalin and Schwartz specifically "assume that the majority want to make an investment that

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[225]*See supra* text accompanying notes 196-208.

[226]*See* Hermalin & Schwartz, *supra* note 3, at 360-64. *See also* Easterbrook & Fischel, *supra* note 1, at 731 (discussing appraisal statutes codifying this rule).

[227]Hermalin & Schwartz, *supra* note 3, at 355.

[228]This belief that inadequate search activity will hamper the market for corporate control and interfere with economic efficiency has been advanced by Professor Schwartz in the related context of managerial resistance to takeovers. *See* Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. & ECON. & ORGANIZATION 229 (1986). One reply to this argument has been that target resistance increases target shareholder gains and indirectly increases the total incentives for all bidders to search. *See* David Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 724 (1987). Clearly, the two contexts have much in common, and the major difference may be that the need to reward search activity is considerably less when the prospective acquirer is the company's own senior management.

will increase value, and also may want to exclude the minority."[229] This, however, assumes what is to be proven and seems inconsistent with the evidence that share prices fall as the control block is assembled. Such a pattern of falling prices is certainly consistent with a market expectation of opportunistic behavior by the new controlling shareholder. In support of their position that buyouts are invariably benign, they argue that the market price should not fall below the preinvestment value of the firm.[230] Specifically, they make three very aggressive claims: (1) "the difficulty of identifying strategies a majority could pursue that would depress the [market] price" makes it unlikely that insiders could attempt such a course of action;[231] (2) it "is unlikely that firms will do freeze-outs to exploit temporary undervaluations of the stock price;"[232] and (3) the market price will "commonly" equal the firm's intrinsic value.[233] They defend the first two claims largely by noting that litigation might be commenced if the squeeze-out was effected at an unfairly low price. Indeed, it might, but the available evidence suggests that securities litigation is typically resolved at a small fraction of the plaintiffs' legal claims.[234] Thus, if defendants will be forced to pay only ten percent or so of this undervaluation to settle these law suits, much of which will be paid in the form of plaintiffs' attorney fees, securities litigation hardly constitutes a strong deterrent. Their final claim, that the market price will not deviate far from intrinsic value, ignores that insiders often possess nonpublic material information that can be profitably exploited[235] while

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[229]Hermalin & Schwartz, *supra* note 3, at 355.

[230]*Id.* at 362.

[231]*Id.*

[232]*Id.* at 363.

[233]Hermalin & Schwartz, *supra* note 3, at 363.

[234]The most recent and complete analysis of securities class actions surveyed 656 class actions that were settled, resolved, or dismissed between January 1991 to December 1994. Using estimates of plaintiffs' own damages prepared by plaintiffs' own expert witnesses, it computed the ratio between the actual settlement or verdict and the maximum damages alleged, estimating that the average securities class action settled for 12.25% of plaintiffs' alleged damages. *Id.* The median settlement was only 10.26% of such damages. *See* Frederick Dunbar et al., *Recent Trends III: What Explains Settlements in Shareholder Class Actions*, NAT'L ECON. RES. ASSOCS., June 1995, at 4 & Table 3a. Other studies using smaller data bases have reached other estimates, both higher and lower, but none find anything approaching the majority of the investor's loss being restored by litigation. *See, e.g.*, Janet C. Alexander, *Do the Merits Matter?: A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

[235]This ability to exploit "inside" information is entirely consistent with the conventional "semistrong" theory of stock market efficiency. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593 (1984).

also failing to account for the recurring pattern under which the corporation's stock price varies with the concentration of its ownership.[236]

Perhaps what is most missing from Professors Hermalin and Schwartz's critique is any sensitivity to institutional detail. The claim that forcing the prospective control seller to share synergy gains will block efficient transactions is a well-known one and has long been used by critics of an equal opportunity rule. Stripped to its essentials, the traditional argument has been that unless the acquirer can bribe the incumbent control group to transfer control, thus, surrendering the private benefits of control, superior management teams will not be able to replace inferior ones. As so stated, this argument has an undeniable logic: the control buyer thinks it can realize greater value from the same assets and is willing to pay a premium for the chance to do so. But when this same argument is generalized and applied to the buyout context, a critical institutional fact is ignored: it is now the incumbent management team that is assuming full control; there is no transition in management. This point has two implications: (1) no payment is logically needed to cause them to surrender the private benefits of control because nothing is necessarily surrendered, and (2) search costs are inherently low. Although outside bidders may need the expectation of substantial rewards to engage in a costly search for potential targets, insiders are inherently in possession of nonpublic information about their own company. In short, the case for denying the minority a share of synergy gains in this context is inherently weaker.[237]

By the same token, the special context of public corporations is one in which the prospect of inefficient control transactions is also more remote than in the closely held corporation context. The ability to receive excess compensation and/or engage in unfair self-dealing can only account for a small portion of the control premium.[238] But one danger does remain: that of the exploitation of asymmetric information.[239] For

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[236]*See supra* text and accompanying notes 198-208.

[237]The one valid argument in favor of increased incentives is that the management control group will assume greater risk in making the buyout. Entitling them to all the prospective synergy gains does certainly compensate them for assuming this risk; however, excess compensation may give them an incentive to undertake overly risky transactions that can have social costs.

[238]By one estimate, this portion is between 3 and 4% of the corporation's value. *See supra* note 178.

[239]Easterbrook & Fischel, *supra* note 1, at 730 (discussing going private transactions and the hostile use of inside information by the majority to "cheat" the minority). As even Professors Easterbrook and Fischel conceded, a corporation may receive information regarding a future business transaction. *Id.* Because this information is not reflected in the value of the stock, wealth will be transferred to the controlling shareholder by freezing out the minority,

example, assume that the managers of a firm recognize, based on their access to material nonpublic information, that the firm has an opportunity to undertake a major strategic investment that should double its value. Rather than immediately undertake this strategic investment on behalf of their shareholders, they instead elect to structure a leveraged buyout that "freezes out" the minority.[240] Such use of asymmetric information represents a form of insider trading, but it is less likely to be prosecuted because, by taking the company private, the defendants eliminate any aftermarket stock price that can demonstrate that material information was withheld from the former shareholders.

Not all cases fit this simple pattern. Sometimes, the control group seeking to effect the freeze-out transaction may have a strategic plan before it makes its initial investment in the firm. Other times, the control group may have only a vague, indefinite or contingent plan until they acquire a substantial stake in the firm which allows them access to material nonpublic information about it.

Across this continuum of possible cases, the critical issue should be: who has the property right in the information that motivates the control group's desire to take over the firm and eliminate the noncontrolling shareholders. Hermalin and Schwartz implicitly view squeeze-out transactions as ones in which controlling shareholders own the intellectual property that they wish to exploit, but this undefended assumption does not apply in all cases. The more that the plans and investment strategies of the insiders rest upon nonpublic information acquired from their own corporation, the more that the minority shareholders can be said to have suffered a double injury. First, valuable information was misappropriated from their firm.[241] Second, they are then cashed out at a price that does not reflect the true value of their investment.[242]

The more ambiguous cases arise when the control group recognizes a strategic opportunity to change the firm's investment or financial policies because of new developments (without misappropriating inside information from the firm), but then develops and refines this strategy

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even though wealth has not actually been created. *Id.* In short, the transaction does not promote efficiency.

[240]The price at which the buyout occurs (i) reflects the manager-shareholders preexisting concentrated ownership, thus, initially depressing the stock market value, and (ii) does not reflect the undisclosed information, which may be a very "soft" sense that market conditions are improving.

[241]Michael R. Schwenk, Note, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 687 (1994).

[242]*Id.*

based on nonpublic information acquired from the firm. Often the exploitation of this new opportunity may fall within the scope of a corporate opportunity.[243] Even when it does not, insiders still owe a fiduciary duty to their minority shareholders to disclose information about any hidden value in the firm's assets prior to purchasing the firm's shares from them. Ultimately, the control block's legal and normative entitlement to use nonpublic information is nonproblematic solely in the special case where they have developed their plans before assuming the role of fiduciaries to the other shareholders. In reality, access to nonpublic information about the firm may be the most important private benefit of control.

In sum, the "going private" phenomena can be explained in terms of two very different rationales. The first sees the buyout as the product of a desire by one group to exploit a business opportunity that requires the elimination of the minority; the second explanation views the same transaction as more likely to involve the exploitation of nonpublic information and the usurpation of business opportunities belonging to the corporation being taken private. Whatever the likely ratio between these two archetypal transactions, many actual cases will involve elements of both. Sensible public policy must recognize the simple reality that each is possible. This, in turn, implies that the concept of "proportionate value" needs to be defined to accommodate the former, while chilling the latter.

PART III: TOWARDS IMPLEMENTATION: THE MEANING OF FAIR PRICE

Standing alone, the appraisal remedy cannot begin to assure the receipt of proportionate value. Not only is the appraisal remedy costly to exercise and thus generally unavailable to small shareholders, but it is subject to broad exceptions, such as Delaware's stock market exception,[244]

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[243]To the extent that it does, Thorpe v. CERBCO, Inc., No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996), serves as a reminder that even a controlling shareholder, holding a clearly blocking position, still owes a duty of loyalty requiring full disclosure. *See supra* text and accompanying notes 86-98.

[244]*See* DEL. CODE ANN. tit 8, § 262(b) (1974 & Supp. 1992). As of the mid-1970s, some 20 states had followed Delaware and similarly enacted a stock market exception to the appraisal remedy. However, some of these exceptions are much broader than the Delaware statute. *See* Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023, 1024 (1976). The stock market exception forces stockholders to agree to a corporate action or sell their shares on the open market. *Id.* Prior to this, a dissenting stockholder could demand that their stock be appraised, later requiring the corporation to "purchase" their stock at the appraisal value. *Id.* at 1023

which render the remedy inapplicable in a wide range of cases. As a practical matter, however, shareholders may be able to outflank this problem by asserting a class action because the Delaware appraisal remedy is not always exclusive.[245] A class action also has the procedural advantage of covering all shareholders within the class who do not opt out, thus providing a remedy for smaller shareholders who cannot afford to retain their own counsel.

Since the *Weinberger* decision in 1983, Delaware courts have authorized such proceedings and required a controlling shareholder who effects a squeeze-out merger to demonstrate two critical elements: fair dealing and fair price.[246] Although Delaware decisions have clearly articulated the procedural steps that should be taken to demonstrate "fair dealing," the substantive valuation standards that should be applied in determining "fair price" remain more uncertain. At its outset, this article suggested that "fair value" in appraisal and "fair price" under *Weinberger* should be integrated and given functionally equivalent meanings. This assertion raises two obvious questions: (1) can the two be equated?, and (2) what should their common meaning entail?

The doctrinal obstacles to an integrated definition do not seem insurmountable. In the *Technicolor* litigation, Chancellor Allen offered a basic formula for valuation:

> The components of value in an acquisition might be considered to be two: the going concern value of the firm as currently organized and managed and the "synergistic value" to be created by the changes that the bidder contemplates, (e.g., new management, cost efficiencies, etc.). . . . It is the expectation of such synergies that allows a rational bidder to pay a premium when he negotiates an acquisition.[247]

(citations omitted).

[245]Fischel, *supra* note 218, at 898-99 (discussing when appraisal is an exclusive remedy and under what circumstances courts will allow a broader range of relief).

[246]*See, e.g.*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *Lynch I*, 638 A.2d at 1115-17.

[247]Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134, 1143 (Del. Ch. 1994), *aff'd*, 663 A.2d 1156 (Del. 1995). Chancellor Allen did not take heed of the possibility that the private benefits of control could justify a premium; however, he was dealing with a 100% acquisition. See also Woo, *supra* note 110, for a discussion of the *Cinerama* decision.

Finding that there has been "a more than 'fair' allocation of synergy value to the sellers,"[248] Chancellor Allen defined "fair price" as follows:

> A fair price does not mean the highest price financeable or the highest price that [a] fiduciary could afford to pay. At least in the non-self dealing context, it means a price that is one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.[249]

Read broadly, this definition is problematic for two reasons. First, it seems to define "fair price" in terms of a fair process.[250] So viewed, the "fair price" element redundantly overlaps with the "fair dealing" element. Second, having noted that synergy gains are distinct from intrinsic value,[251] it provides little guidance by which to determine whether a fair allocation of synergy gains has been made to the minority.

However, on its facts, *Technicolor*'s approach makes perfect sense because the case involved a 100% acquisition by an unaffiliated purchaser.[252] Where there is a high premium and no conflict of interest, the court need not look past the point where it sees some portion of the synergy gains going to the seller.[253] The outcome of such arm's-length negotiations presumptively represents a reasonable business judgment, which does not need, nor normally receive, close judicial scrutiny. From this perspective, integrating the standards applicable to the appraisal remedy with those applicable to normal corporate governance could actually lead to reduced judicial scrutiny at the appraisal stage.

This approach still leaves "fair price" undefined in the more sensitive insider buyout or squeeze-out context, where a fair process cannot be assumed. Here, the principal uncertainty has surrounded whether Delaware law looks to the "third party value" that an unaffiliated bidder would have paid for the company, even though a controlling shareholder is present.[254] Although this standard has clearly been given

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[248]*Cinerama*, 663 A.2d at 1143. This language does suggest that allocation of some portion of the synergy value to the minority shareholders is necessary to meet the "fair price" standard.

[249]*Id.*

[250]In reading Chancellor Allen's view broadly, fair price may be defined as an offer that a reasonable seller could accept.

[251]*Id.*

[252]*Id.* at 1135.

[253]*See Cinerama*, 663 A.2d at 1135.

[254]Some commentators view the "third party" standard, under which the corporation's

weight in some cases, other decisions have seemingly rejected it in favor of a "going concern" analysis.[255] Of course, this is also the context that *Mendel v. Carroll*[256] addressed, in which Chancellor Allen found that the "third party" price could be too high because it necessarily included a control premium that the control group did not need to pay.[257]

From an economic perspective, the problem in the use of any third party standard is that it necessarily incorporates a substantial share of the expected synergy gains. Yet, this is how things normally play out in the real world. As Chancellor Allen recognized in *Technicolor*, a hypothetical willing buyer, negotiating at arm's length, would normally pay some portion of the synergistic gains that it believes the acquisition of the target would create in order to secure the consent of the target's shareholders.[258] Still, economists have responded that, efficient transactions are discouraged to the extent that such a synergistic element is incorporated into the legal definition of "fair value" or "fair price," either at the appraisal stage or in a *Weinberger*-type class action.[259] The irony here is the "efficient" standard that these economists recommend can only be realized in buyouts and other self-interested transactions where arm's-length bargaining is not truly possible. Yet, the goal behind judicial oversight of these transactions is to mimic the outcomes under truly disinterested bargaining. If legal rules should mimic the actual market, they cannot do so by excluding synergy gains from the valuation formula.

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fair value is set equal to the highest price that a third party would pay for it, as the principal alternative to proportionate value. *See* Schwenk, *supra* note 241, 675-76 (citing Harris v. Rapid-American Corp., 603 A.2d 796 (Del. 1992)); Van de Walle v. Unimation Inc., [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,834 (Del. Ch. Mar. 6, 1991), *reprinted in* 17 DEL. J. CORP. L. 390 (1992) (discussing the various methods of valuation used in Delaware). *See also* Boyd Dyer, *An Essay on Federalism in Private Actions Under Rule 10b-5*, 1976 UTAH L. REV. 7, 13 (discussing federal securities rules and relevant case law in the context of squeeze-outs).

[255]*See* Schwenk, *supra* note 241, at 676 (citing Cede & Co. v. Technicolor, No. 7129, 1990 Del. Ch. LEXIS 259, at *66-67 (Del. Ch. Oct. 19, 1990)); Bell v. Kirby Lumber Corp., 413 A.2d 137, 140 (Del. 1980) (rejecting a third party standard). In *Citron v. E.I. DuPont de Neumours & Co.*, the Delaware Chancery Court refused to consider the price that a third-party purchaser was willing to pay for all the stock of a subsidiary controlled by DuPont, in part because the majority shareholder had no intention of permitting such a sale. Citron v. E.I. DuPont de Neumours & Co., 584 A.2d 490 (Del. Ch. 1990). *But see In re* Shell Oil Co., 607 A.2d 1213 (Del. 1992) (recommending the appointment of a neutral expert by the court, *particularly* in valuation matters).

[256]651 A.2d 297 (Del. Ch. 1994).

[257]*See supra* text accompanying notes 134-65.

[258]*Cinerama*, 663 A.2d at 1143.

[259]*See* Hermalin & Schwartz, *supra* note 3; *supra* text accompanying notes 243-58.

Where then should the line be drawn? If one wants both to avoid discouraging outside bidders by employing an unduly generous standard for the "fair value"/"fair price" determination and deny insiders the ability to exploit asymmetric information that belongs properly to the firm and its shareholders, the most sensible line is to deem synergistic gains as a necessary element of fair value *only* in the case of insider buyouts and squeeze-outs and *only* when the buyer had access to the target corporation's confidential business plans and projections in framing its proposal. Implicitly, Delaware decisions seem already to have recognized this distinction.[260] The precedent most clearly on point is probably Chancellor Allen's original appraisal decision in the *Technicolor* litigation, in which he remarked:

> It would be apparent I suppose that had . . . [the bidder] negotiated a one-step cash merger, its particular plan for the company after the merger would be irrelevant to the "fair value" of a dissenters['] stock on the date of the merger. That would surely be the case when those plans were a close secret, but it should be no less true if those plans become known after the acquirer signed a merger agreement and closed on its first-step tender offer.[261]

Essentially, this is a statement that the buyer's projected synergy gains are none of the seller's business, except when they are based upon confidential business information appropriated from the seller.

This analysis still leaves other cases undecided. For example, when the squeeze-out proposal comes from an existing management team, synergistic value is arguably an appropriate element of "fair value" or "fair price," because the new investment proposal almost inevitably was developed based on management's access to nonpublic information that properly belonged to the company and its shareholders. Confidential business information has long been "a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy."[262] Some equitable allocation of the potential synergistic gains

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[260] *See, e.g.*, Cede & Co. v. Technicolor, No. 7129, 1990 Del. Ch. LEXIS 259 (Del. Ch. Oct. 19, 1990).

[261] *Id.* at *67-68.

[262] Carpenter v. United States, 484 U.S. 19, 26 (1987) (quoting 3 WILLIAM M. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 857.1, at 260 (rev. ed. 1986)). *See also* Ruckelshaus v. Monsanto Co., 467 U.S. 986, 1001-04 (1984) (holding that trade secrets are property rights protected by the takings clause of the Fifth Amendment).

between the management team and the corporation is appropriate in such cases, and logically the burden should be on the fiduciary to demonstrate the fairness of the actual allocation. Essentially, this is the rationale underlying the American Law Institute's position that in appraisal cases involving buyouts and squeeze-outs, "the court may include a proportionate share of any gain reasonably to be expected to result from the combination, unless special circumstances would make such an allocation unreasonable."[263] Yet, in arm's-length transactions, the ALI Principles accord a strong presumption to any price accepted by the board of the corporation.[264] Hence, the dissenting shareholder has no legal claim to share in the synergy gains resulting from such an arm's-length transaction.[265]

Of course, intermediate cases exist, such as the familiar two-step acquisition sequence, in which the acquirer first buys control and then effects its squeeze-out merger. As Chancellor Allen implicitly recognized in *Technicolor*,[266] the critical issue should be whether the bidder used material nonpublic information about the target. If not, synergistic gains should not be an element of fair price. Effectively, this compromise parallels the SEC's position in Rule 13e-3, which exempts, from its rigorous "going private" rules, two-step transactions pursuant to a plan and at a price announced at the outset.[267]

Of course, the objection can still be voiced that this approach will at the margin dissuade some management teams from making some buyouts because they could be required to incorporate an element of the expected synergistic gain into their buyout price. But this perspective is incomplete. From a more fully *ex ante* perspective, the proposed rule also chills the incentive to misappropriate information from the firm or to usurp corporate opportunities. In effect, the corporation's right to the exclusive possession of a form of corporate property, such as confidential information, is better protected. Managerial and shareholder interests are thus better aligned, and agency costs are reduced. With the corporation's property rights better protected, the management team also has a greater incentive to pursue a new opportunity in the name of the corporation rather than to structure a buyout to exploit it.

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[263]*See* AMERICAN LAW INSTITUTE, *supra* note 1, § 7.22(c).

[264]*See id.* § 7.22(b).

[265]Of course, the target corporation may negotiate a share of such gains, when it can value them, based on its blocking position.

[266]*See* Cede & Co. v. Technicolor, No. 7129, 1990 Del. Ch. LEXIS 259 (Del. Ch. Oct. 19, 1990).

[267]*See supra* text accompanying notes 64-69.

This article's proposal that a uniform standard should apply across both the appraisal and the *Weinberger* contexts faces one significant doctrinal obstacle. Under the Delaware appraisal statute, the appraisal court is instructed to determine fair value "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."[268] Although this idea makes some sense in the arm's-length transaction where the dissenting shareholder is truly opting out, it is misapplied in squeeze-outs where the shareholder is being expelled and where those who remain may be exploiting asymmetric information.

In any event, the scope of this exclusion is ambiguous. Depending on how broadly this language is read, it can justify a substantial disparity between the "fair price" that a *Weinberger* proceeding requires be paid and the lesser "fair value" that an appraisal proceeding can award. This potential for disparity is well illustrated by the recent decision in *Gonsalves v. Straight Arrow Publishers, Inc.*[269] In that appraisal proceeding, Chancellor Allen granted a motion in limine to preclude petitioner's expert witness from testifying that: (1) the corporation's chief executive, who was also its controlling shareholder, had been grossly overpaid; and (2) a reasonable buyer "would capitalize the difference between what in fact senior management cost the corporation and what the buyer would have to pay for comparable management of the assets."[270] Section 262(h), he ruled, excludes such an element of value and requires that the going concern value of the corporation be fixed in light of the "existing condition of the company, including its existing compensation contracts with senior officers."[271]

Viewed narrowly, this reading of section 262(h) seems to imply that a controlling shareholder can divert "hidden cash flow"[272] to itself and that the appraisal proceeding is powerless to provide any effective remedy when this occurs. Semantically, such an interpretation would read section 262(h) unnecessarily broadly. Clearly, excess salary can sometimes be irrelevant. For example, if the acquirer intends to lay off substantial personnel, the cost saving from staff reductions would be an "element of value arising from the accomplishment . . . of the merger," and, thus, excluded from valuation under Section 262(h).[273] However,

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[268]*See* DEL. GEN. CORP. LAW § 262(h) (1974).

[269]No. 8474, 1996 Del. Ch. LEXIS 106 (Del. Ch. Aug. 22, 1996).

[270]*Id.* at *1.

[271]*Id.* at *2.

[272]I borrow this term from Professor Shishido, who uses it to refer to assets or earnings that are misappropriated from the corporation. *See* Shishido, *supra* note 218, at 67.

[273]*See* DEL. CODE ANN. tit. 8, § 262(h) (1995).

amounts misappropriated from the corporation, including salary overpayments, result not from the "accomplishment of the merger," but more directly from a breach of fiduciary duty by the controlling shareholder. In this view, the overpayment is analogous to a simple theft or misappropriation of a corporate asset. For example, if the CEO of a Delaware corporation stole the share certificates to a major subsidiary and retained their possession himself, it seems highly doubtful that a Delaware appraisal proceeding would ignore the value of the subsidiary in determining the "fair value" of the parent to which the parent's shareholders were entitled in an appraisal action. To do so would reward theft and unnecessarily treat compensation for *past* wrongdoing as a *prospective* "element of value arising from the *accomplishment*. . . of the merger."[274]

Chancellor Allen's opinion implicitly recognized this distinction by adding an important qualification to its holding that evidence of overpayment could not be considered in an appraisal action. Citing *Merritt v. Colonial Foods, Inc.*,[275] he noted that petitioners had not attempted to prove that the allegedly excessive "compensation constituted a breach of fiduciary duty."[276] If such a claim had been raised, he wrote, "[T]here would be strong logic in including the net settlement value of such claim as an asset of the corporation for appraisal purposes."[277] This distinction is critical: "hidden cash flow" has not been misappropriated unless there has been a fiduciary breach, and, absent a fiduciary breach, the past-prospective distinction made above collapses. The practical implication of *Gonsalves* may then only be that a pleading of a fiduciary breach or the filing of a contemporaneous derivative action is necessary when petitioners wish to factor such a misappropriation into the appraisal process. More importantly, however, *Gonsalves* looked to *Weinberger* to determine when "possible sources of value to a would-be buyer [should be] excluded from consideration in an appraisal action."[278] *Weinberger*, it said, made this determination depend on whether "there is evidence that such reorganizational gains *are* part of the existing business plan of the corporation."[279] Where the corporation had such an existing business plan, Chancellor Allen suggested, in what is probably dicta, that such a

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[274] *Id.* (emphasis added).

[275] 505 A.2d 757, 766 (Del. Ch. 1986) (holding that such a claim may be considered in an "entire fairness" suit under *Weinberger* challenging a cash-out merger's fairness).

[276] *Gonsalves*, No. 84747, 1996 Del. Ch. LEXIS 106, at *3.

[277] *Id.* In a footnote, he recognized that valuing such a claim as an element of going concern value would raise "substantial" problems. *Id.* at *2 n.1.

[278] *Id.* at *6.

[279] *Id.* (emphasis added).

"prospective source of value . . . may logically and consistently with the definition of fair value in the statute be quantified and counted in the determination of fair value of the dissenting shares."[280]

This rationale appropriately reconciles *Weinberger* and the appraisal proceeding while integrating the standards for determining "fair value" with those for determining "fair price." Although it remains dicta, it draws a critical distinction between the value of the corporation's intellectual property at the moment before the merger and any future synergy gains that are dependent on the merger. Where an insider group is expelling the minority shareholders and, in effect, appropriating for itself a pre-existing business opportunity belonging to the corporation, the expected gains should not be seen as arising from the accomplishment of the merger. In effect, they are gains which fiduciary misconduct blocked the shareholders from realizing on their own. Hence, no exclusion should be required by the Delaware statute. To the extent that courts cannot distinguish between true synergy gains and misappropriated business opportunities, however, the proposed equivalence of "fair value" and "fair price" fails, and *Weinberger*'s "fair price" concept should be defined more broadly than "fair value" under the appraisal statute.

CONCLUSION

To restate: when a controlling person seeks to eliminate the remaining "minority interest" in its corporation and the minority shareholders object, the reviewing court faces essentially three choices: (1) it could follow an "equal opportunity" rule and seek to share the control premium; (2) it could award only the preannouncement stock price of the corporation; or (3) it could seek to ascertain and award "proportionate value" based on its determination of the intrinsic value of the corporation. The first approach will chill some efficiency-promoting transactions, namely, those where the private benefits of control lead a sub-optimal management to remain in office so long as they can only sell at the same price the minority will receive. Clearly, the second approach should maximize the number of squeeze-out transactions and the incentive of the incumbent management to sell. But it is not clear from either conclusion that economic efficiency is thereby maximized by the second approach.

The problem, of course, is that a controlling shareholder can divert "hidden cash flow" to itself or its affiliates in a manner that reduces the

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[280] *Gonsalves*, No. 8474, 1996 Del. Ch. LEXIS 106, at *6 (citing *Weinberger*, 457 A.2d at 713).

corporation's stock price. The result is a double injury; not only is the diverted cash flow lost, but the expectation of continuing future diversions will further depress the stock value of the corporation. Perhaps more important than diversions of cash flow are diversions of the firm's intellectual property. Because insiders possess asymmetric information about the firm's value, they have an incentive to withhold such information from the market when they plan to make an offer for the firm's remaining shares. Even when such information is known to the market, it still may not be in the self-interest of the controlling shareholder to undertake a risky investment having a present positive value unless and until it first acquires the entire equity in the firm.[281] A project so foregone will again cause the stock market price of the corporation to fall below what it would be under a management having no such conflict of interest.

Thus, this premise that "hidden cash flow" should be restored to the firm and shared proportionately among all shareholders also answers a more perplexing and seemingly unrelated issue in corporate law: When should synergy gains be shared by the acquirer with the expelled minority shareholders? This article's answer is that sharing should be required when and to the extent that such gains reflect business opportunities belonging to the corporation (but not to the extent that the synergy gain derives from opportunities or property belonging to the acquirer). A proportionate value standard that seeks to add back "hidden cash flow" and factor in the value of profitable opportunities that properly belong to the corporation would thus both allocate synergy gains equitably and reduce agency costs.[282]

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[281]This assumption is the starting point in the analysis that Professors Hermalin and Schwartz present: namely, that managers have a project that will increase the value of the firm and that they wish to pursue without minority shareholders. *See* Hermalin & Schwartz, *supra* note 3, at 355. What their analysis omits to specify, however, is who has the property right in this project or proposal. If the idea or project is developed by managers on the corporation's time or through access to the corporation's proprietary information, the employer (i.e., the corporation) would normally then own the property right. Normatively, the value of this property right should be factored into any determination of the corporation's fair value (either in an appraisal or an entire fairness review). To do otherwise is effectively to repeal the corporate opportunity doctrine for the context of corporate control transactions. Of course, I recognize that a court cannot easily value an undeveloped and inchoate business project or opportunity. But it need not do so in the literal sense. Rather, the corporation's property right (in those cases where it exists) provides the rationale for an allocation of expected synergy gains.

[282]Some neoclassical economists still argue that agency costs are borne only by the original founder of the firm, presumably at the time such person sells shares to the public. Most in this debate have recognized, however, that some costs of managerial opportunism are borne by current shareholders. *See* Lucian Bebchuk, *Federalism and the Corporation: The*

In contrast to existing remedies (whose effectiveness can be doubted),[283] the procedural advantage of the squeeze-out stage is that it permits a final "settling-up" determination of the firm's intrinsic value in which the court can limit its focus simply to those diverted losses and foregone opportunities that will materially affect share value. This different focus contrasts sharply with that of the derivative action (where amounts that may be material to a defendant have only a *de minimis* impact on share value) or the securities class action (which tends to focus only on disclosure and not substantive fairness). Not only can the court at this stage ignore immaterial amounts, but it need not assign individual responsibility. If cash flow has been diverted, the important question is not who did it or even that such amounts be repaid, but that the capitalized value of the firm for the future be based upon an appropriate earnings figure that reincorporates such diverted cash flow. Even more importantly, the court at this stage can assess whether the expected synergy gains from the transaction derive from ideas and intellectual property properly belonging to the corporation. To the extent such a finding is made, it provides the justification for an allocation of those expected gains between the buyers and sellers. This simply cannot be done, or even attempted, at the earlier control acquisition stage on which the "triggering thesis" focuses.[284]

In overview, the debate over squeeze-outs resembles the debate over takeover defensive tactics. Indeed, the more the topics change, the more the issues remain the same. The new claim that minority shareholders should receive no more in a squeeze-out merger than the preannouncement market price of their stock is but a corollary of the earlier claim that target managements should not be permitted to resist takeover proposals.[285] Board passivity in both cases is good for bidders,

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Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1437 (1992).

[283]*See supra* notes 234-36 and accompanying text (discussing typically low recovery as a percentage of investor losses in securities class actions).

[284]*See* Elhauge, *supra* note 4.

[285]For the original, provocative article arguing for board passivity, see Frank H. Easterbook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). For subsequent responses that auctions, not passivity, maximized shareholder value and economic efficiency, see Lucian Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982), and Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981). Professor Alan Schwartz, who in the squeeze-out context favors the lower standard of the preannouncement market price (*see* Hermalin & Schwartz, *supra* note 3), is also a strong proponent of the Easterbrook/Fischel passivity rule in the takeover context. *See* Schwartz, *supra* note 228. There is, of course, a consistency to these positions.

but not necessarily for economic efficiency, because assets do not necessarily move to their highest valued uses. Particularly in the squeeze-out context, incentives arise for inefficient transactions that transfer wealth, but do not necessarily create it.

On the doctrinal level, the two contexts are different, however, because the principal purpose of fiduciary duties has long been to constrain opportunism by management and controlling shareholders. Thus, while it is conceivable that corporate law could instruct directors to be passive in the face of an unsolicited tender offer, it seems more questionable for corporate law to take a similarly passive posture in the face of a bid by management or controlling person. Nor has Delaware law done so. As the latest Delaware decisions have recognized,[286] the existence of a controlling shareholder does not change the fiduciary duties of the board to its shareholders. Although the controlling shareholder has the right to pursue its own self-interest, including the right to oppose even higher offers from third parties, the board has the obligation to negotiate for the minority in such a case just as it would for the entire shareholder class in a negotiation with a third party buyer. To takeover theorists, this is known as the "sole owner" standard,[287] and, if accepted, it implies that the board can no more accept the preannouncement market price as disposition of the minority's rights than it could accept a cash tender offer from an unrelated third party at a nominal $1 premium over the market price.[288]

The specific operational rules that follow from this analysis and that should guide the determination of "fair price" and "fair value" can be briefly summarized as follows:

1. A rule entitling minority shareholders to a proportionate share in the "going concern" value of their firm should require the court to determine the extent, if any, to which the expected synergy gains from the transaction derive from intellectual property belonging to the firm, including nonpublic proprietary information that management or the controlling person formulating the bid has used. This approach does not mean that synergy gains must be

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[286]Both *Lynch I* and Thorpe v. CERBCO, Inc., No. 345, 1995, 1996 Del. LEXIS 144 (Del. Apr. 10, 1996), are the leading precedents showing this recognition.

[287]*See* Lucian Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197 (1988).

[288]Presumably, acquiescence in such a premium-less bid would violate the principles stated in Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), and Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985).

automatically shared. Rather, the decisive question is the ownership of the intellectual property. To the extent that it derives from proprietary information properly belonging to the corporation, the gain is one in which the minority shareholders should share, even if the opportunity had been previously foregone or passed up by the incumbent management. If and to the extent, however, that the expected gain derives from property or ideas independently developed by the controlling person, who, for example, bought control of the corporation in order to exploit this already perceived opportunity, no fiduciary principle requires sharing of this portion of the gain.[289]

2. In arm's-length transactions with an unaffiliated entity, the appraisal court can apply a deferential standard of review because there is little likelihood that proprietary information has been suppressed. Here, a strong business judgment presumption should be accorded to the determination of a disinterested board of a public corporation.[290]
3. Given the interdependency of stock price and ownership concentration, stock price cannot be relied upon as an unbiased measure of either "fair value" or "fair price." To do so would be circular because the evidence shows that the structure of share ownership influences the stock price, depressing it as a control block is assembled.[291]

So what will courts really do under these rules? Ideally, the predominant judicial activity will be attempting to reconstruct intrinsic value by adding back the "hidden cash flow" and determining whether the expected gains from the transaction depend upon business opportunities already belonging to the corporation. Because such an inquiry could be limited to transactions that were likely to have materially affected share value, it would be a more manageable undertaking and a more cost-efficient use of judicial time.

In closing, the observation cannot be avoided that the Delaware law on the squeeze-out context is a little bit pregnant. The "proportionate

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[289]Even in this case, the fiduciary may be required to disclose the project or opportunity because its fiduciary position imposes a duty to disclose upon it.

[290]Two-step acquisitions qualifying under SEC Rule 13e-3 are best grouped under this arm's-length heading, unless there is evidence of new knowledge or opportunities arising in the interval between control acquisition and the merger.

[291]*See supra* notes 193-203 and accompanying text.

value" standard has already been recognized at the appraisal context, but its implications have not been explicitly developed in the closely related context of "entire fairness" reviews. This is unstable. Over the long-run, it is necessary to level up or level down. This article has stated the case for "leveling up" by generalizing the proportionate value standard.