provisions of the Merger Agreement must be enjoined so that the Board may carry out its duties under *Revlon* to maximize shareholder value.

VII

[17] I find, however, that the applicants have thus far failed to demonstrate a reasonable probability of success on the merits as to their claim that the "poison pill" stock rights plan adopted by the Board must be redeemed now. There is no evidence that the Board is presently using the poison pill for any improper purpose and it may still have a role in maximizing values. At some future time, the poison pill may no longer serve a valid purpose but that time has not yet arrived. *MAI Basic Four, Inc. v. Prime Computer*, Del. Ch., C.A. No. 10428-NC, Hartnett, V.C. (Dec. 20, 1988).

Plaintiffs may submit a proposed order.

KAHN BROTHERS & CO. v. FISCHBACH CORP.

No. 8987

Court of Chancery of the State of Delaware, New Castle

November 15, 1988

Defendant Posner obtained control of defendant Fischbach Corporation and its board of directors in spite of a standstill agreement restricting Posner to twenty-five percent stock ownership in Fischbach. Plaintiffs sued derivatively to overturn Posner's control of the board of directors claiming that control was obtained through fraud between Posner and Ivan Boesky. Defendants moved to dismiss for failure to state a claim.

The court of chancery, per Chancellor Allen, held that while the fraud alleged by the plaintiffs would otherwise state a claim, failure to allege an intervening election made the complaint insufficient to attack the directors' source of power and, therefore, must be dismissed pending plaintiffs' opportunity to move for leave to amend their complaint.

1. Pretrial Procedure ⟹ 680, 686, 687, 688

On a motion to dismiss, factual allegations of the complaint are accepted as true.

2. Corporations ⟹ 283.3

Delaware Code Annotated title 8, section 225 is a statutory equivalent of a common law *quo warranto* action by which the title of any person to any corporate office may be determined. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

3. Corporations ⟹ 283.3

It is elementary that when any corporate office is usurped by one who has no title thereto, either because there has been no appointment or election at all, or because the appointment or election is void or voidable, *quo warranto* will lie to determine the title to office.

4. Corporations ⟹ 283.3

The Delaware courts have exercised jurisdiction to hear and determine the validity of any election of any director or officer of any corporation organized under the Delaware General Corporation Law.

5. Corporations ⟹ 283.3

The power of the courts under Delaware Code Annotated title 8, section 225(a) is the power to determine the right of any person to hold corporate office. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

6. Corporations ⟹ 320(1)

Wrongs allegedly perpetrated by directors will not be adjudicated in a section 225 action, nor will ownership rights, as distinguished from voting rights, typically be adjudicated in such a proceeding. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

7. Corporations ⟸ 298(6), 320(1)

While questions concerning whether a proxy statement conforms to federal proxy rules may be regarded as collateral and excluded from section 225 litigation as an independent source of relief, fraud in connection with proxy solicitation may properly be the subject of judicial review in a section 225 action. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

8. Corporations ⟸ 320(1)

The question whether an issue is properly litigable in a section 225 action turns upon a determination of whether it is necessary to decide in order to determine the validity of the election or designation by which the defendant claims to hold office. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

9. Pleading ⟸ 406(5)

Pretrial Procedure ⟸ 531, 533, 621

A pleading is not defective for stating the wrong relief as long as it states facts under which some relief could be granted.

10. Corporations ⟸ 283.3

When a stockholder challenges the title of a director to the office claimed, he must challenge the source of the director's authority and he does so by challenging the election or designation by which the director holds office, and not an earlier office.

11. Corporations ⟸ 283.3

If the wrongs alleged by a stockholder challenging the source of a director's authority to hold office are fully proven, the effect of those wrongs are as direct and substantial with respect to the last election of directors as it was with respect to the original designation.

12. Corporations ⟸ 283.3

Pretrial Procedure ⟸ 531, 621

In order to survive a motion to dismiss, a section 225 action must attack the validity of the source of the director's claim of title. DEL. CODE ANN. tit. 8, § 225 (Supp. 1985).

13. Judgment ⟸ 470

When a Florida judgment could be collaterally attacked if procured by fraud that is extrinsic to the matter litigated, then a Delaware court will treat the Florida judgment similarly.

14. Courts ⟸ 493.3

A stipulation of dismissal of a Florida judgment does not raise questions of comity requiring reopening the Florida case because the Florida court never became substantively involved with the earlier case.

Joseph A. Rosenthal, Esquire, Kevin Gross, Esquire, and Carolyn D. Mack, Esquire, of Morris, Rosenthal, Monhait & Gross, Wilmington, Delaware; Jonathan Plasse, Esquire, of Goodkind, Wechsler, Labaton & Rudoff, New York, New York; and Sidney B. Silverman, Esquire, of Silverman & Harnes, New York, New York, for plaintiffs.

Jesse A. Finkelstein, Esquire, Gregory V. Varallo, Esquire, and Anne F. Bugg, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Lawrence A. Blatte, Esquire, of Rosen & Reade, New York, New York, for defendants Victor Posner, Bernard I. Posner, Steven Posner, Melvin R. Colvin, Dante C. Fabiani, Thomas A. Prendergast, Walter Sieckman, Martin Rosen, Pennsylvania Acquisition Corporation, and Pennsylvania Engineering Corporation.

P. Clarkson Collins, Jr., Esquire, of Morris, James, Hitchens & Williams, Wilmington, Delaware, for defendants John W. Snow, Edwin A. Wilinski, Charles R. Acker, Philip Heller, Alfred R. Manville, and Fred Korth.

David C. McBride, Esquire of Young, Conaway, Stargatt & Taylor, Wilmington, Delaware, for defendant Fischbach Corporation.

ALLEN, *Chancellor*

The pending motion seeks to dismiss Count I of the amended complaint as failing to state a claim upon which relief may be granted. The amended complaint purports to allege three claims. The first claim is brought by plaintiffs in their individual capacities as shareholders of defendant Fischbach Corporation ("Fischbach"). The second and third counts of the amended complaint are stated as derivative claims; they purport to allege claims of breach of contract and breach of fiduciary duty. Those aspects of the amended complaint are not involved in determination of the present motion.

Count I purports to be brought pursuant to Section 225 of our corporation law; that provision confers jurisdiction upon the Court of Chancery to "hear and determine the validity of any election of any director . . . and the right of any person to hold such office." The essential claim of Count I is that in 1985, defendant Victor Posner deceived the then existing board of Fischbach into taking steps which permitted him to secure voting control of the Company despite the existence of a standstill agreement that restricted him to 25% stock ownership of the Company. As a result, in that year, he was able to have himself designated chairman of Fischbach's board and to designate persons whom the then existing board appointed to board positions constituting a majority of all such positions. Thereafter, the shareholders (with Posner-controlled entities controlling a majority of the vote) dutifully elected these same persons to additional terms. This original alleged deception is claimed to have rendered invalid the board's action in appointing these Posner designees and to have infected their subsequent election.

The relief sought under Count I includes an order (1) declaring that the individual defendants do not validly hold office, (2) appointing a receiver of that corporation to take control of its affairs until a new election may be had, (3) requiring the convening of a special stockholders' meeting and (4) declaring that stock held of record by Mr. Posner or his related entities may, at such meeting, be voted by such receiver.

Named as defendants are Victor Posner and eleven other individuals who constitute the Fischbach board of directors, Pennsylvania Engineering Corporation ("PEC") and its subsidiary Pennsylvania Acquisition Corporation ("PAC"), both Delaware corporations, and APL Corporation, a New York corporation. Only certain of the defendants have appeared.[1] They have moved to dismiss Count I of the amended complaint..

1. APL Corporation has failed to appear in this action.

[1] Before recounting the legal contentions of the parties of this motion, I set forth the facts as alleged in the amended complaint that relate to Count I. It hardly needs to be mentioned that, on a motion to dismiss, I accept the factual allegations of the complaint as true.[2]

I.

Fischbach is the nation's largest electrical contractor. Its principal office is in New York City. Mr. Posner owns or controls 54% of the outstanding stock of Fischbach and serves as chairman of its board of directors. This stock is actually owned by PEC and its PAC subsidiary (40.7% of the outstanding stock) and by APL (13.9%) which, in turn, are controlled by Victor Posner.

Posner began accumulating Fischbach stock prior to August 29, 1980. On that day, the Company entered into a standstill agreement with PEC signed both by Posner and PEC. That agreement provided that neither Posner nor entities controlled by him would acquire more than 24.9% of Fischbach's outstanding stock unless, *inter alia*, a third party (1) filed a Schedule 13D under the Securities Exchange Act of 1934 disclosing the acquisition of more than 10% of Fischbach's stock or (2) a notice was filed under Section 7A of the Clayton Act disclosing an intention to do so. This agreement would ultimately lead to concurrent, if brief, litigation in the courts of Florida and New York. Both of those suits were settled and dismissed pursuant to an agreement by the then board of Fischbach (1) to release Posner from any arguable continuing obligation under the standstill agreement, and (2) to appoint his designees to Fischbach's board upon Posner's acquiring voting control of the firm. The gist of Count I of the amended complaint is that the claim that led to this settlement agreement releasing Posner from any continuing obligation under the standstill agreement was procured by deception and that, therefore, the acquisition of voting control and the designation of directors was wrongful and, more than that, invalid. It is asserted that the directors thus appointed (and later elected) do not validly hold office.

The deception alleged involves the notorious arbitrageur Ivan Boesky. The story told by the complaint includes the following: On or about December 28, 1983, after the signing of the standstill

2. Paragraphs 3(a) through (e) of the amended complaint contain various claims of improper conduct by Mr. Posner in the past relating to companies other than Fischbach and are totally irrelevant to the issues presented on the pending motion.

agreement, Executive Life Insurance Company filed a Form 13D disclosing its ownership of more than 10% of Fischbach's common stock. Executive Life then almost immediately thereafter sold all of its stock in Fischbach to the Company on January 9, 1984. On April 13, 1984, PEC brought suit in Florida seeking a declaratory judgment that the purchase by Executive Life had terminated its obligations under the standstill agreement. Also in April, 1984 the Company instituted a declaratory judgment action in New York seeking a declaration of the reverse: the continuing vitality of the obligations created by the standstill agreement despite the brief ownership of Executive Life of more than 10% of the Company's stock.

During the course of these litigations, Mr. Ivan Boesky, on July 10, 1984, filed a Form 13D indicating *his* ownership of 13.4% of the Company's common stock. The effect this filing must have had on the incumbent board is not specified in the amended complaint, but it can be imagined. First, the board had to deal with Posner; then it repurchased a substantial block of stock from Executive Life; now it has another large position to deal with. It must have appeared to the incumbent board that they were trying to push water uphill.

Posner and Fischbach held settlement discussions. In these negotiations, Posner took the position that Boesky's purchase itself removed any litigable questions about the continuing vitality of the standstill agreement. On January 9, 1985, Fischbach and PEC entered into a settlement agreement pursuant to which (1) the New York and Florida actions were dismissed with prejudice, (2) Fischbach and PEC executed general releases in favor of each other, (3) obligations under the standstill agreement were acknowledged as terminated, and (4) upon the acquisition by PEC and related entities of more than 50% of the Company's stock, Posner would be appointed chairman of the board and he would designate, for board appointment, a majority of the directors of the Company.

Thereafter, on February 28, 1985, Boesky sold, indirectly, all of his Fischbach stock to Posner (*i.e.*, to APL, another Posner-controlled entity).

On September 4, 1985, Posner acquired in excess of 50% of Fischbach's stock. On October 18, 1985, he was appointed chairman of the Company and designated persons to fill a majority of board positions.

It is alleged in this litigation, however, that Boesky and Drexel Burnham Lambert, Inc. were acting on behalf of Posner when they acquired 13.4% of the Company's stock and that, therefore, the development that led to the termination of the Florida and New

York litigations—the filing of a Form 13D by Boesky—and to Posner's acquisition of control, was a deception that invalidates the acts of the then incumbent directors in appointing Posner and his designees to the Company's board.

Count I also contains some allegations about wasteful expenditures by the Company since Posner has assumed office; but those allegations, if they state a claim, state a derivative claim and are duplicated by Count III of the amended complaint. They have no relevance to plaintiffs' Section 225 claim that is treated on this motion.

II.

As indicated above, the pending motion to dismiss is directed only to Count I of a three count complaint. That count purports to be brought under Section 225 of our corporation law. It asserts, broadly speaking, that the current directors hold their office as a direct consequence of fraudulent conduct. While Count II asserts a derivative claim on behalf of Fischbach arising from the alleged fraud and breach of contract, Count I seeks to assert rights of plaintiffs as stockholders of Fischbach. In that capacity, they assert a right to have in place only a duly elected board of directors. That right is said to be conferred by Section 225 which permits a shareholder to have a judicial review in this court of "contested election[s] of directors." It provides in pertinent part:

> Upon application of any stockholder . . . the Court of Chancery may hear and determine the validity of any election of any director . . . and the right of any person to hold such office, and in case any such office is claimed by more than one person, may determine the person entitled thereto.

The relief sought includes the "removal" of the directors of the Company (more precisely, a declaration that they were never validly elected) and the ordering of a new election, in which wrongly acquired stock would not be voted by Mr. Posner but by a court appointed receiver.

Defendants have moved to dismiss Count I as failing to state a claim under Section 225. They assert a host of arguments in support of that position, most importantly as follows: First, Section 225 only addresses "contested elections" (as its caption states) or arguably "contested designations," but in no event does it authorize the court to pass upon the validity of a claim to office unless there

is some other claimant. Second, in no event will the propriety of how a shareholder acquired his stock be litigated as part of a Section 225 case. Third, defendants argue that in no event is a receiver an authorized remedy in a Section 225 action. Fourth, defendants assert that an intervening election has dissipated the effect of the allegedly tainted designation of defendants as directors and rendered moot the question posed by the Section 225 claim. Finally, defendants contend that the effect of the Florida judgment dismissing with prejudice the claims that the standstill agreement continued to have vitality prevents the relitigation here of an essential element of plaintiffs' theory.

III.

For the reasons that follow, I conclude that plaintiffs have pleaded facts that constitute a claim upon which relief may be granted. I need make no determination now as to the form of remedy to which plaintiffs may be entitled should they prove that Mr. Posner fraudulently caused the earlier litigation to be dismissed and that the Executive Life purchase did not vitiate the standstill agreement, so that the acquisition of voting control of the Company will be shown to have constituted a breach of the standstill agreement.

A.

[2-5] As to the contention that Section 225 authorizes a shareholder action only when there is a contested election, I cannot accept that proposition as sound in light of the language of that Section or its purpose. As I read Section 225, it is a statutory equivalent of a common law *quo warranto* action by which title to corporate office may be determined. *See* 2 Fletcher Cyclopedia of Corporations §§ 365, 368-370 (1981). It is elementary that "when any corporate office is usurped by one who has no title thereto, either because there has been no appointment or election at all, or because the appointment or election is void or voidable . . . *quo warranto* will lie to determine the title to office . . . ." Fletcher, *supra* at § 365; *State ex rel. Richards v. Brooks*, Del. Super., 74 A. 37 (1909). In Delaware, however, since 1923 (*see* 33 Del. Laws c. 104) this court, no doubt as part of its legislatively conferred general superintendence of the corporation law, has exercised jurisdiction "to hear and determine the validity of any election of any director or officer of any corporation organized under the General Corporation Law of this state . . . ." *Fleer v. Frank H. Fleer Corporation*, Del. Ch., 125 A. 411, 415 (1924). This grant of authority should, in my opinion, be interpreted as a legislative

determination to create in this court a remedy with respect to claims concerning title to corporate office that is no less broad and encompassing than the common law writ which it supplements. The statutory words are consistent with such an understanding. The power is to "determine . . . the right of any person to hold such office." 8 *Del. C.* § 225(a). Our cases have so construed Section 225. Thus, for example, in *Grossman v. Liberty Leasing Co., Inc.*, Del. Ch., 295 A.2d 749 (1972), the power to determine the state of title to the office of director was held to extend to a claimant whose title derived from the board itself who purported to appoint a new director to a vacancy.

Defendants' argument that Section 225 is only available when there is a dispute concerning the outcome of an election contest, while focusing upon the factual context in which most Section 225 cases will arise, is itself too narrow to be squared with a fair reading of the statute itself or with sound policy. Such an interpretation would create a lacuna in which the old common law remedy, abandoned for these purposes more than sixty years ago, would have to be pressed into fresh service.

B.

[6-7] As to defendants' second argument—a stock holder may not litigate in a Section 225 action the propriety of how a shareholder came to own his shares—is, again, too broad to be endorsed. An action under Section 225 is, it is true, a special statutory action that is, in some respects, narrow. Special rules concerning the joinder of claims (including, for example, a restriction upon permissive counterclaims) are followed in such actions so that the expedition such actions require may be promoted. Thus, it has long been the rule that wrongs allegedly perpetrated by directors will not be adjudicated in such an action (*e.g.*, *In Re Tonopah United Water Co.*, Del. Ch., 139 A. 762 (1927)), nor will ownership rights, as distinguished from voting rights, typically be adjudicated in such a proceeding. *See, e.g.*, *Rosenfield v. Standard Electric Equipment Co.*, Del. Ch., 83 A.2d 843 (1951). *But see Mercer v. Rockwell Oil Co.*, Del. Ch., 68 A.2d 721 (1949). These restrictions on the joinder of claims in such an action are imposed as a means to permit the form of action to be as uncluttered as possible so that prompt resolution of the vital question whether defendants validly hold office may be had. They obviously do not mean, however, that issues are necessary for decision of that question are not cognizable in a Section 225 action. Thus, for

example, while questions concerning whether a proxy statement conforms to federal proxy rules may be regarded as collateral (*Standard Power and Light Corp. v. Investor Associates, Inc.*, Del. Supr., 51 A.2d 572 (1947)) and excluded from the litigation as an independent source of relief, fraud in connection with proxy solicitation may properly be the subject of judicial review in a Section 225 action. *Atterbury v. Consolidated Coppermines Corp.*, Del. Ch., 20 A.2d 743, 746 (1941).

[8] In each instance, the question whether an issue is properly litigable in a Section 225 action turns, in my opinion, upon a determination of whether it is necessary to decide in order to determine the validity of the election or designation by which the defendant claims to hold office. In this instance, whether Mr. Posner acquired his control block of stock as the result of a fraud *practiced upon the corporation itself* (as opposed to fraud practiced upon an individual shareholder) and whether, if so, his voting of such stock should be considered void or voidable are not issues that are collateral to the question of the title to office of the directors he has caused to be in office. It may be that plaintiffs will be unable to prove their claims of fraud (or their claim that the Executive Life transaction did not itself vitiate the standstill agreement), and it may be that even if he proves those claims, it will not be determined that the vote attached to the shares acquired after the fraud must be set aside (that matter has not been briefed and, absent that guidance, I do not address it). But what does seem reasonably clear is that these issues are critical to the theory that plaintiffs advance in support of their claim that the directors who purport to hold office do not do so validly. Thus, they are, in my view, cognizable in this Section 225 action.

C.

[9] I pass over defendants' third argument—that a receiver cannot be appointed in a Section 225 action to hold a meeting and vote the Posner stock or some of it. What relief will be available and appropriate should the facts pleaded be proved will be decided at another stage. It is no defect in a pleading that it seeks the wrong relief (if it does) so long as it states facts upon which some relief may be granted.

D.

[10-11] I turn then to defendants' fourth argument that an intervening election has rendered moot the question of the validity

of the original designation of the Posner designated directors. Two things should be said concerning this argument. First, it is surely correct that when a stockholder challenges the title of a director to the office claimed, he must challenge the source of the director's authority. That means he must challenge the election or designation by which the director holds office, not some earlier one. Second, it is also plain that if the wrongs alleged are fully proven, the effect of those wrongs would seem to be just as direct and substantial with respect to the last election of directors as it was with respect to the original designation. (The complaint, of course, does not itself allege all that might have occurred between the time it treats and now, and thus, in saying what I have, I assume no change in relevant circumstances.)

[12] The complaint itself does not allege an intervening election, and thus is not itself defective. Defendants have stated that there has been such and would do so by affidavit I am sure, if required to do so. Accordingly, as I conclude that in order to survive a motion to dismiss, a Section 225 action must attack the validity of the sources of the director's claim of title, I will grant the motion to dismiss this claim unless, within thirty days, plaintiffs move for leave to file a further amendment that corrects this deficiency.

E.

Lastly, defendants assert that the judgments entered by stipulation in the Florida action precludes here any litigation of the claim that the Executive Life purchase did not vitiate the standstill agreement. Since they are unable to prove that claim defendants say that plaintiffs cannot prove the facts that, on their theory, would justify relief, even if the Boesky-related aspects of the complaint were proven. In that event, there would be no real basis to contend that Posner had acquired his stock wrongfully vis-a-vis the corporation, and thus no arguable basis to set aside the voting of it. This argument is premised upon the comity that we extend to the actions of other courts and upon the full faith and credit clause.

[13] This court could not justify by the full faith and credit clause, nor by principles of comity, according to the Florida stipulation of dismissal greater effect than would the courts of that state. In Florida, a judgment may be collaterally attacked if procured by fraud that is extrinsic to the matter litigated. *Canal Authority v. Harbord, Inc.*, Fla. Supr., 433 So.2d 1345 (1983). Here, the allegations plainly involve a charge of extrinsic fraud. The Boesky "parking" arrange-

ment (assuming it occurred) was used as a ruse to persuade the board of Fischbach to abandon its litigation position and submit to the dominance of Posner. Thus, I conclude that a Florida court would permit the judgment to be set aside upon proof of these allegations. This court should treat the Florida stipulation of dismissal similarly. Moreover, it is appropriate, upon proof of the fraud alleged, to litigate this matter here insofar as relief relating to the ordering of a further meeting is sought—relief that may not properly be afforded by another court. *Perrott v. United States Banking Corp.*, 53 F. Supp. 953 (D. Del. 1944).

[14] As to notions of comity, there is here no basis to find that either efficiency or respect counsel sending this stockholder to Florida to seek derivatively to open the judgment there. The Florida court never became substantively involved with the earlier case.

As to the claim of laches, I find no unreasonable delay. Surely the disclosure by the SEC of the Boesky-Posner connection is the operative date and there was, from that time, little delay.

The pending motion to dismiss shall be granted unless, within thirty days, plaintiffs move to amend their complaint, in which event decision on the motion will be reserved until such motion is determined. If that motion is granted, the current motion will be denied.

MAI BASIC FOUR, INC. v. PRIME COMPUTER, INC.

No. 10,428

Court of Chancery of the State of Delaware, New Castle

December 20, 1988

The plaintiff, MAI, commenced an all-cash tender offer for all the shares of defendant, Prime Computer. Prime's Board of Directors retained two independent financial advisors who expressed their opinion that the offer was inadequate. As a result, Prime's Board adopted an array of antitakeover devices, including a shareholder rights plan, an employee severance bonus plan, an employee pension plan, an employee retention plan, a stock appreciation rights plan, a stock option plan, and Prime's board moved forward the date of the

corporation's annual meeting so that it would take place before the plaintiff's financing commitments expired.

In response to the plaintiff's request for a preliminary mandatory injunction to set aside the antitakeover defensive devices, the court of chancery, per Vice-Chancellor Hartnett, reasoned that, even though MAI's offer was not coercive, the offer represented a premium over current market value and Prime's stockholders would be denied an opportunity to make their own investment judgment as to whether they should accept the tender offer. The court held that Prime's actions were reasonable responses to MAI's tender offer since: (1) the offer had been pending less than one month, (2) MAI would not increase its offer without the antitakeover devices, and (3) there was no showing that MAI would suffer irreparable harm if the antitakeover devices remained in place for now.

1. Injunction ⟸ 14, 136(1)

To obtain a preliminary injunction, a plaintiff must demonstrate that it has a reasonable probability of success on the merits and that, absent the injunction, it will suffer irreparable harm.

2. Injunction ⟸ 12, 23, 136(1)

To obtain a preliminary injunction, a plaintiff must show that the harm it would suffer, absent an injunction, outweighs the harm to defendant if relief is granted.

3. Injunction ⟸ 126, 133, 136(1)

Where a preliminary mandatory injunction is sought, the plaintiff has an even greater burden because the legal right sought to be protected must be clearly established.

4. Corporations ⟸ 310(1)

The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors. DEL. CODE ANN. tit. 8, § 141(a) (1985).

5. Corporations ⟸ 310(1)

In discharging their responsibilities, the directors of a corporation owe fiduciary duties of care and loyalty to its shareholders.

6. Corporations ⟸ 310(1)

The principles that directors of a corporation owe fiduciary duties of care and loyalty to the shareholders are the bedrock of Delaware law regarding corporate takeover issues.

7. Corporations ⟸ 310(1)

When the business judgment rule applies to corporate decision making, there is a presumption that the board has acted in informed good faith and in the honest belief that its action was taken in the best interests of the corporation.

8. Corporations ⟸ 310(1)

A higher duty than the business judgment rule is imposed on a board in connection with the adoption or implementation of antitakeover measures.

9. Corporations ⟸ 310(1)

Because corporate directors face an inherent conflict when confronted with a possible loss of corporate control, the directors have the burden of proving that, in adopting or implementing takeover defensive measures, they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness.

10. Corporations ⟸ 310(1)

The burden of proving that in adopting or implementing takeover defensive measures the directors had reasonable grounds for believing that there was a danger to corporate policy and effectiveness is satisfied by a showing of good faith and reasonable investigation.

11. Corporations ⇐ 310(1)

Under Delaware law, antitakeover devices cannot be used merely to defeat a hostile tender offer which is neither coercive, inadequate, nor a threat to the corporation.

12. Corporations ⇐ 310(1)

A board of directors' response to a tender offer is a reasonable one if it is fair, just, equitable, and appropriate, considering all the facts and circumstances.

Michael D. Goldman, Esquire, of Potter, Anderson & Corroon, Wilmington, Delaware, for plaintiffs.

Jesse A. Finkelstein, Esquire, of Richards, Layton & Finger, Wilmington, Delaware, for defendants.

HARTNETT, *Vice-Chancellor*

The plaintiff, MAI Basic Four, Inc. ("MAI"), commenced an all-cash tender offer for all the shares of defendant, Prime Computer, Inc. ("Prime"), on November 15, 1988, and it now seeks a preliminary mandatory injunction setting aside a vast array of anti-takeover defensive devices put in place by the directors of Prime after plaintiff had expressed an interest in acquiring Prime.

I find that the plaintiff is not entitled to a preliminary injunction because it has not borne its burden of showing that the directors of Prime have thus far acted unreasonably.

I

Plaintiff claims that the entrenchment devices adopted by the directors of Prime are designed only to serve as an absolute and permanent bar to prevent the stockholders from considering, on the merits, the all-cash tender offer.

In its reply brief plaintiff states:

> "This case offers what is perhaps the most eggregious [sic] fact pattern yet presented to a Delaware court in the context of defensive corporate action. The record as developed in discovery (as contrasted with the conflicting and

> self-serving affidavits submitted by defendants) presents a woefully uninformed board cavalierly adopting a host of devastating defensive strategies to 'protect' stockholders from a tender offer at a significant premium over market, notwithstanding the board's freely conceded failure to offer the shareholders an alternative of any kind. There is no doubt that Prime instituted its vastly expensive defense arsenal without the slightest care or consideration, without expert advisors and in direct response to a suggestion from Basic proposing a business combination. In so doing, they have violated their fiduciary duties . . ."

Unfortunately for the plaintiff the record does not sustain its broad brush hyperbole.

The anti-takeover defenses adopted include a "flip-in/flip-out" shareholder rights plan; an employee severance bonus plan; an employee pension plan where none previously existed; an employee retention plan providing that employees who continue in employment for one year after a change in control of the corporation and then leave will receive special benefits; a stock appreciation rights plan; and stock options which accelerate with a change of control. All of the anti-takeover devices can, however, be rescinded by the Board of Prime without penalty or the incurring of any obligation to the recipients of benefits. The total economic impact of the devices makes it unlikely that any tender offer could be completed while they remain in place.

Plaintiff first challenges the adoption of these anti-takeover defenses on the grounds that the Board did not have sufficient information to have made an informed judgment as to whether a threat to Prime existed before it adopted the takeover defenses and that the Board was not fully informed when it adopted the measures. The record, however, does not substantiate these allegations. Although the directors could have been better informed, the record shows that they had sufficient information in order to have reasonably perceived that the plaintiff intended to acquire the shares of Prime for the lowest price possible.

The only real basis for the present challenge to the existence of the takeover defenses is the undisputed fact that defendants have not responded to the tender offer in a way which plaintiff desires.

Plaintiff claims that "the defensive mechanisms enacted by Prime cannot be lawfully maintained absent an active program to pursue alternative transactions to maximize shareholder value" and cites the recent case of *City Capital Associates Limited Partnership v. Interco,*

Inc., Del. Ch., No. 10105-NC, Allen, C. ___ A.2d ___ (Nov. 1, 1988).

Defendant, in effect, responds that the Board of Prime has determined, based on the opinions of its financial advisors, that the $20 per share offered is inadequate and has therefore rejected it. It further asserts that it is willing to consider any further or improved offers and that it is "studying the alternatives available to Prime." The Board has also accelerated the date for Prime's next Annual Meeting so that it will occur prior to the expiration of the financing commitments which plaintiff has obtained in connection with its tender offer. This will allow the stockholders to vote the present directors out of office if they are dissatisfied with their performance. The Board, however, has not yet posed any counter offer to plaintiff, nor has it taken any steps to alter the capital structure of Prime, change any voting rights, or sold any assets in response to the tender offer.

The issue therefore is whether Prime can be forced to redeem the anti-takeover defenses at the present time.

II

[1-2] In order to obtain a preliminary injunction, the plaintiff must demonstrate that it has a reasonable probability of success on the merits and that, absent the injunction, it will suffer irreparable harm. In addition, the plaintiff must show that the harm it would suffer absent an injunction outweighs the harm to defendant if relief is granted. *Allen v. Prime Computer*, Del. Supr., 540 A.2d 417 (1988); *Ivanhoe Partners v. Newmont Mining Corp.*, Del. Supr., 535 A.2d 1334 (1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, Del. Supr., 506 A.2d 173 (1986).

[3] Where a preliminary mandatory injunction is sought, the plaintiff has an even greater burden because the legal right sought to be protected must be clearly established. *David v. Shell Oil Co.*, Del. Ch., C.A. No. 7923-NC, Walsh, V.C. (June 12, 1985); See also *SLC Beverages, Inc. v. Burnup & Sims, Inc.*, Del. Ch., C.A. No. 8860-NC, Hartnett, V.C. (Aug. 20, 1987); *In re Hybrilonics, Inc.*, Del. Ch., C.A. No. 8035-NC, Hartnett, V.C. (July 28, 1986); *Nomad v. Damon*, Del. Ch., C.A. No. 10173-NC and No. 10189-NC (Consolidated), Hartnett, V.C. (Sept. 16, 1988).

III

[4-6] In considering whether plaintiff has shown the reasonable probability that it will prevail on the merits, I must take into con-

sideration that the ultimate responsibility for managing the business and affairs of a corporation falls on its Board of Directors. 8 *Del. C.* § 141(a); *Ivanhoe Partners v. Newmont Mining Corporation*, Del. Supr., 535 A.2d 1334 (1987); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, Del. Supr., 506 A.2d 173 (1986). In discharging this function, the directors of a corporation owe fiduciary duties of care and loyalty to its shareholders. *Aronson v. Lewis*, Del. Supr., 473 A.2d 805 (1984). These same principles are the bedrock of Delaware law regarding corporate takeover issues. *Revlon*, supra, at 179; *Moran v. Household International, Inc.*, Del. Supr., 500 A.2d 1346 (1985).

[7-10] When the business judgment rule applies to corporate decision making, there is a presumption that the Board has acted in informed good faith and in the honest belief that its action was in the best interests of the corporation. *Polk v. Good*, Del. Supr., 507 A.2d 531 (1986); *Aronson v. Lewis*, supra. A higher duty is imposed on a board, however, in connection with the adoption or implementation of anti-takeover measures. *Unocal Corp. v. Mesa Petroleum Co.*, Del. Supr., 493 A.2d 946 (1985). In *Unocal*, the Delaware Supreme Court noted that corporate directors face an inherent conflict when confronted with a possible loss of corporate control. This potential for conflict places upon the directors the burden of proving that in adopting or implementing takeover defense measures they had reasonable grounds for believing that there was a danger to corporate policy and effectiveness. This burden is satisfied by a showing of good faith and reasonable investigation. *Unocal*, 493 A.2d at 955. In addition, the directors must show that the responsive action taken was reasonable in relation to the threat posed. *Revlon*, supra; *Unocal*, supra; *Nomad*, supra.

As in the present case, however, where a majority of a board (6 out of 7) favoring the takeover defenses consisted of disinterested directors, the burden of persuasion falls upon the plaintiff to show a breach of the directors' fiduciary duties. *Moran*, supra.

[11] Recently this Court in *Capital City Associates Limited Partnership v. Interco, Inc.*, Del. Ch., C.A. No. 10105-NC, Allen, C. _ A.2d ___, (Nov. 1, 1988), granted a preliminary injunction requiring the corporation to redeem certain anti-takeover devices because there was no longer any valid legal reason for their existence. Plaintiff reads more into *Interco* than is there, however. *Interco* was predicated on facts which clearly showed that the anti-takeover devices had out-lived their purposes. The facts in *Interco* were quite different than present here. In *Interco*, the suit came at the end of a long tender offer struggle after the corporation proposed a restructuring

in lieu of the pending tender offer and the only purpose for the anti-takeover devices became to protect the restructuring. And at least one-half of the Board also had economic interests which would be favored by the restructuring. *Interco*, however, does hold that anti-takeover devices cannot be used merely to defeat a hostile tender offer which is neither coercive, inadequate, nor a threat to the corporation. See also *Grand Metropolitan Public Ltd. Co., et al v. The Pillsbury Company, et al*, Del. Ch., C.A. No. 10319-NC, Duffy, J. (December 16, 1988).

IV

[12] The unanswered issue, therefore, is whether the failure of Prime's Board to thus far do more in response to plaintiff's tender offer has been a reasonable response. A reasonable response must be one which is fair, just, equitable and appropriate, considering all the facts and circumstances.

Needless to say, it is not easy to determine what is a reasonable response to a tender offer after the directors, in the proper exercise of their business judgment, have determined it to be inadequate and it is therefore necessary to carefully review all the factors having a bearing on the course pursued by the directors here.

For the most part the pertinent factors to be examined in reviewing the actions taken by the Board are not disputed. Six of the seven directors of Prime are outside directors and there has not even been an allegation that they are anything but disinterested. The Board, immediately after being advised of the tender offer, retained two outside independent financial advisors who expressed their opinion that the $20 per share offer was inadequate. The offer represents a relatively small premium over the recent selling price of Prime's shares and the initial contact by the plaintiff to the corporation's officers indicated that the plaintiff had as great an interest in being acquired by Prime as it did in acquiring Prime. Prime has recently obtained new management and is only now on the verge of reaping the economic benefits of its recent acquisition of Computervision. As a result, the projections by Prime's management for the future are optimistic. The directors of Prime have moved forward the date for the annual meeting of the corporation so that it will take place before plaintiff's financing commitments expire. The directors, in 1985, attempted to place Prime on the market, thus indicating that entrenchment is not the primary motive of the Board. The tender offer has been pending for less than a

month, and less than 1% of the stockholders have tendered their shares. The tender offer contains numerous contingencies which have not yet been fulfilled, and plaintiff has been less than candid in revealing the value its experts have established for Prime. Two outside investment bankers, operating independently of Prime, have publicly expressed their opinion that the value of Prime's shares is in the $23 to $28 per share range. It also appears that plaintiff is prepared, and is in a position, to offer more than $20 per share but only the existence of the anti-takeover devices will compel it to do so.

On the other hand, the tender offer is for all cash and there is nothing about it which would indicate that it is coercive to the stockholders. It appears to be bona fide and represents a premium over current market value. Although the directors acted on the basis of adequate information and data in finding that plaintiff's tender offer constitutes a threat to Prime and its stockholders, and in finding that the offering price is inadequate, the data relied upon could have been more comprehensive. Nor have the directors of Prime apparently arrived at a value for the corporation and they have not, as yet, made a counter offer to plaintiff. Nor have they apparently sought another possible suitor. It appears unlikely that the corporation could propose a leveraged buy-out at over $20 per share and the corporation presently has no other announced plans to increase the value of the shares.

It also seems likely that if the present stalemate continues indefinitely the stockholders of Prime will be denied an opportunity to make their own investment judgment whether they should accept a tender offer because the anti-takeover mechanisms are so burdensome that no prospective tender offeror could afford to buy the shares as long as they are in place.

V

After considering all these factors, I find that plaintiff has not borne its burden of showing that the directors of Prime have thus far acted unreasonably. Of particular significance is the short time the tender offer has been pending and the fact that without the anti-takeover devices being in place, plaintiff will not increase its offer. Nor has there been any showing that plaintiff will suffer any irreparable harm if the preliminary injunction is not granted. The harm which the shareholders will suffer, however, if the takeover defenses are struck down at this early stage, also clearly are greater than any harm to plaintiff.

The application for a preliminary injunction is therefore denied. IT IS SO ORDERED.

PINSON v. CAMPBELL-TAGGART, INC.

No. 7499

Court of Chancery of the State of Delaware, New Castle

February 28, 1989

(Revised April 21, 1989 & August 11, 1989)

Petitioners, being minority stockholders in the target corporation, brought an appraisal action seeking a reevaluation of the merger price per share based on the contention that the acquiring company, in an interested merger transaction, is obliged to demonstrate that the merger price per share is inherently fair. The court of chancery, per Vice-Chancellor Jacobs, refused to apply the entire fairness doctrine to stock appraisal actions but modified the price per share based on errors in the respondents' stock appraisal methods.

1. Corporations ⇐ 182.4(6), 203

For purposes of a section 262 appraisal, it is inappropriate to discount the fair value of a security to reflect its non-marketability and the fact that the security represents only a minority interest. DEL. CODE ANN. tit. 8, § 262 (1981).

2. Corporations ⇐ 307, 310(2), 316(1)

Fiduciaries who stand on both sides of a merger and fix its terms have a fiduciary duty to treat minority stockholders with entire fairness.

3. Corporations ⇐ 307, 310(2), 316(1)

The fiduciary duty to treat the minority stockholders with entire fairness, embraces the obligation both to deal fairly with the minority stockholders and to pay a fair price in the transaction.

4. Corporations ⟸ 316(1), 584

In any action challenging the fairness of an interested merger, the defendant fiduciaries have the burden of proving that the merger was entirely fair in all aspects.

5. Corporations ⟸ 185, 584

Because an appraisal proceeding is legally and conceptually distinct from a breach of fiduciary duty proceeding, there is no need to engraft the "entire fairness" conceptual apparatus upon appraisals brought under Delaware Code Annotated, title 8, section 262. DEL. CODE ANN. tit. 8, § 262 (1981).

6. Corporations ⟸ 307, 310(2), 320(10)

Under Delaware law, compensating procedural safeguards are created that subject those fiduciaries to the exacting requirement that they demonstrate to a carefully scrutinizing court their utmost good faith on the most scrupulous inherent fairness of the bargain.

7. Corporations ⟸ 584

In an appraisal proceeding, liability need not be established because no inquiry is made into claims of wrongdoing in the merger; rather, a shareholder who seeks an appraisal and who complies with statutory procedural requirements is automatically entitled to recover the adjudicated "fair value" of his stock.

8. Corporations ⟸ 182.4(6)

In a section 262 appraisal action, the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of dissenters' shares. DEL. CODE ANN. tit. 8, § 262 (1981).

9. Evidence ⇐ 90, 94

The conventional burden of proof concept is that where the evidence on both sides of an issue is in equipoise, a court will rule against the party having the burden of proof.

10. Corporations ⇐ 182.4(6)

In an appraisal action, no presumption, favorable or unfavorable, attaches to either side's valuation, including the actual merger price.

11. Corporations ⇐ 182.4(6)

Because no determination of liability is required to obtain relief under section 262, and since neither side is benefitted or burdened by any presumption, the burden of proof in an appraisal action should be the same as in any normal civil action, i.e., proof by a preponderance of the evidence. DEL. CODE ANN. tit. 8, § 262 (1981).

12. Corporations ⇐ 584

Damages ⇐ 87(1)

In an appraisal action, the Delaware General Corporate Law only allows recovery of the petitioning stockholder's attorneys' fees and other litigation expenses by a pro rata apportionment against the value of the shares entitled to an appraisal. DEL. CODE ANN. tit. 8, § 262(j) (1981).

13. Corporations ⇐ 182.4(6)

In determining the value of a minority stockholder's shares of stock, the court may consider any valuation method that is admissible in evidence and is generally acceptable in the financial community.

14. Corporations ⇐ 182.4(6)

Today the discounted cash flow method is widely accepted in the financial community as a legitimate valuation technique.

15. Corporations ⇐ 182, 584

The objective of any valuation technique is to measure, in an objectively fair way, the intrinsic value of the merged corporation, consistent with the mandates of Delaware law. DEL. CODE ANN. tit. 8, § 262(h) (1981).

16. Corporations ⇐ 320(11)

An investment banking firm's preliminary draft report, not authorized as the issuance of a formal fairness opinion, does, nonetheless, contain evidence that bears importantly on the valuation question, evidence that may properly be considered and given such weight as may be appropriate.

17. Corporations ⇐ 584

Where earnings are averaged, it is normally inappropriate absent extraordinary circumstances, to exclude an unusually good or bad year from the average in computing the value of stock.

18. Corporations ⇐ 182.4(6), 320(11)

Interest ⇐ 38

Under Delaware Code Annotated, title 8, section 262(h), the reviewing court shall determine the fair value of the shares being appraised together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining the fair rate of interest, the court may consider all relevant factors, including the rate of interest which the surviving or resulting corporation would have had to pay to borrow money during the pendency of the proceeding. DEL. CODE ANN. tit. 8, § 262(h) (1981).

19. Corporations ⇐ 182.4(6), 203

Interest ⇐ 38

Under Delaware Code Annotated, title 8, section 262(i), the fair rate of interest used to determine the fair value of stockholders'

shares may be simple or compound as the court may direct. DEL. CODE ANN. tit. 8, § 262(i) (1987).

20. Interest ⟸ 38

The determination of the precise method, by which interest is to be determined after taking all relevant factors into account, is reserved to the sound discretion of the court.

Januar D. Bove, Jr., Esquire, of Connolly, Bove, Lodge & Hutz, Wilmington, Delaware; George H. Cain, Esquire, and Stephen R. Underhill, Esquire, of Day, Berry, & Howard, Stamford, Connecticut, for petitioners.

Steven J. Rothschild, Esquire, and Andrew J. Turezyn, Esquire, of Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware, for respondents.

JACOBS, *Vice-Chancellor*

The Petitioners, minority shareholders of Rainbo Baking Company of Tulsa ("Rainbo Tulsa"), seek appraisal of their shares pursuant to 8 *Del. C.* § 262, as the result of a merger that became effective on January 31, 1984. In that merger Rainbo Tulsa was absorbed into a wholly owned subsidiary of its parent company, Campbell-Taggart, Inc. ("C-T"), and Rainbo Tulsa's minority shareholders received $1,935.75 cash for each of their shares. Believing that amount to be inadequate, Petitioners initiated this proceeding, which was tried on October 15-22, 1986. Post-trial briefing was completed on December 22, 1986, and supplemental letter memoranda were submitted on March 7 and 8, 1988. This is the Opinion of the Court determining the fair value of the Petitioners' Rainbo Tulsa shares.

I. BACKGROUND FACTS

Rainbo Tulsa was a Delaware corporation that made and distributed various bakery products in Oklahoma. Founded in late 1920s by the father of Petitioner E. Rex Pinson, Jr., Rainbo Tulsa later became a 69% subsidiary of C-T. At the time of the merger, Rainbo Tulsa had 2,750 issued and outstanding shares, 1,764 of which were

owned by C-T. The Petitioners owned 761 of the remaining 986 minority shares.

C-T is a Dallas, Texas based food products company that operates several distinct businesses, including bakery products, refrigerated foods, frozen foods, and its international division. At the time of the merger, C-T operated its bakery products division through 53 separate bakery subsidiaries located throughout the United States. In those 53 subsidiaries, only 13 were wholly owned by C-T. C-T held the majority stock interest in the remaining 40 bakeries, including Rainbo Tulsa.

On November 2, 1982, C-T was acquired by Anheuser-Busch Companies, Inc. ("A-B"), a corporation headquartered in St. Louis, Missouri and which operates, among other businesses, one of the nation's major breweries. Shortly after A-B acquired C-T, it formed a task force to explore the feasibility of consolidating C-T's bakery operations. That consolidation would involve closing down certain bakeries and acquiring the minority interests in the 40 bakery subsidiaries not wholly owned by C-T. After preparing various strategic and financial studies, the task force recommended, in March, 1983, that C-T acquire the minority shareholder interests in all 40 of its "minority interest" bakery subsidiaries.

In the late spring of 1983, A-B retained Dillon Read & Co., Inc. ("Dillon Read"), its investment banker, to advise it in connection with acquiring the minority interests in the 40 bakeries. In September, 1983, Dillon Read submitted to A-B a "preliminary draft" report in which Dillon Read suggested valuations for each of the bakery subsidiaries, including Rainbo Tulsa. However, Dillon Read did not, nor was it asked to, ultimately value the minority interests or furnish a "fairness opinion."

After it was decided that C-T would acquire the minority interests, A-B contacted two other investment banking firms, Morgan Stanley & Co. and Merrill Lynch, in the late summer of 1983. Both firms were asked if they would be interested in valuing the 40 "minority interest" bakeries. Morgan Stanley expressed no interest in performing 40 separate valuations of companies of that size. Merrill Lynch apparently was interested, but A-B ultimately decided that Merrill Lynch would require too much time to perform the valuations, thereby unduly prolonging the acquisition process.[1] Ultimately,

1. There is no evidence of precisely how much time Merrill Lynch would

A-B decided not to retain Merrill Lynch or any other independent financial advisor to appraise the minority bakeries. The reasons expressed by C-T's management to the C-T Board (in addition to the need for expedition) was that the cost of obtaining an independent opinion was disproportionately high in relation to the transaction value, and that C-T knew more about the bakery industry and its own subsidiaries than any outside investment banker could learn within a reasonable time. (DX11).

Accordingly, the task of valuing Rainbo Tulsa and the other 39 subsidiaries fell to C-T's planning department, which consisted of Messrs. John Piotrowski (a member of C-T management and the Respondents' principal trial witness) and two other C-T employees. Those persons used different valuation methodologies, depending in part upon whether a particular bakery was to be closed or would continue to operate as a going concern. Because Rainbo Tulsa would continue to operate, it was valued by the discounted cash flow method, at $1,935.75 per share. Since Rainbo Tulsa's directors were affiliated with and not independent of C-T, Rainbo Tulsa's valuation was not the product of an arm's length negotiation. C-T likewise determined (also unilaterally) separate values for each of the other 39 minority interest subsidiaries.

Thereafter, a recommendation was made to A-B's Board of Directors, and then to C-T's Board, that C-T acquire, in separate mergers, all 40 minority interests for an aggregate price of $20.7 million. A-B's Board approved the acquisition in December, 1983. The C-T Board's approval followed on January 11, 1984, and Rainbo Tulsa's directors approved the merger by written consent on January 23, 1984. On January 31, 1984, the merger was formally consummated.

Shortly thereafter, Rainbo Tulsa's minority stockholders received a Notice of Merger dated February 1, 1984, together with an accompanying Information Circular which disclosed the $1,935.75 per share cash merger price.

This appraisal proceeding followed.

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have needed. Respondents' witness, Mr. John Piotrowski, speculated that if it took one week to value each bakery, then the process would require 40 weeks. However, no showing was made that C-T or A-B ever attempted to inquire whether Merrill Lynch could expedite that process.

II. *THE PARTIES' VALUATION CONTENTIONS*

A. The Respondents' Valuation of Rainbo Tulsa

The parties' valuation arguments are best understood in terms of the C-T planning department's valuation methodology, which was the "discounted cash flow" method. In performing that valuation, C-T used 1983 as the "base year" for projecting future cash flows for each of the next fifteen years. In projecting those cash flows, C-T assumed that Rainbo Tulsa would experience no (0%) earnings growth in 1984 and 1985, 5% growth in 1986 and 1987, and 3% growth thereafter through 1998. The combined present value of those yearly cash flows, discounted at a 17% rate, was then added to the corporation's terminal value (also discounted at 17%) to arrive at a total value, which was the $1,935.75 per share merger price.

B. The Petitioners' Valuation Contentions

Petitioners challenge the fairness of the merger price on the ground that the assumptions underlying the discounted cash flow valuation were incorrect and severely understated Rainbo Tulsa's fair value. Specifically, Petitioners contend that: (1) 1983 was an improper "base year" for cash flow projections, because that year was aberrational and not fairly reflective of Rainbo Tulsa's historical earnings performance; (2) C-T's earnings growth assumptions were unfair and without basis in historical fact; (3) the 17% discount rate was improper, because it improperly attributed to Rainbo Tulsa an exaggerated and unwarranted degree of investment risk, and (4) the assumption that the $1.226 million intercompany debt would be repaid at the beginning of the 15 year projection period, was improper and unfairly depressed the entire cash flow projection.

[1] The Petitioners initially contended that Rainbo Tulsa's fair value was $3,464.90 per share.[2] That valuation rests upon the tes-

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2. On March 7, 1988, the Petitioners advised the Court that they had upwardly revised that valuation to $4,679.27 per share, based upon this Court's Opinion in an unrelated litigation handed down while this case was *sub judice*. *Cavalier Oil Corp. v. Harnett*, Del. Ch., C. A. Nos. 7959, 7960, 7967 and 7968, Jacobs, V. C. (February 22, 1988) (appeal pending, Del. Supr., No. 235, 1988). In *Harnett*, this Court pertinently ruled that for purposes of a § 262 appraisal, it was inappropriate to discount the fair value of a security to reflect its non-marketability and the fact that the security represents only a minority interest. Contending that both sides had improperly utilized such discounts in their valuations,

timony of their trial expert, Mr. Paul A. Perlin, a director of the corporate finance department of Neuberger & Berman, a New York investment banking concern. Mr. Perlin testified that he valued Rainbo Tulsa by four alternative methods: book value, capitalized earnings, and two alternative versions of a formula that involved combining weighted book value and weighted historical earnings.

In performing his book valuation, Mr. Perlin multiplied Rainbo Tulsa's 1983 year-end book value by 2.5, which was the ratio of acquisition price to book value that A-B paid to acquire C-T in 1983. The resulting value was then discounted by 30% to achieve a result consistent with an earnings multiple of 9.5 to 10 times earnings. By that approach, Mr. Perlin arrived at a value of $3,503.56 per share.

Under his second (capitalized earning) valuation, Perlin employed earnings multiples similar to those A-B used to acquire C-T in 1983 (*i.e.*, from 12.9 to 14.4 times earnings). Perlin applied those multiples to Rainbo Tulsa's average earnings for the period 1979-1983, and arrived at earnings values of $3,440 and $3,840.48 per share, respectively. A similar computation for the 1978-1982 period resulted in corresponding earnings values of $4,590.34 and $5,124.10 per share. Those values were then discounted by 30% to eliminate the value attributable to a control premium. The resulting earnings values were $2,408.30 and $2,688.34 per share, respectively, for 1979-1983, and $3,213.24 and $3,586.87 per share, respectively, for 1978-1982. Perlin selected the midpoint between the two 1978-1982 earnings figures, arriving at a value of "roughly $3,400 per share."

Mr. Perlin's third valuation approach involved weighting earnings value and book value on a 3:1 basis. Using his 1978-1982 (alternative) earnings values of $3,213.24 and $3,586.87 per share, and his book valuation of $3,503.66 per share, Perlin computed alternative weighted values of $3,285.50 and $3,565.40 per share. Taking the midpoint between those two values, Perlin arrived at an overall weighted valuation of "roughly $3,425 per share."

Because of his misgivings about reported earnings for 1983, a year he regarded as a major deviation from the company's historic

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the Petitioners upwardly revised Mr. Perlin's valuation figures to eliminate those discounts.

The Respondents object to the Petitioners' effort to recalculate their contended-for values on various grounds. Because discounts play no role in (and therefore are irrelevant to) the valuation methodology ultimately adopted by this Court, it is unnecessary to address the "discount" issues raised in this appraisal.

performance, Perlin was not satisfied with these valuations. Accordingly, he performed a fourth computation, based upon a formula previously used by C-T to acquire minority shares in its bakeries. Under that formula, each year's earnings during the previous five years was weighted in descending order (*i.e.*, giving a weight of 5 to the most recent year, a weight of 4 for the prior year, etc.). Applying that method to Rainbo Tulsa's earnings for 1978 through 1982, Perlin computed average earnings of $393.29 per share, which he then capitalized at a multiple of 10[3] to arrive at an earnings value of $3,932.90 per share. Weighting that earnings value at 75%, and book value ($2,062 per share) at 25%, Perlin arrived at his ultimate valuation of $3,464.90 per share.

Perlin concluded that $3,464.90 was the appropriate "fair value" for Rainbo Tulsa, because it was based upon a time-tested formula that C-T had used in the past and that reasonably weighted Rainbo Tulsa's most important valuation components.

C. The Respondents' Valuation Contentions

The Respondents contend that the merger price was fair, and, in fact, exceeded Rainbo Tulsa's statutory fair value, which they claim is $1,218 per share. Their valuation is based upon the testimony of their expert trial witness, Professor James E. Walter, of the Wharton School of Finance of the University of Pennsylvania. Professor Walter employed four separate valuations, each based upon a different methodology.

Professor Walter's preferred valuation method was a discounted cash flow analysis. Walter assumed that Rainbo Tulsa's sales would grow at the rate of a $6^1/_2$% per year until 1990, at which point a reinvestment in plant and equipment would be needed to provide added capacity. The projected cash flows (*i.e.*, dividends) available to investors and the terminal value of the enterprise were all discounted at the rate of 15%. The resulting value, $1,874 per share, was then discounted by 35% to reflect the illiquidity of the Petitioners' shares, to achieve a value of $1,218 per share.

In his second valuation, Professor Walter capitalized Rainbo's average historical earnings for three years (1981-1983), using an

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3. Ten was the multiple most closely approximating the 9.5 multiple that Perlin deemed appropriate for Rainbo Tulsa. It was also the price-earnings ratio that Dillon Read had used to value C-T's 40 bakeries.

earnings multiple of 2.6.[4] By that process Professor Walter computed a value of $1,436 per share, which, after applying a 35% illiquidity discount, was reduced to $933 per share.

Professor Walter's third method involved projecting Rainbo Tulsa's after-tax earnings (adjusted for capital expenditures and increases in working capital) over the 15 year period, 1984 through 1998. It was assumed that earnings would grow at a 3% rate, and that 73.2% of all earnings would be paid out to stockholders as dividends. The resulting values—$1,929 per share (using a 14% discount rate) and $1,424 (using a 17% discount rate)—were then discounted by 35% for illiquidity, to arrive at ultimate values, respectively, of $1,254 and $926 per share.

Professor Walter's fourth valuation was based upon the weighted formula method used by C-T to value the stock in certain of its minority subsidiaries. Under that formula (also used by Mr. Perlin), weighted earnings for the period 1979-1983 were computed and then capitalized by an earnings multiple of 6. The resulting earnings value was then weighted at 75%, and book value was weighted at 25%. The two weighted values were then combined to arrive at an ultimate fair value of $2,037 per share.

III. PRELIMINARY ISSUES—THE IMPACT OF *"ENTIRE FAIRNESS" CONSIDERATIONS*

Before the Court can determine these substantive issues of fair value, it must first consider two threshold procedural questions that concern, broadly speaking, the relevance and impact of the "entire fairness" fiduciary standard in a § 262 appraisal.

[2-4] In *Weinberger v. UOP, Inc.*, Del. Supr., 457 A.2d 701 (1983), and earlier cases, the Supreme Court held that fiduciaries who stand on both sides of a merger and fix its terms have a fiduciary duty to treat the minority stockholders with entire fairness. That fiduciary duty embraces the obligation both to deal fairly with the minority stockholders and to pay a fair price in the transaction. An important procedural consequence of that duty is that in any action challenging the fairness of an interested merger, the defendant fi-

4. That multiple was achieved by applying a 35% illiquidity discount to Walter's derived multiple of 4. That latter multiple was derived by utilizing C-T's historical stock values to determine implied discount rate(s) for C-T's earnings. Those rates were then adjusted downward by 10%, to achieve multiples for Rainbo Tulsa of 4.1 (using a 10 year average) and 4.6 (using a 5 year average).

duciaries have the burden of proving that the merger was entirely fair in both aspects. As thus viewed, the "entire fairness" concept encompasses both substantive duties and procedural burdens.

Traditionally, the entire fairness standard has been applied in representative "breach of fiduciary duty" actions for injunctive, rescissory or damage relief in connection with an interested merger or similar transaction. The Petitioners contend here that that standard should also apply in appraisal proceedings. Specifically, they argue that the Respondents, who stood on both sides of the merger and dictated its terms, should have the burden of proving the entire fairness of the merger price and any other of their contended-for "fair values." Petitioners also urge that the fact that Respondents dealt unfairly with them[5] bears upon the credibility of the Respondents' substantive "fair value" contentions. Finally, Petitioners argue, apart from the burden of proof, that their unfair treatment by Respondents entitles them to an award of litigation expenses, including attorneys' fees, under 8 *Del. C.* § 262(j) and general equitable principles.

These preliminary questions are now addressed.

A. The Burden of Proof

[5] It is not disputed that if this were an action for injunctive or other equitable relief based upon claims of fiduciary wrongdoing in the merger, Respondents would have the burden to prove the entire fairness of the merger, both as to fair dealing and price. *Weinberger v. UOP, Inc.*, *supra*, 457 A.2d at 710; *Sterling v. Mayflower Hotel Corp.*, Del. Supr., 93 A.2d 107, 110 (1952). This is, however, an appraisal proceeding. As such, it is legally and conceptually distinct from a "breach of fiduciary duty" action of the kind involved in *Weinberger*. For that and the other reasons now discussed, there is no need to engraft the "entire fairness" conceptual apparatus upon appraisals brought under 8 *Del. C.* § 262.

[6] *First*, the rationale for imposing the "entire fairness" burden is that in a self dealing transaction, the minority shareholders' interests are not being adequately safeguarded, because the fiduciaries charged with protecting the minority have a conflicting self-interest. Our law, therefore, creates compensating procedural safeguards by

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5. The unfair dealing is said to arise (*inter alia*) from Respondents' having unilaterally fixed the merger price without obtaining an independent fairness opinion, and having failed to disclose certain allegedly material financial information.

subjecting those fiduciaries to the exacting requirement that they demonstrate to a carefully scrutinizing court "their utmost good faith and the most scrupulous inherent fairness of the bargain." *Weinberger v. UOP, Inc.*, *supra*, 457 A.2d at 710; *Gottlieb v. Heyden Chemical Corp.*, Del. Supr., 91 A.2d 57, 58 (1952).

[7] That rationale is not implicated in a § 262 appraisal. That is because that rationale's premise is that the burden of proof must be shifted to afford minority shareholders a fair opportunity to establish fiduciary liability, which, in turn, is necessary to obtain relief in an equitable action. However, liability need not be established in an appraisal, because no inquiry is made into claims of wrongdoing in the merger. *Cede & Co. v. Technicolor, Inc.*, Del. Supr., 542 A.2d 1182, 1189 (1988). Rather, a shareholder who seeks an appraisal and who complies with statutory procedural requirements is automatically entitled to recover the adjudicated "fair value" of his stock.

[8] *Second*, the substantive scope of an appraisal, which involves the issue of "fair value," is narrow. The Supreme Court recently confirmed the narrowness of the scope of appraisal proceedings in *Cede & Co. v. Technicolor, Inc.*, *supra*, 542 A.2d at 1187:

> . . .[I]n a Section 262 appraisal action the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of dissenters' shares.

Thus, whether or not there was "fair dealing" in the merger, is an issue not cognizable in an appraisal.[6] If "entire fairness" is relevant in an appraisal, it is only with respect to the merger price.

[9] *Third*, the Petitioners' "entire fairness" burden of proof argument overlooks the normal evidentiary function of the burden of proof concept, and the limited relevance of that function in the appraisal context. The conventional burden of proof concept is that where the evidence on both sides of an issue is in equipoise, a court will rule against the party having the burden of proof. But, as

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6. In *Cede & Co.*, *supra*, the Supreme Court did recognize that in certain situations it might become necessary to consolidate an appraisal with an equitable fraud/breach of fiduciary duty action for purposes of trial, and perhaps for discovery as well. Nonetheless, the Supreme Court reaffirmed and underscored the fundamental conceptual and procedural differences between these two types of proceedings and the distinctness of the remedies available under each.

observed in *Cavalier Oil Corp. v. Harnett, supra*, at 54, that conventional approach is of limited utility in an appraisal, because § 262 mandates that the Court "shall appraise" (*i.e.*, shall independently determine) the fair value of the dissenting stockholders' shares. To import an "entire fairness" burden of proof concept into appraisal actions would not automatically dispose of the valuation controversy, because even if the merger price is found to be not entirely fair, the dissenting shareholders must still persuade the Court of the validity of their affirmative valuation position. If they do not, the Court is in all events required to determine "fair value" independently, based upon its objective evaluation of the evidence.

[10-11] From the foregoing, the following may be concluded: In an appraisal action, each side has the burden of proving its respective valuation position. No presumption, favorable or unfavorable, attaches to either side's valuation, including the actual merger price. Because no determination of "liability" is required to obtain relief under § 262, and since neither side is benefited or burdened by any presumption, the burden of proof in an appraisal action should be the same as in any normal civil action, *i.e.*, proof by a preponderance of the evidence. *See Murphy v. T. B. O'Toole, Inc.*, Del. Super., 87 A.2d 637, 638 (1952); *Oberly v. Howard Hughes Medical Institute*, Del. Ch., 472 A.2d 366, 386-7 (1984).

But there is one *caveat*: it should not be concluded that in an appraisal the Court will blind itself to or ignore the manner and procedures by which the merger price was arrived at. If corporate fiduciaries engage in self-dealing and fix the merger price by procedures not calculated to yield a fair price,[7] those facts should, and will, be considered in assessing the credibility of the Respondent corporation's valuation contentions. Equity and logic require no less. If a particular merger price would not be "entirely fair" in an equitable action claiming breach of fiduciary duty, no different result should obtain in an appraisal, where the issue is whether that identical merger price constitutes "fair value."[8] Otherwise, a minority shareholder seeking an appraisal would be left worse off, procedurally speaking, than in an equitable action, and the effectiveness of the

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7. For example, by not obtaining an independent appraisal by a disinterested financial advisor, or by not establishing an independent negotiating committee.

8. In *Cede & Co., supra*, the Supreme Court recognized that in a fraud/breach of fiduciary duty action, the valuation approach may be the same as that employed in determining value in an appraisal under § 262. (542 A.2d at 1187 at FN 9).

appraisal remedy would be impaired. The underlying substantive duties governing fiduciary conduct remain constant. They should not be denigrated because the remedy being sought is a statutory appraisal.

B. The Litigation Expense Issue

In addition to their burden of proof argument, Petitioners also contend that the Respondents' unfair dealing justifies an award against the surviving corporation (C-T) of the Petitioners' attorneys' fees and expert witness costs. Petitioners claim entitlement to such relief based upon what they characterize as an independent claim:

> . . .for such other and further relief as the Court deems appropriate in the circumstances, in the light of defendants' unfair conduct towards plaintiffs, defendants' breach of fiduciary duty towards plaintiffs as minority shareholders of Rainbo, and defendants' misrepresentations. . . (Amended Complaint, Prayer for Relief (C)).

Having considered the parties' arguments on this point, I conclude that that issue need not be decided, because no legal basis for granting the relief requested has been shown. The appraisal remedy is a creature of statute. *Kaye v. Pantone, Inc.*, Del. Ch., 395 A.2d 369, 374-375 (1978), *cited with approval* in *Cede & Co.*, *supra*, 542 A.2d at 1186. As for litigation expenses, 8 *Del. C.* § 262(j) provides that:

> The costs of the proceeding may be determined by the Court and taxed upon the parties as the Court deems equitable in the circumstances. Upon application of a stockholder, the Court may order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding, including, without limitation, reasonable attorney's fees and the fees and expenses of experts, to be charged pro rata against the value of all the shares entitled to an appraisal.

[12] By its own terms the statute does not authorize the Court to tax a petitioning stockholder's attorneys' fees and other litigation expenses against the surviving corporation. Those expenses are recoverable only by a *pro rata* apportionment against the value of the shares entitled to an appraisal. 8 *Del. C.* § 262(j). Petitioners here do not seek to recover their litigation costs through such an appor-

tionment.[9] Rather, they seek to recover their expenses, as costs, against the corporation on the basis of a nonstatutory claim of unfair dealing. However, a claim of that kind is not independently cognizable in an appraisal proceeding. *Cede & Co. v. Technicolor, Inc.*, *supra*, 542 A.2d at 1189-1190. Accordingly, Petitioners are not entitled to an award of their attorneys' fees and litigation expenses against the surviving corporation.

I turn now to the substantive issues touching on "fair value."

IV. *THE FAIRNESS OF THE MERGER PRICE*

A. Preliminary Observations

[13] By their very nature, appraisals normally tend to present difficult questions. In this particular case, those difficulties were compounded by the parties' chosen manner of presenting their valuation positions. In *Weinberger v. UOP, Inc.*, *supra*, the Supreme Court liberalized the appraisal proceeding by permitting this Court to consider any valuation method that is admissible in evidence and is generally considered acceptable in the financial community. Construing that invitation as broadly as possible, the parties have offered up no less than four separate valuations each, for a total of 8 potential "fair values" from which they would have the Court pick and choose.

In matters of this kind, it is problematic enough to decide between even two conflicting appraisals. To be confronted with eight of them boggles the mind, especially where (i) the briefs do not adequately discuss, in conceptual terms, the propriety or impropriety of applying those methodologies to the present factual circumstances, and (ii) the parties dispute the critical assumptions (and, to an extent, even the facts) underlying their multitudinous approaches. Were the Court to accept the parties' invitation to adjudicate each of their separate valuations, this already prolix Opinion would become unmanageable in length.

The foregoing is simply prologue to the Court's initial problem, which was how best to treat the parties' "Chinese menu" of competing valuations. The Court concluded that the most rational, efficient approach would be first to determine whether the $1,935.75

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9. That is undoubtedly because apportionment would be of no practical benefit to Petitioners, who own all but two (2) of the shares for which appraisal is being sought in this proceeding.

merger price is fair value. That is because on a conceptual level, that question encompasses various subsidiary issues, the resolution of which would materially advance the determination of the other, competing valuations. Moreover, on a practical level, should it be found that the merger price did not represent fair value, then, *a fortiori*, neither would the Respondents' other valuations, all of which, with one exception,[10] were for lesser amounts. Accordingly, the Court first considers the $1,935.75 per share merger price and for the reasons discussed *infra*, determines that that price does not constitute Rainbo Tulsa's fair value. Next, the Court considers the competing, higher valuations. For the reasons discussed in Section V, *infra*, only two of those competing valuations need be addressed—those based upon the C-T "formula," which is found to be the appropriate valuation method in this case.

B. Specific Issues Relating To The Fairness of the Merger Price

[14] As previously stated, the Petitioners challenge the fairness of the merger price by attacking the basic assumptions underlying C-T's discounted cash flow valuation.[11] To elucidate the discussion of the specific valuation issues, C-T's discounted cash flow computation of the Rainbo Tulsa merger price is set forth in the chart below:

Year	EARNINGS PROJECTIONS (% INCREASE)	PROJECTED CASH FLOW ($000)	PRESENT VALUE OF CASH FLOWS (DISCOUNTED AT 17%) ($000)
1983	0	$ (1,226)	$ (1,226.0)
1984	0	967	826.5
1985	5	967	706.4
1986	5	1,015	633.7
1987	3	1,066	588.9
1988	3	1,098	500.8

10. The exception is the Respondents' $2,037 per share valuation arrived at by use of the C-T "weighted earnings/book value" formula.

11. The Petitioners also attack the validity of the discounted cash flow approach as a valuation methodology, but that contention lacks merit. Today the discounted cash flow method is widely accepted in the financial community as a legitimate valuation technique. (*See Cavalier Oil Corp. v. Harnett, supra*). While the particular assumptions underlying its application may always be challenged in any particular case, the validity of that technique *qua* valuation methodology is no longer open to question.

1989	3	1,131	440.9
1990	3	1,165	388.2
1991	3	1,200	341.7
1992	3	1,236	300.8
1993	3	1,273	264.8
1994	3	1,311	233.1
1995	3	1,351	205.3
1996	3	1,391	180.7
1997	3	1,433	159.1
1998	3	8,414	789.4

$$\frac{\$\ 5{,}314.3}{2{,}750} = \$\ 1.932.47^{12} \text{ per share}$$

Each of the disputed assumptions employed by C-T in its discounted cash flow valuation is separately addressed.

A. The Use of 1983 Earnings As A Projection Base

C-T projected Rainbo Tulsa's future cash flows from a "1983 earnings" base of $967,000. In point of fact, Rainbo Tulsa's actual earnings for 1983 were only $320,000; the $967,000 figure represented 1983 actual earnings, as augmented by certain adjustments. Because the cash flow projections were prepared in mid-September, 1983, C-T utilized actual earnings figures for the first 36 weeks of 1983, and estimated earnings for the balance of that year. The resulting figure was then adjusted by adding (i) approximately $400,000 of non-reimbursed losses from embezzlements by Rainbo Tulsa's then president (those losses were not discovered until late 1983) and (ii) additional amounts representing marketing, maintenance, and related expenditures that, for valuation purposes, were deemed "extraordinary" and, therefore, not properly chargeable against 1983 earnings.

Petitioners sharply criticize C-T's use of the $967,000 figure as the projection "base" because, in their view, Rainbo Tulsa's 1983

12. There is no documentary or other record evidence where C-T's calculation of the present value of Rainbo Tulsa's projected cash flows is set forth. The calculation found in the column ("Present Value of Cash Flows") was performed by the Court, using the standard formula used to compute present value. The Court's calculation resulted in a per share price ($1,932.47) that is slightly lower than the merger price calculated by C-T ($1,935.75), a discrepancy that in this context is immaterial.

earnings were aberrational and unrepresentative of its historical pattern of earnings and sales growth. Petitioners contend that the use of 1983 earnings prejudicially understated C-T's entire discounted cash flow valuation, and in support, they point to Rainbo Tulsa's earnings and sales for the 1978-1983 period, which were as follows:

Year	Net Income (000's)	Sales (000's)
1978	$ 713	$12,409
1979	809	15,328
1980	938	17,566
1981	1,187	20,289
1983	320	26,156
1982	1,179[13]	23,102

Petitioners emphasize that between 1978 and 1982, sales and net income grew at average annual rates of 16.8% and 12.7% respectively. In contrast, growth in the baking industry averaged only a 5.1% increase in sales and a .1% increase in net income. Petitioners emphasize also that Rainbo Tulsa's historically upward sales growth trend continued into 1983, sales having increased by 13% over 1982. They urge that if expenses had increased proportionately with sales (*i.e.*, had also increased by 13%), then expenses for 1983 would have been only $23.9 million, rather than $25.7 million. That difference alone, it is argued, would have increased "adjusted" 1983 earnings from $967,000 to $1.1 million, *i.e.*, a $397 per share increase over the $1,935.75 merger price. Petitioners point out that the magnitude of the increase was within C-T's control, and that C-T's and A-B's plan to eliminate Rainbo Tulsa's 1983 expenses in order to achieve an unfairly low earnings base from which a lower discounted cash flow projection would inevitably result.[14]

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13. $1,179,000 is the 1982 earnings figure used by Professor Walter (DX34, table 5); $1,152,000 is the figure used by Dillon Read in its draft report. (PX54). Both figures represent actual earnings less a one-time cumulative adjustment for a change of accounting method for the investment tax credit. Petitioners urge that the use of actual 1982 earnings (*i.e.*, without the adjustment) is required. In my view, the adjusted figure of $1,179,000 is the more accurate and fair presentations of 1982 earnings.

14. The $967,000 adjusted earnings figure was clearly low in relation to 1981 and 1982 earnings, because 1983 expenses, even taking into account the "adjust-

The Respondents contend that $967,000 was a fair "earnings base," because it was more predictive of Rainbo Tulsa's future earnings than pre-1983 earnings. Specifically, Respondents argue that: (i) C-T's pre-1983 high levels of profitability was achieved primarily by price increase and a low level of reinvestment in its businesses; (ii) that practice (realizing short-term profits through price increases and underinvestment) was especially pronounced in the forty "minority interest" bakeries; (iii) while producing higher "near-term" profits, that policy also eroded the bakeries' long term competitive position; (iv) by 1983 the baking industry had become more price competitive, which severely limited Rainbo Tulsa's ability to increase profits by simply raising prices; (v) consequently, in order to increase profits, the bakeries needed to increase their tonnage (the volume of bread products sold) and also had to become more efficient by lowering their unit costs.

To accomplish that, however, would require a substantially higher level of capital investment and marketing expenditures for the 40 bakeries than had been done in the past. As Dillon Read noted in its draft report:

> For Anheuser-Busch to correct this situation, substantial capital improvements are required. Some bakeries will be found where the returns from potential improvements are not adequate. These will have to be shut down or consolidated with other bakeries. An operational method that may have to be adopted by Campbell Taggart is cross baking, where certain plants specialize in particular products, shipping these products to other bakeries that do not produce them and receiving different products from the other bakeries. Also, a reallocation of routes along either customer or product lines may be necessary. Anheuser-Busch believes an increased marketing and advertising effort is also . . . required to meet the competitive challenge. This will involve the application of some of the practices that Anheuser-Busch has used to such great effect in the beer market. Stepped

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ments," were disproportionately high. Also, it is undeniable that C-T had a self-interest in maximizing those expenses and had the ability to achieve that goal if it wanted to do so. But there is no direct evidence that C-T, in fact, purposefully manipulated expenses to minimize 1983 earnings. That observation, however, does not conclude the analysis, because even if C-T is assumed to have acted in complete good faith, the $967,000 figure may objectively still be an inappropriate base figure.

> up advertising, regional and national media programs, coordinated marketing efforts for large regional and national customers, and experimentation with different price and advertising combinations all may be utilized.

(PX54, p.10)

The inevitable impact of implementing such a program in this price-competitive environment would be to reduce the bakeries' net income. Dillon Read so recognized in its draft report, noting that such diminished profitability might be unfair to the bakeries' minority shareholders, but that C-T could avoid that problem by acquiring all outstanding minority interests. (PX54, p.10)

Respondents contend, for these reasons, that it was fair to use adjusted 1983 earnings as the basis for projecting future cash flows. Essentially, Respondents take the position that because the prior years' earnings were influenced by policies that would not be continued in the future, it was more sensible and fair to project future cash flows based upon an earnings year (1983) which did not reflect those policies.

Having considered these conflicting positions, the Court concludes that the Respondents have failed to establish by a preponderance of the evidence that it was appropriate or fair to base Rainbo Tulsa's protected future cash flows upon the $967,000 adjusted 1983 earnings figure.

First, if there was a policy of "underinvestment" in the 40 "minority interest" bakeries *as a group*, that policy was not shown to have affected Rainbo Tulsa *individually*. According to Dillon Read, a relevant "benchmark" for measuring the appropriate level of reinvestment was the ratio of capital expenditures to depreciation. For the period 1978-1982, the average ratio for all 40 "minority interest" bakeries was 1:3, as contrasted with 1:6 for five of C-T's publicly traded competitors. In the case of Rainbo Tulsa, however, that ratio was 2:8. (PX54, Exh. C, p.2; and third page from end). Moreover, Rainbo Tulsa's increase in sales (over 1982) did not result solely from price increases: between 1982 and 1983, its tonnage also increased from 37.60 to 45.45 tons, *i.e.*, by 21%. (PX106).[15]

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15. Respondents suggest that the tonnage increases did not represent "real" tonnage growth, but were transfers from other subsidiaries, most notably the Ft. Smith bakery. But Respondents have not shown why, once Ft. Smith became an asset of Rainbo Tulsa, its tonnage should not be attributed to Rainbo Tulsa. Respondents also argue that the 2:8 capital-expenditure-to-depreciation ratio is

Second, and of even more importance, C-T's use of 1983 earnings as the projection base unfairly burdened Rainbo Tulsa's minority stockholders with extraordinary expenses that would create future benefits only for Rainbo Tulsa's majority stockholders (A-B and C-T). Those expenses were unilaterally determined and imposed by C-T and A-B, not by outside market forces. It may be assumed that these costs were imposed for valid business reasons, namely, to strengthen the to-be reorganized bakery division as a whole and, ultimately, to make it more competitive and more profitable over the long term. But that could not be achieved cost-free: the price would be to reduce Rainbo Tulsa's (and other bakeries') earnings over the near term, starting in 1983.[16]

The choice of 1983 earnings as the basis for all future cash flow projections was inequitable, because the minority shareholders who would bear those costs were being "cashed out" in the merger, and therefore would not share in the resulting long term increased earnings and future values.[17] Moreover, C-T's valuation mechanism provided no discernible offsetting or compensating equivalent value to the minority shareholders as a *quid pro quo* for their having to bear such costs.

[15] The objective of any valuation technique is to measure, in an objectively fair way, the intrinsic value of the merged corporation, consistent with the mandates of Delaware law. *See* 8 *Del. C.* § 262(h); *Weinberger v. UOP, Inc.*, *supra*, 457 A.2d at 713. For the above reasons, the Respondents have not persuaded the Court that the use of adjusted 1983 earnings, as the basis for C-T's discounted cash flow valuation, was objectively fair.

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artificially high, because it reflected the 1982 Ft. Smith acquisition. But even if the Ft. Smith investment is excluded, that ratio would still remain at 1:6, *i.e.*, at Dillon Read's "benchmark" level.

16. In a written presentation to the A-B Board on December 21, 1983, for its consideration of the merger proposal, it was stated that "These changes could benefit the company as a whole but be detrimental to an individual bakery . . . consequently would be difficult to implement equitably to all parties, with minority interests outstanding." (PX5, p.3). It was further stated that "Investments in the future of these types will, in most if not all [subsidiaries], negatively impact on short term earnings and consequently reduce current dividends . . . as a trade-off against improving longer term earnings." (*Id.*, p.4)

17. Projected earnings would not return to pre-1983 levels until 1991, (the eighth projection year). Moreover, earnings would increase in very modest (3%) increments, and by 1997, would reach only $1,433,000—only 21% higher than the 1981 earnings level attained 16 years earlier.

B. The Validity of C-T's Growth Projections

The $1,935.75 merger price did not represent Rainbo Tulsa's fair value for other reasons as well. That price was based upon C-T's assumption that Rainbo Tulsa's earnings would experience no (0%) growth in 1984 and 1985, 5% growth in 1986 and 1987, and 3% growth thereafter through 1998. Petitioners maintain that Rainbo Tulsa's future outlook, viewed objectively as of the merger date, did not justify such dismal expectations.

C-T's growth assumptions were supported by the testimony of Mr. John Piotrowski, a member of C-T's management. Mr. Piotrowski testified that by the time A-B came upon the scene in 1983, the competitive environment in the bakery industry had greatly intensified,[18] and that the Tulsa economy was beginning to "flatten out," and (according to Census Bureau estimates) would grow at only a 1.5% rate.

The Petitioners challenge Piotrowski's testimony as being unsupported by any independent documentary evidence and inconsistent with contemporaneous A-B and industry pronouncements. They point to the announcement in a May, 1983 industry periodical that "the bakery industry this year stands to post record-high sales [a 9% sales increase in 1983] as the nation looks to spring back from more than two years of recession." (PX83, p.1). They also emphasize A-B's 1983 Annual Report to Shareholders, wherein A-B was similarly optimistic about the bakeries' future growth prospects.[19]

Having considered the arguments, I conclude that while the relevant competitive environment had intensified, the evidence does not establish that the increased competition justified the extremely modest growth rates C-T projected for Rainbo Tulsa. Mr. Piotrowski's testimony, which is central to that proposition, was basically hearsay, resting upon information supplied by "bakery presidents and the people in the market at that point in time." Moreover, Mr. Piotrowski—who was both an executive of an interested party

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18. By way of example, Piotrowski pointed to the experience during the spring of 1983, when Rainbo Tulsa announced a 3 to 5% price increase. Farm Fresh, a principal competitor, countered that increase by a $.06 per unit price decrease, which forced Rainbo Tulsa to roll back its price.

19. The Annual Report stated:

> Operating profits were down in 1983 as a result of competitive pressures and the cost of expanded marketing programs and expenditures to upgrade facilities and vehicles. However, these costs were incurred to lay a foundation for *future growth and expansion.* (PX103, p.20, emphasis added).

(C-T) and a member of the Planning Committee that determined Rainbo Tulsa's value—cannot be viewed as disinterested on that subject. C-T did not independently corroborate Mr. Piotrowski's testimony with documentary evidence, such as a market survey or similar study conducted to determine the "competitiveness" of the relevant market and its likely impact upon Rainbo Tulsa's future growth prospects. C-T's growth assumptions amount, therefore, essentially to estimates made without independent, objective support by a party having a conflicting self interest. As such, they cannot be regarded as fair or reasonable.

C. The Validity of the 17% Discount Rate

To determine the present value of Rainbo Tulsa's projected future cash flows, C-T utilized a 17% discount rate. Petitioners contend that that rate attributed an unjustifiable degree of investment risk to Rainbo Tulsa, and that the appropriate discount rate should have been 14%.

The Respondents' rationale for selecting the 17% rate was articulated by Mr. Piotrowski, who testified that in valuing the bakeries, A-B and C-T used a range between 14% and 21%. The former rate represented "minimum risk" projects (14% was A-B's cost of capital) and the latter rate (21%) represented "high risk" investments. The 17% rate was chosen because Rainbo Tulsa was a "low to medium risk project," and because 17% was consistent with a recent Wharton School study indicating that the cost of equity for "blue chip companies" was 16.8%.

Petitioners respond—and the record shows—that Rainbo Tulsa was a "star performer" in C-T's constellation of bakeries, averaging a 22.9% net return on equity for the period 1978-1982, as contrasted with 7.9% for the other 40 "minority interest" bakeries. Moreover, Rainbo Tulsa had a 5 year average profit margin of 9.5% (contrasted with an average 3.3% margin for both the "40 bakery group" and selected "baking industry" competitors), and was one of C-T's top two or three net income producers. Petitioners point out that almost 70% of C-T's total sales had been generated by its bakery division. Finally, A-B's own investment banker, Dillon Read, preliminarily concluded in its draft report that a 14% discount rate was more appropriate than 17%:

> The discount rate selected by Anheuser-Busch was 14%. Serious consideration was given to selecting a rate of 17% based on a Wharton School study showing investor expec-

> tations of 16.8% returns on equity investments in food companies. The undiversified nature of the minority holdings would tend to increase the required discount rate, but the bakeries are relatively unlevered, reducing the risk to the point where a 14% rate is more appropriate. (PX54, Exh. C, at 4).

Having considered and weighed the evidence, I find that it fails to preponderate in favor of either side. The Respondents' effort to justify a 17% discount rate based upon Rainbo Tulsa being a "low to medium risk" investment and upon the Wharton study, is undercut by the fact that in September, 1983, A-B itself had specifically considered and rejected the 17% rate. The 14% rate A-B selected for the 40 bakery group was thought by Dillon Read to be more appropriate. (PX54, Exh. C, p.4). Moreover, Rainbo Tulsa's having consistently outperformed the 40 bakery group suggests that Rainbo Tulsa should merit a lower discount rate than the 40 bakery group. Respondents offer no satisfactory explanation for A-B's subsequent reversal of position on this point, nor have they shown that Rainbo Tulsa's superior overall performance was considered when C-T decided to use the 17% discount rate.

Respondents rejoin by attacking the Petitioners' reliance upon the Dillon Read report which, Respondents claim, was only a draft report and not a formal opinion by that firm. For that reason, Respondents contend that the report deserves minimal or no evidentiary weight. I disagree.

[16] It is correct that the draft report was not a formal fairness opinion of Dillon Read. Indeed, A-B refused to authorize the issuance of such an opinion. However, that circumstance does not strip the report of all evidentiary significance. As a draft report, the Dillon Read document, standing alone, would likely be insufficient to establish that 14% was a fair discount rate. Nonetheless, the report does contain evidence that bears importantly on the valuation question—evidence that may properly be considered and given such weight as may be appropriate. The draft report did not develop full blown from Dillon Read's imagination. It was based upon facts and assumptions supplied by A-B's and C-T's own management. Respondents cite no authority that would require the Court to blind itself to those value-related facts, or to the well-reasoned conclusions flowing therefrom, contained in that report. That Dillon Read's conclusions were preliminary goes to their weight, not their admissibility, and Respondents have not shown that the information un-

derlying those conclusions was erroneous in any material respect.

For these reasons, the Respondents failed to establish by a preponderance of the evidence that the selection of a 17% discount rate was appropriate or fair.

D. C-T's Treatment of Intercompany Debt

At the time of the merger, Rainbo Tulsa owed C-T $1,226,000. In projecting Rainbo Tulsa's future cash flows, C-T assumed that the intercompany debt would be repaid at the beginning of the fifteen year projection period. The Respondents' justification was that the debt was currently due and could have been called at any time. Petitioners hotly dispute the "first year payback" assumption as unfair and unsupported by the record. They contend that C-T should have assumed that the debt would not be repaid until the end of the fifteen year projection period, and argue that if that had been done, Rainbo Tulsa's valuation would have increased by $400 per share.

The record demonstrates that C-T did not regard the intercompany debt as a current liability, and did not treat the debt as such on its books, until Rainbo Tulsa was valued for purposes of the merger. Thus, on Rainbo Tulsa's December 28, 1982 financial statement, intercompany debt was not shown as a current liability. (PX99). However, by February 1, 1984, when the Information Circular was sent to shareholders after the merger, the debt had suddenly acquired current liability status. No convincing explanation for that bit of serendipity is offered, nor have Respondents shown that objective economic circumstances required an early payback of the intercompany debt. Rainbo Tulsa could have borrowed the monies from sources other than C-T, and the accounting text upon which the Respondents relied permits the assumption that in projecting future cash flows, long term debt will be refinanced.[20]

Therefore, I find that the Respondents have failed to satisfy the Court that their "first year payback" assumption concerning the intercompany debt was fair.

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20. The Respondents do correctly point out that if it is assumed (as Petitioners contend) that the intercompany debt will be refinanced and repaid at the conclusion of 15 years, an additional yearly interest cost would result. That added interest would reduce projected earnings in some amount. The Petitioners have not shown to the Court's satisfaction that that added interest cost was factored into their valuation. Accordingly, Petitioners have not established the amount by which the merger price would have increased if C-T had utilized the Petitioners' fifteen year debt repayment assumption.

E. Other Evidence of Unfairness of the Merger Price

The fundamental flaws in the assumptions underlying C-T's discounted cash flow valuation, preclude a finding that the $1,935.75 per share merger price represents Rainbo Tulsa's fair value. I do recognize, however, that in valuation matters of this kind, reasonable persons may differ. Therefore, the Court has considered additional evidence. That evidence tends to independently confirm the Court's conclusion.

First, it is highly significant that in its September, 1983 draft report, Dillon Read, using the assumptions and data supplied by A-B, preliminarily valued Rainbo Tulsa at amounts higher than the $1,935.75 per share. In that report, Dillon Read determined an "overall value" for Rainbo Tulsa of $8,258,000 ($3,002 per share), a "minority interest value" of $2,965 per share, and a "formula" value of $2,183 par share. (PX54, Exh. E). By way of hindsight, it is apparent that those amounts were more than A-B and C-T were willing to pay.

Second, the record indicates that Dillon Read questioned the fairness of the merger price. On January 18, 1984, after C-T and A-B had determined the merger prices for the 40 minority interest bakeries, Mr. A. J. Magro, a Dillon Read analyst who prepared the draft report, wrote an internal memorandum to his superior, Mr. William Purcell, commenting upon valuation summaries that C-T had prepared for each of the 40 bakeries. Mr. Magro criticized C-T's stated justifications for certain of those valuations, and, in particular, had the following to say about C-T's valuation of Rainbo Tulsa:

> Of primary concern, however, are valuations where the value selected is not the highest value derived. In most of these cases, the justification for choosing the lower value is weak. Examples of this are Beaumont, Columbus, Pueblo, Tulsa. (PX58, p.2).
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> * * *
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> It appears arbitrary why in some cases the 1983 CTI formula is used while in others the cash flow value is used when the selected value is the lower of the two. See Pueblo, Tulsa. (*Id.*).[21]

21. Magro also noted that in some cases "comments on recent trends appear to be contradictory with recent earnings," and that the summaries provided "no real support of [the dismal] longer term earnings projections." (PX58, pp.1,2).

Third, the evidence suggests that A-B and C-T rejected Dillon Read's preliminary valuations, and decided not to retain Merrill Lynch, because they were not prepared to pay the price an independent investment banker would likely conclude was fair. The resulting impression is that the 40 bakery group (including Rainbo Tulsa) was valued in such a way that the sum of those valuations would not exceed the total amount that A-B had decided, *a priori*, to pay.

After Dillon Read submitted its September, 1983 draft report, representatives of A-B, C-T, and Dillon Read met on October 13, 1983. Notes taken at that meeting indicate that it was then contemplated that Merrill Lynch would render a fairness opinion and that Dillon Read would prepare a memorandum (most likely a variation of its draft report) to assist Merrill Lynch in its efforts. At that meeting, A-B's representative proposed to pay an aggregate price of $18.8 million to purchase the 40 minority interests. Dillon Read's Mr. Purcell responded that $18.8 million would not be acceptable. Mr. Magro added that $25 million was more likely to be acceptable to Merrill Lynch. (PX27). An A-B representative, Mr. Ritter, then commented that because ". . . [w]e can't persuade Dillon Read at $18 million, [it is] not likely that we can persuade Merrill Lynch." (PX27, p.3).

Later that same month, A-B decided not to retain Merrill Lynch to value the 40 bakeries. Its stated rationale is that Merrill Lynch's valuation would have taken too long. But that rationale finds support only in the undocumented testimony of Mr. Piotrowski. The record discloses no effort having been made to negotiate with Merrill Lynch for an expedited valuation. Moreover, the contemporaneous documents suggest a different explanation, namely that Merrill Lynch would likely not approve what A-B was willing to pay.

At A-B's December 13, 1983 board meeting, it was recommended that A-B pay up to $21.5 million for the minority interests in the 40 bakeries. (PX5, p.9). That figure was subsequently lowered to $20.7 million, which became the ultimate aggregate purchase price. That amount ($20.7 million) was determined solely and unilaterally by A-B and C-T, unconstrained by arm's length bargaining, by an independent negotiating committee, or by a valuation done by independent experts.

Viewing the evidence as a whole, the Court has serious doubts as to whether C-T's and A-B's valuation of Rainbo Tulsa was principled, as opposed to opportunistic. The evidence, while not conclusive, creates the clear impression that C-T's valuation of Rainbo

Tulsa was influenced and constrained, *a priori*, by the aggregate amount or range that A-B was willing to pay. The Court makes no finding in that regard, but simply notes that that evidence tends to confirm the other, independent evidence that the $1,935.75 per share merger price did not constitute Rainbo Tulsa's fair value.

V. *THE DETERMINATION OF FAIR VALUE*

A. Preliminary

Because the merger price does not represent fair value, *a fortiori*, neither do the Respondents' other contended-for valuations at lesser amounts. Their only valuation not falling within that description is Professor Walter's $2,037 per share figure based upon the C-T "weighted earnings value/book value" formula.

As a result of the foregoing analysis, three issues remain to be decided: (a) the validity of Professor Walter's $2,037 per share valuation, (b) the validity of the Petitioners' competing valuations, and (c) this Court's independent determination of fair value. Those issues, while conceptually distinct, may be addressed concurrently, because they arise from a common source: the C-T "weighted earnings value/book value formula" valuation method (referred to hereinafter as "the formula").

To reiterate, under the formula a 75% weight is assigned to "earnings value" and a 25% weight is assigned to "book value." "Earnings value" is determined by weighting each of the past five years' earnings in descending order. Both Professor Walter and Mr. Perlin based their valuations upon that approach. Mr. Perlin chose that "formula" value ($3,464.90 per share) over the three separate valuations he had determined by other methods, because he preferred the:

> . . . time-tested formula that had been applied in situations similar to this in the past. . . [and that]. . . gives a reasonable weighting to the two components that I think are most important in this case. . . .

(Trial Tr., Vol. II, p.23).

Although the experts reached different results in applying the formula methodology, both agreed that that approach was conceptually valid. Their consensus is highly significant, because the parties were able to agree upon little else. Indeed, their experts' accord on that single point may be the only defined piece of conceptual solid

ground in a whirlpool of valuation controversy. For those reasons, the Court determines that the "formula" is the most appropriate method for determining the fair value of Rainbo Tulsa. In addressing the validity of the parties' competing, and quite different, formula valuations, the specific sources of those differences will be identified and addressed. Out of that process an independent determination of Rainbo Tulsa's fair value will emerge.

The issues dividing the parties are most easily identified by comparing each side's "formula" computation of fair value. Under the formula, "fair value" may be expressed thusly:

$$\text{Fair Value} = (\text{Average 5 years' Weighted Earnings}) \times (\text{multiple}) \times .75 + (\text{Book Value}) \times .25$$

By that method Professor Walter computed fair value as follows: (DX34, p.18)

Weighted Earnings:

Year	Earnings (000)		Weight		Earnings Value (000)
1983	$ 541	×	5	=	$ 2,705
1982	1,179	×	4	=	4,714
1981	1,187	×	3	=	3,561
1980	938	×	2	=	1,876
1979	809	×	1	=	809
					$13,665

Average Weighted Earnings:

$$\frac{\$13,665}{15} = \$911$$

(+ $19 accounting adjustment for investment tax credit) = $930

Book Value: $5,668

Fair Value Computation (000):

Fair Value =	($930)	× (6) × .75	=	$4,185
+	($5,668)	× .25	=	1,417
				$5,602

Fair Value Per Share:

$$\frac{\$5,602,000}{2,750} = \$2,037$$

Petitioner's expert, Mr. Perlin, determined a higher value ($3,464.90) by using earnings for a different period and a higher earnings multiple.[22] His valuation is set forth below:

Weighted Earnings:

Year	Earnings (000)		Weight		Earnings Value (000)
1982	$1,248	×	5	=	$ 6,240
1981	1,187	×	4	=	4,748
1980	938	×	3	=	2,814
1979	809	×	2	=	1,618
1978	713	×	1	=	713
					$16,133

Average Weighted Earnings:

$$\frac{\$16,133}{15} = \$1,076$$

Book Value: $5,668

Fair Value Computation:

($1,076) × 10 × .75 = $8,070
\+ ($5,668) × .25 = 1,417
$9,487

Fair Value Per Share:

$$\frac{\$9,487,000}{2,750} = \$3,450$$

It is apparent from these computations that two issues divide the parties: (i) whether 1983 earnings should be included in the weighted earnings value computation, and (ii) what should be the appropriate earnings value multiplier (Petitioners argue for a multiplier of 10; Respondents argue for a multiplier of 6).[23]

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22. Mr. Perlin's $3,464.90 valuation is not supported by any calculation that could be located in the record. If one performs the appropriate calculation based on the values Mr. Perlin claimed to have used, the result is $3,450 per share, as computed above. However, in light of the valuation rulings made *infra*, the discrepancy between Mr. Perlin's claimed $3,464.90 valuation and the $3,450 value computed above, is not significant.

23. Both experts agree upon the book value. Professor Walter used a book value of $5,668,000. If that figure is divided by 2,750 (the number of outstanding shares) the result is $2,061 per share, which is the value used by Mr. Perlin.