NATE under US GAAP were below the prescribed target levels, Marceau's right to purchase additional shares under §4.7 has been triggered. That poses the second Class B stock issue, which is how many Class B shares Marceau is entitled to purchase.

### *B. The §4.7 Formula Dispute*

Any search for an answer to that question must start with the language of the formula itself. Section 4.7 pertinently provides:

> Purchaser shall have the right to purchase a number of shares of Class B Stock . . . for the price of $1.00 per share . . . such that the percentage of outstanding shares of Common Stock held by Purchaser after giving effect to such purchase shall be equal to the lesser of (x) nine million divided by the product of Net After Tax Earnings minus $300,000 for the fiscal year ended June 30, 1989, multiplied by twelve, and (y) 75% of SHC's total outstanding capital stock as of September 30, 1990 after giving effect to such purchase . . . .

(PX 1, §4.7.)

The parties agree that in this case, the number yielded by the formula in "(x)" is 1.18. However, they disagree as to what that number signifies. Marceau contends that 1.18 is a fraction that must be multiplied by 100 to convert it to a percentage, i.e., 118%. Under that interpretation, Marceau is entitled to purchase that number of shares which would result in its owning, after the purchase, the lesser of 118% and 75% of the outstanding Class B stock, or 75%. SHC contends, on the other hand, that the number 1.18 is itself a percentage, such that Marceau is entitled to purchase that number of shares which would result in its owning the lesser of 1.18% and 75% of the outstanding Class B stock. Since 1.18% is less than the 49% of the outstanding Class B stock that Marceau already owns, Marceau is entitled to purchase no (0) shares.

While SHC's interpretation deserves credit for ingenuity, it is fatally flawed as a matter of evidence and logic.

First, SHC's present interpretation of the formula was never developed until October 1990, and was done solely for purposes of litigation. No documentary or other evidence generated either before or at the time that the Marceau agreements were signed, or during the 15 months thereafter, shows that Flemming or Cobb ever believed that the formula meant what SHC now claims it means. On the

contrary, Flemming's and Cobb's documented understanding of the formula during that entire period of time is flatly at odds with SHC's current interpretation, but is fully consistent with Marceau's.

By way of example, on May 18, 1988, Meziere telecopied to Cobb a memorandum setting forth in detail Meziere's understanding of how the concept that later became embodied in the §4.7 formula would work. (PX 29.) Meziere's memorandum showed that if 1989 NATE were $1 million, Marceau would be entitled to own 75% of SHC's Class B stock.[19] Meziere specifically invited Cobb to tell him if he (Cobb) had any different understanding of the formula. Cobb never did. Moreover, during the fall of 1988, Cobb gave Meziere a chart that contained Cobb's notes expressing his understanding of that formula. Cobb's understanding was consistent with both Meziere's May 18, 1988 memorandum and Marceau's own interpretation. (PX 41.)

Finally, Flemming's own writings from and after January 1989 evidence that his understanding of the formula was identical to Marceau's. In his January 24, 1989 letter to Namy, Flemming stated that "[t]he warrants produce a 50% dilution to the non-Marceau

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19. The text of Meziere's memorandum is as follows:

I confirm that, concerning the warrants, the deal agreed was:

if the earnings 1988/1989 are < [$1.5 million] and
if the earnings 1989/1990 are < [$4 million]

the company will issue such shares [at] $1 so that the price earnings of Marceau equal 12.

So the formula is[:]

12 x Earnings 1989 = [$9 million]/x

where x = % of participation of Marceau in SHC after exercise of warrants.

For instance

a) if earnings = [$1.5 million] x = 49%
b) if earnings = [$1.2 million] x = 62.5%
c) if earnings = [$1 million] x = 75%
d). . . .
a) number of shares to issue for Marceau is 0
b) number of shares issued: 73,462
100,000 + 73,462/204,077 + 73,462 = 62.5%
c) number of shares issued: 212,231
100,000 + 212,231/104,077 + 212,231 = 75%
d) etc.

In case of misunderstanding, please call me this afternoon in my office. As I have told you, we have a board meeting tomorrow morning.

*Philippe.*

(PX 29.)

shareholders." (PX 47 at MR 001187.) Thus, Flemming recognized that if Marceau became the 75% owner of SHC's outstanding shares, Flemming's interest would be reduced from 51% to 25%, i.e., a 50% dilution. That same understanding appears in a memorandum written in early 1989, in which Flemming stated that if 1989 NATE were less than $1.8 million, Marceau would be entitled to purchase additional Class B shares, which would result in "a 25% (i.e. 50%) dilution." (PX 46.)

[6] Second, wholly apart from being an afterthought that runs counter to the undisputed evidence of what the parties understood the formula to mean, SHC's interpretation would produce illogical results. A construction of a contract that would render any of its provisions illusory or meaningless is to be avoided. *Seabreak Homeowners Ass'n, Inc. v. Gresser*, Del. Ch., 517 A.2d 263, 269 (1986), *aff'd*, Del. Supr., 538 A.2d 1113 (1988). If SHC's interpretation of the formula were accepted, the result would be precisely that.

Under §4.7, Marceau's right to purchase additional Class B shares is triggered if 1989 NATE fall below $1.8 million and 1990 NATE fall below $4.3 million. When Marceau begins to purchase additional Class B shares, it necessarily will start from its present 49% ownership level, and will increase its ownership up to the 75% maximum. Under SHC's interpretation of the formula, however, the number of additional shares that Marceau may purchase cannot rise above 49% unless SHC's 1989 NATE fall below $315,306. Thus, SHC's interpretation creates a $1.5 million discontinuity between the $1.8 million "trigger" level and the $315,306 threshold that SHC claims must be crossed before Marceau can buy its first additional Class B share. That discontinuity renders illusory and meaningless the $1.8 million NATE trigger provided in §4.7. Under SHC's interpretation, once 1989 NATE fall below $1.8 million SHC would have a "right" to purchase additional Class A shares, but that "right" could not be exercised unless 1989 NATE fell below $315,306. A right that cannot be exercised is no right at all. In reality, the $315,306 NATE figure would become the relevant threshold for triggering Marceau's §4.7 stock purchase right, and the stated $1.8 million NATE target figure would, as a practical matter, be read out of the contract. Such a construction of the formula cannot be accepted.

Finally, SHC argues that to adopt Marceau's construction of the formula would defeat the parties' true intent and confer a "windfall" upon Marceau. The parties' "true" intent (SHC says) was to assure that Marceau's investment would be worth $9 million as of

June 30, 1989, assuming its SHC stock were valued at 12 multiplied by earnings. SHC claims that Marceau's interpretation of the formula would result in Marceau's investment being worth $10.6 million, resulting in a $1.6 million windfall above Marceau's initial $9 million investment in SHC's equity. That argument confuses the parties' mutual contractual intent with their individual goals. Protecting Marceau's initial $9 million investment may have been one of the parties' objectives; however, that was not their contract. That is, the parties did not agree to a formula that would allow Marceau to buy additional Class B shares up to the level where the value of its investment reached $9 million. Rather, the parties' mutual intent and contract was the §4.7 formula itself. To accept SHC's argument would be tantamount to rewriting that formula. Furthermore, SHC's interpretation of the formula would ensure that the value of Marceau's investment (at 12 multiplied by 1989 earnings) would be only $1.9 million, a totally nonsensical result. (Pl. Rep. Br. at 8-9.)

Lastly, SHC asserts that it did not assent to the formula because Cobb lacked the authority to bind SHC to it, and Flemming did not "focus" upon the formula's language. (Def. Br. at 49.) That contention gives new meaning to the concept of zealous advocacy. Flemming admitted that Cobb had the authority to negotiate §4.7. He also admitted that he had read the agreements before signing them. (PX 143, Flemming 167; Tr. III at 88.) Moreover, and of fundamental importance, SHC and Flemming were represented by highly competent counsel who carefully negotiated and drafted contract language to which Flemming and SHC manifested their assent in the way that truly counts: by executing the agreements. And if that were not enough, after signing the agreements, Flemming acknowledged in letters to Marceau his prior assent to that formula, and never claimed otherwise until the parties became embroiled in this dispute. Flemming cannot be heard to do so now.

To conclude: Marceau's interpretation of the formula is the correct one. As a consequence, Marceau is entitled to purchase, at $1 per share, an additional 212,246 Class B shares.

## IV. THE CLASS A STOCK CLAIMS

Marceau's Class A stock claims (unlike its Class B stock claims) do not concern its right to acquire additional Class A stock at all. That Marceau has that right is undisputed. Rather, at issue is whether Flemming will have a right to "put" his shares of SHC to Marceau if Marceau obtains Class A voting control.

As earlier noted, if by converting the Note Marceau comes to own over 50% of SHC's Class A stock, Flemming would have an "option right" to make equalizing purchases of Class A shares (and also, if applicable, Class B shares) to preserve his proportionate interest in SHC. Flemming would also have a right to "put" all of his shares (i.e., his entire interest) in SHC to Marceau. Of great importance, however, is that both rights are subject to cancellation if SHC fails to achieve certain NATE targets. Flemming's option right is canceled if 1989 NATE are less than $800,000 *or* if 1990 NATE are less than $2.8 million; and his put right is canceled if 1989 NATE are less than $300,000 *or* if 1990 NATE are less than $1.3 million.

Marceau claims, and asks this Court to declare, that if it becomes a majority owner of SHC's Class A stock by converting the Note, it (Marceau) will not become subject to Flemming's option or put rights, because in these circumstances both rights have been canceled.[20] SHC does not dispute that Flemming's option right has been canceled, because SHC's 1990 NATE fell below the $2.8 million threshold. The sole remaining dispute is over whether Flemming's put right has been canceled as well.

Even that would not be in dispute if SHC's NATE figures were accepted as valid, because SHC's claimed NATE exceeded the cancellation threshold levels of $300,000 for 1989 and $1.3 million for 1990. The dispute arises because Marceau has challenged the validity of the 1990 NATE figure: it contends that that figure, if properly determined, would be less than $1.3 million.

Marceau advances two separate arguments to support its position. First, it contends that SHC was required to—but did not—follow the accounting policies set forth in the Exhibit Financials (PX 3), which improperly increased 1990 NATE from $1,118,000 to $1,528,000. (PX 138 D at 2.) Second, Marceau argues that even if SHC was not contractually required to follow the accounting policies in the Exhibit Financials, it was obligated to comply with GAAP, which (Marceau claims) SHC failed to do in its treatment of three specific income items in the 1990 financial statements. The result, it is said, was to inflate 1990 NATE above the $1.3 million threshold.

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20. Because Marceau is uncertain whether by exercising its conversion right it will become obligated to acquire Flemming's SHC shares, it has postponed exercising its conversion right, without objection by SHC, until this Court has first determined the parties' rights and obligations under the Marceau agreements.

Those two arguments, both disputed by SHC, are now addressed.

### *A. The Exhibit Financials Argument*

Marceau's first argument rests upon the premise that the Purchase Agreement obligated SHC to follow the accounting policies set forth in the Exhibit Financials. Alternatively, Marceau argues that, at the very least, SHC was equitably precluded from departing from those accounting policies. Neither contention, in my view, is correct.

The contract provision upon which Marceau relies to support its position is anything but clear. That provision is §7.2 of the Purchase Agreement, which states:

> *Exhibits.* All statements contained in any exhibits attached hereto or delivered by or on behalf of the parties hereto to the other shall be deemed representations or warranties, as the case may be.

(PX 1, §7.2.)

That the Exhibit Financials are an "exhibit" is undisputed. What is contested is the legal conclusion that Marceau asks this Court to draw, which is that SHC "represented" or "warranted" that it would follow the accounting policies set forth in that exhibit. Marceau urges that it would have made no sense for it to have insisted upon including the Exhibit Financials as an exhibit, except to obtain assurance that the accounting policies in that exhibit would be used to determine 1989 and 1990 NATE.

In response, SHC argues that to say that the Exhibit Financials constituted a representation or warranty is not enough. The Court must next ask: what were those representations and warranties? SHC argues that to answer that question, the Court must consider §3.1(d)(ii) of the Purchase Agreement, which states:

> SHC has furnished Purchaser with (*a*) a copy of the financial projections of [SHC and Subsidiaries] for the fiscal years 1989 and 1990 and (*b*) a pro forma consolidated balance sheet of SHC and Subsidiaries, as of July 1, 1988, together with a description of the accounting policies utilized therein, both of which are attached as Exhibit 3.1(d)(ii) and *SHC represents and warrants that such projections and pro forma consolidated balance sheet (i) were prepared in good faith on the basis of information and assumptions which SHC believes to be reasonable and (ii) have taken into consideration the changes in assets and capital structure resulting from the transactions contemplated hereby.*

(PX 1, §3.1(d)(ii), emphasis added.)

SHC contends that the underscored language establishes that SHC's only representations and warranties were that the projections and *pro forma* balance sheet in the Exhibit Financials (i) were prepared in good faith and based on reasonable assumptions and (ii) took into account changes in assets and capital structure resulting from the contemplated transactions. No other representation or warranty was made, in particular no warranty that the accounting policies in the Exhibit Financials would be used to prepare SHC's future financial statements. Finally, SHC emphasizes that the only other Purchase Agreement provision explicitly addressing the preparation of financial statements is §4.5(b), which does not mention the Exhibit Financials. (PX 1, §4.5(b).)

Marceau responds that §3.1(d)(ii) is not a specific provision that overrides the more general §7.2. Rather, each of these sections creates separate yet related representations and warranties. Under Marceau's reading, §3.1(d)(ii) is a representation that describes the accounting policies which *were* used to create the Exhibit Financials, while §7.2 is a warranty that those accounting policies *will* be used to prepare SHC's future (i.e., 1989 and 1990) financial statements.

The difficulty with Marceau's position is that it rests critically upon §7.2, which does not express the meaning that Marceau seeks to have inferred from it. Section 7.2 says only that "all statements contained in any [attached] exhibits will be deemed representations or warranties, as the case may be." (PX 1, §7.2.) That is, §7.2 states that the exhibits constitute representations or warranties, but it does not tell us the content of those representations or warranties. Implicitly recognizing this, Marceau relies upon extrinsic evidence to show that the parties intended that in preparing its future financial statements, SHC would use the Exhibit Financials' accounting policies.

The difficulty with that approach is that it presupposes a contractual ambiguity for which Marceau nowhere contends nor attempts to establish. Section 3.1(d)(ii) addresses the issue of what representations and warranties SHC is making with respect to the Exhibit Financials. That provision unambiguously provides that the only such representations were that the accounting policies in the Exhibit Financials were used to prepare the Exhibit Financials, and that the projections were based on reasonable assumptions and prepared in good faith. Nothing in §7.2 metamorphoses those clear statements in §3.1(d)(ii) into ambiguities that justify resorting to extrinsic evidence. The Court, however, has considered the extrinsic evidence,

and has found that none of that evidence establishes that the parties intended a construction different from the plain meaning of the contract language. *See Klair*, 531 A.2d at 223.

Marceau next argues, in the alternative, that SHC should be deemed equitably compelled to use the accounting policies of the Exhibit Financials because SHC is estopped from doing otherwise. Marceau claims that it relied upon those accounting policies in deciding to invest in SHC. Marceau further claims that it would hardly have agreed to make its contract rights dependent upon whether SHC met specified earnings targets, yet failed to prescribe a standard for determining SHC's performance, thereby leaving SHC free to manipulate its earnings to Marceau's disadvantage.

[7] I find that argument unpersuasive. Concerning estoppel, there is no evidence that SHC engaged in any inequitable conduct that caused detrimental reliance by Marceau. SHC represented only that the Exhibit Financials "were prepared in good faith on the basis of information and *assumptions* which SHC *believe[d]* to be reasonable." (PX 1, §3.1(d)(ii), emphasis added.) That language cannot have induced Marceau reasonably to conclude that the accounting policies of the Exhibit Financials would govern the preparation of SHC's future Financial statements. Nor did SHC make any warranty of that kind to Marceau during the negotiations. If (as Marceau claims) it was highly material to it that NATE be determined in accordance with the accounting principles set forth in the Exhibit Financials, it would have been a simple matter to express that intention in clear contract language. The parties' failure to do this cannot be laid at SHC's doorstep. Nor is it correct to say that Marceau negotiated a standardless agreement. The parties did agree upon a standard, namely, that NATE would be determined in accordance with "generally accepted accounting principles, consistently applied."[21]

Accordingly, I conclude that SHC was not contractually required to follow the accounting policies in the Exhibit Financials in preparing

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21. In a footnote to its brief Marceau argues that if the Court finds no explicit contractual obligation to use the accounting principles in the Exhibit Financials, such an obligation should be implied by application of the duty to perform a contract in good faith. (Pl. Op. Br. at 54 n.33.) However, the premise of any claim for breach of an implied covenant of good faith and fair dealing is that the parties failed to negotiate with respect to the matter in issue. *See Katz v. Oak Indus. Inc.*, Del. Ch., 508 A.2d 873, 880 (1986). In this case the parties expressly addressed the subject of what accounting standards apply in §4.5(b), which requires the application of "[GAAP], consistently applied."

its 1989 and 1990 financial statements.[22] Therefore, if Flemming is to be deprived of his put right, it can only be on the basis of Marceau's alternative contention that SHC, in preparing its financial statements, violated GAAP in the three alleged respects.[23]

### *B. The Noncompliance-With-GAAP Argument*

Preliminarily, it must be noted that to defeat Flemming's put right, Marceau must establish all three of its claimed violations of GAAP. If Marceau were to establish all three alleged GAAP violations, SHC's 1990 NATE would be reduced from $1.528 million to $1.275 million—just $25,000 shy of the $1.3 million threshold. (Pl. Op. Br. at 62.) Since each of Marceau's three GAAP claims involved allegedly wrongful inflation of NATE by more than $25,000, Marceau's failure to establish any one of those claims would leave Flemming's put right in place.

[8] Any assessment of Marceau's contentions must begin with the law. The only case authority that the parties have cited (and that this court has been able to find) describing the role of a court in determining whether a challenged accounting practice conforms to GAAP is *Godchaux v. Conveying Techniques, Inc.*, 5th Cir., 846 F.2d 306 (1988). Quoting from *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), the Court in *Godchaux* stated as follows:

> Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions. "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management.

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22. SHC also contends that Marceau, through Namy, waived any right it might have had under the Purchase Agreement to insist that SHC adhere to the accounting policies set forth in the Exhibit Financials. The argument is that in meetings held among Flemming, Cobb and Namy in May 1989, Namy told Cobb that SHC was not bound by the accounting policies contained in the Exhibit Financials. That contention is unsupported by any testimony of Namy or by any contemporaneous documentation. It is based solely upon the self-serving testimony of Cobb and Flemming, and I find it wholly unpersuasive. In all events, however, because SHC is not contractually required to adhere to the Exhibit Financials' accounting policies, it is unnecessary to address the waiver issue in further detail.

23. Marceau originally claimed four distinct violations of GAAP, but effectively conceded one of them in its Opening Brief. The fourth claim did not reappear in Marceau's Reply Brief.

> *Thor* requires the [trial] court to defer to the professional judgment of the accountant who prepared [the party's] financial statements. This rule of law suggests that an ethical, reasonably diligent accountant may choose to apply any of a variety of acceptable accounting procedures when that accountant prepares a financial statement. The rule also limits a [trial] court, in reviewing such an accountant's work, to deciding only whether the accountant chose a procedure from the universe of generally accepted accounting principles.

*Godchaux*, 846 F.2d at 315 (quoting *Thor*, 439 U.S. at 544 (citation omitted)).

That approach to resolving disputes which center upon accounting, not legal, principles is, in my view, sound. Courts are not expert in the intricacies of accounting theory. They are now endowed with greater wisdom to decide whether one accounting principle is superior to another as a legal matter, where both principles fall within the highly discretionary range of accounting judgments denominated by the accounting profession as "GAAP." Thus, for Marceau to prevail, it must demonstrate that SHC's accounting judgments on the subjects under challenge fell outside the range of judgments permitted by GAAP.

Marceau argues that SHC violates GAAP in three respects:

First, SHC is said to have wrongfully disregarded its retained appraiser's (Touche Ross) estimate of the useful life of its SHC's customer contracts, by substituting SHC's own chosen (and longer) period for amortizing the value of those contracts. The result was to increase 1990 NATE by $161,000 over what it would otherwise have been.

Second, Marceau contends that SHC's accountants (Coopers & Lybrand) wrongfully agreed to "pass" (i.e., not insist upon) certain audited adjustments on to SHC's 1990 income that Coopers & Lybrand had proposed. Those adjustments, if made, would have reduced 1990 NATE by $47,000.

Third, it is argued that SHC's accountants wrongfully included certain items as income in 1990 that, in fact, were earned in 1989 but not detected in that year. The result was to increase 1990 NATE by $45,000.

Having reviewed the evidence and arguments pertaining to these disputes, I conclude that Marceau has failed to carry its burden of demonstrating that SHC violated GAAP as to all three claims.

However, because Marceau's inability to prove any single claim operates to prevent it from defeating Flemming's put right, only one claim is addressed here in detail: Marceau's second claim that SHC should have made, and Coopers & Lybrand should have insisted upon, $47,000 of downward adjustments to SHC's 1990 NATE.

[9] The sole issue is whether the adjustments were material. The experts for both sides agree that "[GAAP] require only that an accountant reveal all *material* information." *Godchaux*, 846 F.2d at 316. Thus, if Coopers & Lybrand's audited adjustments to SHC's 1990 income were material, then they were required to be made; if not, then they need not have been made.

As used in the accounting context, the term "materiality," like "GAAP," is not precise and is highly fact specific in its application. Concerning the materiality of "passed" audited adjustments (sometimes also described as "unadjusted differences"), *Montgomery's Auditing*, a treatise published by Coopers & Lybrand and relied on by both sides, states the following:

> The question of how large a "difference" must be before it is material has never been definitely answered in the accounting and auditing literature. Many auditors have developed rules of thumb for setting materiality thresholds, such as some percentage of one or more financial statement totals. Net income is a commonly cited base for assessing materiality, but there are others, such as total assets, equities, or revenues, as well as trends in each of these . . . . Five to ten percent of net income is frequently used, but is affected in individual cases by nonquantitative criteria . . . . In addition, many auditors assign greater significance to differences that change the client's trend of earnings than to those that do not.

"Completing the Audit," *in Montgomery's Auditing*, ch. 21 (11th ed. 19___). (DX 52 at 7.)

Furthermore, "[q]ualitative considerations also influence an auditor in reaching a conclusion as to whether misstatements are material." Statement on Auditing Standards No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU Section 312.27.) (DX 52 at 7.)

The cited authorities suggest that materiality has both quantitative and qualitative aspects, neither independent of the other but both interrelated. To put it differently, an income item may be so small as to be not material quantitatively, yet may still be material qualitatively.

In this case, Marceau argues that the "passed" audited adjustments are quantitatively material, not in and of themselves, but when considered together with Marceau's two other claimed violations of GAAP. Marceau contends also that the "passed" audited adjustments are qualitatively material because they determine whether or not Flemming can retain his put right. These contentions are now addressed.

### 1. Quantitative Materiality

The only standard the parties have suggested for determining the quantitative materiality of an income item is *Montgomery's Auditing* (DX 52 at 7). That authority indicates that auditors generally consider items to be quantitatively material if they amount to five to ten percent of net income. (*Id.*) Because the parties have provided no other standard by which the materiality issue may be tested, the standard for purposes of this case will be whether the "passed" audited adjustments amount to over five percent of SHC's net income.[24]

Marceau argues that the "passed" audited adjustments are material only when considered together with its other two claimed violations of GAAP. Assuming *arguendo* (and contrary to this Court's ruling) that Marceau's two other accounting claims are valid, the "passed" audited adjustments would represent only 3.8% of SHC's net income for 1990.[25] Accordingly, the Court is unable to conclude

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24. That is, the Court does not regard that particular quantitative standard being applied here as precedent generally applicable in other cases. The standard employed here may or may not be worthy of more general application, but because the parties have not adequately briefed that issue, it is applied here for purposes of this case only. That limitation is equally applicable to the qualitative materiality standard discussed *infra*.

25. Since it is assumed that Marceau's other GAAP violation claims are valid, SHC's 1990 NATE must be revised downward by the amount of those other claimed violations, as follows:

| | |
|---|---|
| SHC's Claimed NATE: | $1,528,000 |
| Amortization "Error": | (161,000) |
| 1989 "Error": | (45,000) |
| (Hypothetical) NATE: | $1,322,000 |

*Montgomery's Auditing* states that materiality is usually determined as a percentage of net income. Therefore, it is necessary to convert NATE into net income. In this case that is done by deducting an $89,000 interest adjustment. (*See* PX 138 G at 2;

that the "passed" audited adjustments were quantitatively material.

2. Qualitative Materiality

The only standard disclosed by the record for determining qualitative materiality is also found in *Montgomery's Auditing* (at 616-17), in the section entitled "Qualitative Considerations in Assessing Materiality." That authority states:

> Other qualitative factors may also influence the auditor's response to likely misstatements in the financial statements. These factors may warrant consideration that goes beyond the quantitative significance of the misstatements. Following are examples of factors that may cause the auditor greater concern and prompt other reactions than the quantitative amounts themselves might indicate.
>
> [1] Contractual arrangements, debt covenants, buy-sell agreements and union contracts may be geared to various financial statement elements or relationships, such as the current ratio.
>
> [2] Situations in which the investor-based materiality rule is difficult to apply. For entities such as privately owned companies, trust and others, the auditor may need to consider who are the likely users of the financial statements and what their interests are and designate a materiality level appropriate for their needs. Special user needs may tighten customary materiality standards.

(Tr. V at 66; Pl. Op. Br. at 61.)

In applying this somewhat imprecise standard, one must keep in mind the deference normally accorded to the accountants who prepare financial statements. Assuming that the accountant acts ethically and with reasonable diligence, courts will normally scrutinize the accountant's work only for the limited purpose of determining whether the chosen accounting procedure falls outside the universe

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PX 1, §4.8; DX 52 at 9):

| | |
|---|---|
| (Hypothetical) NATE: | $1,322,000 |
| Interest Adjustment: | (89,000) |
| (Hypothetical) Net Income: | $1,233,000 |

Expressing the $47,000 amount of the "passed" audited adjustments as a percentage of (Hypothetical) Net Income, yields the 3.8% percentage figure:

$47,000 ÷ $1,233,000 = .038 = 3.8%

of practices referred to as "GAAP." *See Godchaux*, 846 F.2d at 315; *Thor*, 439 U.S. at 544. Thus, unless Marceau can establish to the Court's satisfaction that the "passed" audited adjustments were qualitatively material, the Court must defer to Coopers & Lybrand's judgment that these adjustments were not material. Marceau has failed to carry that burden.

Marceau's qualitative materiality argument may be summarized thusly: (i) under the above-quoted standard, "contractual arrangements" are qualitative factors to be considered; (ii) Flemming's put right is such a "contractual arrangement"; (iii) the propriety or impropriety of the "passed" audited adjustments will determine whether Flemming retains his put right; (iv) therefore the "passed" audited adjustments were material. (Pl. Op. Br. at 59; Pl. Rep. Br. at 31-32; Post-Tr. Arg. at 42.)

SHC concedes that "contractual arrangements" are appropriate qualitative factors to be considered in determining materiality, and that Flemming's put right is a "contractual arrangement." However, as SHC points out, the put right is but one part of a larger, more comprehensive set of contractual arrangements that Coopers & Lybrand considered. Despite these considerations, Coopers & Lybrand still concluded that the "passed" audited adjustments were immaterial and no persuasive evidence has been shown that that accounting judgment was wrong. Therefore, SHC argues, the Court should defer to Coopers & Lybrand's judgment. (Tr. V at 66-70; Post-Tr. Arg. at 44-45; Def. Br. at 40.)

I find SHC's reasoning to be the more persuasive. The *Montgomery's* standard is flexible and permissive, not precise and mandatory. That authority discuses factors that "may . . . influence" materiality; it does not say they "must determine" materiality. *Montgomery's* suggests that an auditor "consider" contractual arrangements; it does not make such arrangements determinative. In short, Marceau is attempting to transform a materiality standard that is imprecise and discretionary into one that contains precise, affirmative, and mandatory criteria. Unfortunately, no such affirmative, mandatory criteria can be found within the text that is the source of the standard.

In the end, this amounts to a dispute between highly qualified experts who disagree in good faith over the meaning of an accounting standard, and over whether that standard has been met in this case. Given the state of the record and the deference that must be accorded to the accountant's judgment in those circumstances, I conclude that Marceau has failed to carry its burden of proving that the "passed"

audited adjustments were material. It therefore follows that if Marceau elects to exercise its conversion rights under the Note, Flemming continues to possess his right to put his SHC shares to Marceau under the Shareholder's Agreement.

## V. SHC'S AFFIRMATIVE DEFENSE AND COUNTERCLAIM

Finally, SHC has asserted an affirmative defense of unclean hands and a counterclaim for relief based upon the "Irreconcilable Differences" provision in Article VIII of the Shareholders Agreement. For the reasons now discussed, neither contention has merit.

### *A. Unclean Hands*

In its post-trial brief SHC argued that during the eighteen-month period after the June 30, 1988, agreements were excuted, Marceau attempted to depress SHC's earnings by preventing it from entering certain business markets. However, SHC did not seek any relief on the basis of this allegedly inequitable conduct. When asked at oral argument about the relevance of that contention, SHC's counsel responded that it amounted to "unclean hands," a defense to a reformation claim that SHC was seeking to attribute to Marceau. (Post-Tr. Arg. at 85.)

The defense is unsupported and comes too late. Marceau was a 49% stockholder and, as such, did not have the power, either directly or through its board representatives, to block management's business decisions. Nor is there any credible evidence that Marceau exercised what power it did have to thwart SHC's business growth, as SHC argues. In addition, unclean hands was never pleaded as a defense or advanced as an argument in SHC's brief; and it leads nowhere, because Marceau never asserted a reformation claim to which unclean hands can operate as a defense.

### *B. Irreconcilable Differences*

SHC also claims entitlement to relief on the basis that there exists an "Irreconcilable Difference" under §8.1 of the Shareholders Agreement. (PX 6, §8.1.) That provision states that in the event of an "Irreconcilable Difference," either Flemming or Marceau can offer to sell their shares to the other or can offer to buy all of the other's shares. "Irreconcilable Difference" is defined by §8.3 as follows:

> For purposes of this Article, an Irreconcilable Difference shall mean any dispute between Flemming and Marceau which meets the following criteria: (i) it involves a proposal (the "Proposal") by one party that SHC adopt a particular course of action with respect to its *business, management or finances* (including the modification or termination of a previously adopted course of action); (ii) the Proposal is such that its adoption would represent a material change in the fundamental business or financial strategy of SHC or in the nature of the investment represented by the Common Stock (including any proposal for a public offering of Common Stock in the United States); and (iii) Marceau and Flemming disagree as to whether such Proposal should be adopted and are unable to resolve their differences with respect to it after due consideration. . . . Notwithstanding the foregoing, the exercise of Marceau of any of its rights granted to it pursuant to sections 4.2, 4.4 and 4.6 of the Stock Purchase Agreement shall not be deemed to give rise to an Irreconcilable Difference under this Article nor shall any action taken by any party in *breach* of this Agreement or the Stock Purchase Agreement permit such party to claim that an Irreconcilable Difference has arisen when the other party objects to or contests such *breach*.

(PX 6, §8.3, emphasis added.)

SHC contends that the dispute between Flemming and Marceau concerns whether SHC should "rescind its decision to conform its accounting to predominant industry practices and U.K. GAAP as an essential step toward such a listing on the London Stock Exchange." That proposal, SHC argues, relates to SHC's "business, management or finances," and therefore constitutes an "Irreconcilable Difference." (Def. Br. at 67-68.)

SHC's argument mischaracterizes both Marceau's position and the nature of the parties' dispute. Marceau does not categorically oppose a London Stock Exchange listing or the preparation of financial statements under UK GAAP for all purposes. What Marceau opposes is SHC using the UK GAAP financial statements to determine the parties' rights under the Purchase Agreement. Marceau also contends that the use of UK GAAP constitutes a breach by SHC of the Purchase Agreement. Indeed, all of Marceau's claims involve claims of breaches of one or more of the Marceau Agreements. For that reason SHC has failed to establish the existence of "Irrec-

oncilable Differences" as defined by the Shareholders Agreement. (Pl. Op. Br. at 69; Pl. Rep. Br. at 34.)

## VI. CONCLUSION

For the reasons previously set forth:

1) Marceau is entitled, under §4.7 of the Purchase Agreement, to purchase 212,246 additional shares of Class B common stock of SHC, at $1 per share.
2) Should Marceau exercise its right under the Note to convert a portion of the principal amount into additional Class A shares sufficient to make Marceau the owner of over 50% of SHC's outstanding Class A shares:
   a) Flemming shall not have the option right conferred by the Option Agreement; and
   b) Flemming shall have the put right conferred by the Shareholders Agreement.
3) No "Irreconcilable Differences" as defined in the Shareholders Agreement has been shown to exist.

Counsel shall submit an appropriate form of Order implementing the rulings made herein.

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## *IN RE* MESA LIMITED PARTNERSHIP PREFERRED UNITHOLDERS LITIGATION

No. 12,243 (Consolidated)

*Court of Chancery of the State of Delaware, New Castle*

December 10, 1991

Plaintiffs, preference unitholders in Mesa Limited Partnership (Mesa), sought to preliminarily enjoin a unitholder vote on a proposed conversion of the limited partnership to a corporation. Plaintiffs argued that the partnership was already dissolved by virtue of statements in the proxy materials, that the proxy materials were misleading, and that the transaction was unfair. In particular, the proposed conversion was claimed to be unfair because of preferential treatment given the general partner, T. Boone Pickens, the conversion ratio

of stock for partnership units was too low, and the preference unitholders would not be paid arrearages.

The court of chancery, per Vice-Chancellor Hartnett, held that statements in the proxy statement that Mesa lacked revenues with which to make distributions and, therefore, should be converted into a corporation, did not amount to a written determination by the general partner that the continued operation of Mesa was not in the best interests of the partners, which under the partnership agreement would have resulted in dissolution. The court denied the motion for a preliminary injunction. The court found that the proxy statement, while not containing the precise language plaintiffs thought necessary, was not materially misleading. The court then held that the plaintiffs, whose evidence consisted of showing the conversion, favored the general partner and that one expert thought the deal unfair, failed to prove to a reasonable probability that the proposed transaction was unfair.

1. Injunction ⟹ 212

To obtain a preliminary injunction of a unitholder vote on a proposed conversion from a limited partnership to a corporation, the plaintiff must show a reasonable probability of success on the merits, that irreparable harm will occur absent the injunction, and that such irreparable harm outweighs harm to the defendant if relief is granted.

2. Partnership ⟹ 289

The language of a limited partnership agreement that relates to dissolution of the partnership must be read precisely.

3. Partnership ⟹ 289

Contracts 95

If a contract is ambiguous in its terms, a court must read the agreement as a whole.

4. Partnership ⟹ 289

General partner's statements in a proxy statement that the partnership would be unable to pay distributions in the foreseeable future

and should be converted into a corporation was not a written determination that continued operation, was not in the best interests of the partners and, therefore, did not dissolve the partnership pursuant to the partnership agreement.

5. Securities Regulation ⟹ 278

Proxy materials soliciting unitholder approval of conversion from a limited partnership to a corporation are misleading only if the materials do not supply unitholders with all information needed for them to make a reasonably informed decision whether the conversion proposal is in their best economic interests.

6. Corporations ⟹ 101

Plaintiff failed to bear the burden of showing a reasonable probability of unfairness of the transaction sought to be enjoined when plaintiff's sole evidence of unfairness was testimony of a single expert and, therefore, failed to meet the burden of showing reasonable probability of success on the merits.

7. Corporations ⟹ 308(1), 308(6)

A unitholder vote to approve a conversion from a limited partnership to a corporation will not be preliminarily enjoined simply because the proposal calls for generous treatment of the general partner, at least not when such treatment is shown to be within the normal range of executive compensation.

8. Securities Regulation ⟹ 278

Partnership ⟹ 261

A unitholder vote on a transaction of disputed fairness will not be enjoined if the terms of the transaction are sufficiently explained in the proxy materials so that a reasonably astute unitholder can form his own business judgment as to the economic desirability of the proposed transaction and can vote for or against the transaction accordingly.

William Prickett, Esquire, Michael Hanrahan, Esquire, Elizabeth M. McGeever, Esquire, Bruce E. Jameson, Esquire, and April Caso

Ishak, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware, for plaintiff Lacos Land Company.

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Charles F. Richards, Jr., Esquire, William J. Wade, Esquire, Thomas A. Beck, Esquire, Daniel A. Dreisbach, Esquire, and Matthew J. Ferretti, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and James Edward Maloney, Esquire, and Paul Reichert Elliott, Esquire, of Baker & Botts, Houston, Texas, of counsel, for defendants Mesa Limited Partnership, T. Boone Pickens, and Pickens Operating Company.

HARTNETT, *Vice-Chancellor*

Plaintiffs, who own Preference Units of Mesa Limited Partnership, a Delaware limited partnership, seek to preliminarily enjoin a December 12, 1991, unitholder vote on the proposed conversion of the limited partnership into a Texas corporation. The motion must be denied because the plaintiffs have not shown the reasonable probability that the partnership has been dissolved as the result of statements in the proxy materials, that the proxy materials do not sufficiently set forth the terms of the transaction to allow for an informed unitholder vote or that the proposed transaction is unfair to the unitholders.

I

While time constraints make it impossible to set forth all the facts and all the contentions of the parties, some recitation of the background facts might be helpful.

In December of 1985 Mesa Petroleum Company, a Delaware corporation, was converted into Mesa Limited Partnership ("Mesa"), a Delaware limited partnership. At that time Mesa Petroleum Com-

pany's gas and oil production yielded large amounts of operating income, and the conversion to limited partnership form allowed cash distributions to be made directly to the equity owners in a manner with more favorable tax implications. The actual business and operations of Mesa are conducted by its three directly owned subsidiary limited partnerships and one indirectly owned subsidiary.

The ownership of the limited partner interests is divided between two classes of equity: Common Units and Preference Units. The Partnership Agreement provides that the Preference Unitholders are entitled to a cash distribution preference in an amount determined under a formula set forth in the Agreement. Under the Partnership Agreement, upon the dissolution of Mesa, any arrearage in the distribution preferences would be due before payment could be made to the Common Unitholders. There is presently a one year arrearage in distributions to the Preference Unitholders with a value of $1.87 per unit. It presently does not seem likely, however, that there will be sufficient funds available to pay any accrued preferences in the foreseeable future.

The general partners of Mesa are defendants T. Boone Pickens and his wholly owned Texas corporation, Pickens Operating Company (collectively "General Partner"). The General Partner owns a 2% interest in Mesa, as well as a 2% interest in each of the three direct subsidiaries. Pickens also owns approximately 5.5% of the outstanding Common Units.

According to the Partnership Agreement, the power to manage Mesa is vested in the General Partner. Mesa's "management team" consists of the General Partner, employees of Mesa, and officers and employees of BTC Partners, Inc. ("BTC"), a consulting group that regularly performs financial services for Mesa.

From 1986 to the first quarter of 1990, Mesa made cash distributions to the limited partners amounting to $7.75 for each Common Unit and $5.625 for each Preference Unit. During that same period Mesa also substantially increased its natural gas reserves, as well as its debt, through the acquisition of the assets of two other gas producing companies. Due to this large increase in debt and the failure of gas prices to rise as anticipated, Mesa suspended all cash distributions to unitholders after the first quarter of 1990.

As early as the middle of 1989, the General Partner considered whether Mesa should be converted into a corporation due to changes in the tax laws and in the gas industry. Active review of the issue was postponed, however, while some of Mesa's assets were sold and its debt was restructured. At Mesa's annual meeting on May 16,

1991, the General Partner reported that the conversion question was again under consideration.

In the period following the 1991 annual meeting of the Partnership, the General Partner and management continued to evaluate the desirability of a conversion to corporate form and began to consider the possible structure of the transaction. To this end they held discussions in July with five investment banking firms to obtain suggestions about the conversion and its structure.

After evaluating the numerous alternatives for treatment of the distribution preference of the Preference Unitholders, the General Partner and management concluded that a single class of equity, common stock, should be issued by a new corporation to replace the two existing classes of Partnership Units.

The reason given for replacing the Preference Unitholders right to receive cash with stock was that low natural gas prices and Mesa's debt obligations made the payment of any preferred distribution rights an unlikely event for the foreseeable future. Additionally, a single class of equity would allegedly strengthen Mesa's capital structure and improve its liquidity in the trading markets.

In mid-July, Mesa formally engaged Lehman Brothers and PaineWebber Incorporated to be the managers and financial advisors for the proposed conversion. Salomon Brothers was engaged to render an opinion as to the fairness of the transaction from the viewpoint of the Common Unitholders, and Kidder, Peabody & Co., Inc. was engaged to render a fairness opinion from the viewpoint of the Preference Unitholders.

On July 24, 1991, the General Partner, other management representatives, and the Advisory Committee met to discuss various aspects of the conversion and to begin establishing the overall scope of the transaction. The exact structure of the proposal was not determined at that time.

The plaintiffs challenge the impartiality of the Advisory Committee, whose purpose, according to the Partnership Agreement, is to review the policies of Mesa and to advise the General Partner about any potential conflicts of interest. The Committee met by telephone on July 31, 1991, to discuss the treatment of the General Partner's interests in a proposed conversion. At the telephone conference, the Committee focused on the need for at least part of the General Partner's interest to be continued in the form of a general partner interest to prevent the triggering of a "change of control" provision in an indenture governing Mesa's subordinated debentures. If Pickens ceased to be the General Partner, the bondholders would

have the right to redeem their bonds at par. It was decided that Mesa could not afford such an event and that Pickens' role as a General Partner must therefore be preserved.

The Committee also discussed the tax consequences for the General Partner as a result of his retaining a general partnership interest. They opined that the General Partner's exclusive ability to make use of passive losses for tax purposes would be fair to the new corporation and its shareholders. They also concluded that all aspects of the treatment of the General Partner in the conversion were fair to Mesa and to all the unitholders because the revised partnership interest the General Partner would own would be the economic equivalent of the common stock he would otherwise have received in the new corporation.

By August 1, 1991, Sidney Tassin, the sole shareholder of BTC, a financial advisor to Mesa, advised Salomon Brothers and Kidder, Peabody & Co., Inc., that he would recommend a conversion ratio for the Preference Units of between 1.23 to 1.25 shares of common stock for each partnership unit. This range of possible exchange ratios was submitted to the General Partner and the Advisory Committee at a meeting held on August 2, 1991.

After considering the consequences of the proposed transaction, the General Partner concluded that the conversion of Mesa into corporate form was in the best interests of all the unitholders and that it should be submitted to a vote of the unitholders voting as two separate classes. He also concluded that, subject to the receipt of favorable fairness opinions from Salomon Brothers and Kidder, Peabody, the conversion ratio should be set at 1.25 shares per unit for the Preference Units and at 1.0 shares per unit for the Common Units.

The Advisory Committee then held a separate meeting and reaffirmed their earlier conclusion that the treatment of the General Partner in the transaction was fair to Mesa and the unitholders. They also concurred in the General Partner's determination that the allocation ratios were fair to both classes of units.

The General Partner then reconvened the full meeting of management and the Advisory Committee. Salomon Brothers and Kidder, Peabody presented their analyses of the ratios and opined that the allocation was financially fair from the perspective of the Preference Unitholders and the Common Unitholders, respectively.

Significantly, there was no input from the unitholders in formulating the transaction and no provision was made for the buyout of the interest of any unitholders who disagreed with the proposal.

Plaintiffs assert that the entire process was flawed because of the General Partner's self-dealing.

On August 5, 1991, Mesa issued a press release announcing the proposed transaction and filed proxy materials with the Securities and Exchange Commission ("SEC"). On October 14, 1991, following SEC review, Mesa mailed the Proxy Statement/Prospectus ("Proxy Statement") dated October 11, 1991, to all unitholders of record as of October 4, 1991.

The Proxy Statement sets forth, among other things, the basic steps of the conversion. The transaction is to be effected in the following four stages:

> (1) Mesa will transfer substantially all of its assets and liabilities to the Corporation in exchange for all of the Corporation's Common Stock, and Mesa will dissolve;
> (2) excluding the General Partner, unitholders will receive 1.00 shares of Common Stock for each Common Unit and 1.25 shares of Common Stock for each Preference Unit;
> (3) the Corporation will implement a one-for-five reverse stock split, and unitholders (excluding the General Partner) will receive .2 shares of Common Stock for each Common Unit and .25 shares of Common Stock for each Preference Unit; and
> (4) the General Partner's Common Units and General Partnership interests will become a 4.24% general partner interest in each of Mesa's direct subsidiaries.

Elsewhere in the Proxy Statement it is also stated that amendments to the Partnership Agreement that would eliminate the Preference Unitholders' distribution arrearage are necessary to the completion of the conversion.

At a November 5, 1991, meeting of Mesa's management, the Advisory Committee, and the conversion proposal managers, the General Partner determined that the allocation ratio should be revised from 1.25 to 1.35 shares of common stock per Preference Unit. The Advisory Committee concurred in the decision of the General Partner, and all in attendance concluded that further fairness opinions were not needed.

The new allocation ratio is set forth in a November 8, 1991, supplement ("Supplement") to the Proxy Statement. The Supplement also contains corrections for programming errors in the original Proxy Statement as well as updated information about historical trading prices of the Units. It also informed the unitholders that the

special meeting date for their vote on the transaction would be postponed until December 12, 1991.

II

The genesis of this litigation was the complaint filed by plaintiff Albert Fruman on August 8, 1991, seeking declaratory and injunctive relief in connection with the proposed conversion. Thereafter, plaintiffs Lacos Land Company, Sonem Partners, Ltd. and Anthony J. Masters filed similar complaints.

All of the actions were consolidated by order of the Court on November 18, 1991.

Both Lacos Land Company and Fruman then moved to preliminarily enjoin a vote on the proposed transaction.

III

[1] The standards for a preliminary injunction are well established. To obtain a preliminary injunction the plaintiff must demonstrate a reasonable probability of success on the merits and that irreparable harm will occur absent the injunction. Additionally, the plaintiff must show that the harm it would suffer absent an injunction outweighs the harm to the defendant if relief is granted. *Allen v. Prime Computer, Inc.*, Del. Supr., 540 A.2d 417 (1988).

IV

Plaintiffs first claim that the partnership by its terms has already been dissolved pursuant to 6 *Del. C.* §17-801(1) as a result of statements in the Proxy Statement. If this is so, the pending vote of the unitholders would be moot because the Partnership will have already been dissolved.

6 *Del. C.* §17-801(1) states:

"A limited partnership is dissolved and its affairs shall be wound up upon the first to occur of the following:

> (1) At the time or upon the happening of events specified in the partnership agreement."

Section 15.1(a) of the Partnership Agreement provides in pertinent part:

> "Except as provided in Section 15.1(b), the Partnership shall be dissolved upon

(iv) A written determination by the General Partners that projected future revenues of the Partnership will be insufficient to enable payment of projected Partnership costs and expenses or, if sufficient, will be such that continued operation of the Partnership is not in the best interests of the Partners;

or

(v) An election to dissolve the Partnership by the affirmative vote of the Majority interests."

Plaintiffs assert that statements appearing in the Proxy Statement constituted a written determination by the General Partner dissolving the Partnership. I disagree.

[2] Nowhere in the Proxy Statement does the exact language of dissolution, as set forth in §15.1(a)(iv) of the Partnership Agreement, appear. The language of a limited partnership agreement must be read precisely. *Boesky v. CX Partners, L.P.*, Del. Ch., C.A. No. 9739-NC, Allen, C. (Apr. 28, 1988), *reprinted in* 14 Del. J. of Corp. L. 230 (1989).

[3] In construing a contract, if an ambiguity exists, a court must read the agreement as a whole. *E.I. duPont de Nemours & Co. v. Shell Oil Co.*, Del. Supr., 498 A.2d 1108, 1113 (1985); *Seabreak Homeowners Ass'n, Inc. v. Gresser*, Del. Ch., 517 A.2d 263, 269 (1986).

If the Proxy Statement is read as a whole, it is clear that the General Partner has proposed that a conversion of the Partnership form to the corporate form occur (which would constitute a dissolution of the partnership) only if there is an affirmative vote of the unitholders (voting as separate classes), as such vote is provided for in §15.1(a)(v) of the Partnership Agreement.

[4] The General Partner's statement that the partnership in its present form will not have sufficient revenues to pay any distributions in the foreseeable future and therefore the partnership should be converted to a corporation if such conversion is approved by a vote of the two classes of unit owners was not a written determination of dissolution, but was rather an explanation of why an affirmative vote on the plan was desirable.

Further, in the Proxy Statement it is stated: "The transaction will be implemented through an exchange of partnership assets for the company's common stock." This clearly indicates that no dissolution will occur until after there is an exchange of Partnership assets for the new corporate stock.

The Proxy Statement also provides that if the transaction is not consummated for any reason, the Partnership will be expected to continue.

To hold that the partnership has already been dissolved, although the General Partner clearly never intended to do so, might seriously jeopardize the financial interests of the unit owners. Equity has traditionally abhorred any inadvertent forfeiture of rights. *See Marshall v. Vicksburg*, 82 U.S. (15 Wall.) 146 (1872).

The Court, therefore, finds that the Partnership has not been dissolved.

V

In seeking to meet the standards for a preliminary injunction, plaintiffs next contend that the Proxy Statement and the Supplement thereto are fatally misleading as to the rights of the Preference Unitholders. They claim that the proposed elimination of the Preference Units' distribution arrearage is not explained well enough to enable the holders of those units to know that they would be giving up a valuable contract right to a preference by voting for the transaction. In plaintiffs' view, the explanation of the allocation ratios is insufficient to apprise the Preference Unitholders of the consequences of the transaction. Plaintiffs, therefore, conclude that any vote by the holders of Preference Units on the conversion proposal would be tainted.

Plaintiffs further argue that the Preference Unitholders have not been told that they, voting as a separate class, can defeat the proposal and the amendment to the Partnership Agreement that will eliminate the distribution arrearage that they are, at least in theory, now entitled to receive. They also urge that the Preference Unitholders will feel coerced by the perception that the vote of the Common Unitholders alone can eliminate a right of the Preference Unitholders.

Plaintiffs are technically correct that the Proxy materials do not precisely state that a "contract right" will be given up and that the Preference Unitholders voting as a class must vote to amend the Partnership Agreement. The Proxy materials do, however, clearly state in a number of places that the preferred distribution right of the Preference Unitholders is to be fully satisfied by the issuance of a higher ratio of common stock to the Preference Unitholders than to the Common Unitholders. The Proxy materials also state that approval of the transaction would require a favorable vote of a majority of both classes of units, each voting as a separate class.

[5] While the Proxy materials do not contain the exact words that plaintiffs deem necessary, the plaintiffs have not shown that the unit owners do not have all the information they need to make a reasonably informed decision whether the conversion proposal is in their best economic interests. *Barkan v. Amsted Indus. Inc.*, Del. Supr., 567 A.2d 1279 (1989); *In re Anderson Clayton Shareholders Litig.*, Del. Ch., 519 A.2d 680 (1986).

Plaintiffs have therefore failed to show that there is a reasonable probability that the Proxy Statement and Supplement are materially misleading. The December 12th vote of the unitholders, therefore, should not be enjoined on this ground.

VI

Plaintiffs next urge that the unitholder vote and the consummation of the transaction should be preliminarily enjoined because the structure and terms of the conversion are unfair to the Preference Unitholders. They claim that the common stock to be issued to the Preference Unitholders will be worth substantially less than is the present value of the distribution arrearage. To support this claim, plaintiffs have submitted the affidavit of an expert who concluded that the ratio of common stock to be distributed to the Preference Unitholders is unfair to them.

[6] Plaintiffs, however, have not borne their burden of showing the reasonable probability of unfairness by the introduction of their expert's conclusions as to the appropriate basis for setting the allocation ratio. The most plaintiffs have shown is that there is a dispute between the opinion of their expert and the opinions of the defendants' experts. Where the Court cannot from the record determine that there is a reasonable probability that a fact essential to an applicant's position is true, the applicant has failed to meet his burden of showing the reasonable probability of success. *McConnell v. Emory*, Del. Ch., C.A. No. 10,678-NC, Hartnett, V.C. (Sept. 28, 1989).

VII

Plaintiffs also take issue with the treatment that the General Partner will receive upon completion of the conversion. They deem it unfair that the General partner will not receive common stock for his Common Units but rather will receive a general partner interest in each of Mesa's direct subsidiaries.

As previously discussed, there appears to be a valid business reason why the General Partner must be continued in that role to prevent a precipitous calling of debt obligations. The value of the assets to be received by the General Partner is subject to differing opinions but plaintiffs have not shown that their estimate is any more valid than is the estimate of defendants' experts.

Plaintiffs also contend that setting forth in the Proxy Statement the options and the future compensation that the General Partner will receive from the new Texas corporation, if the conversion proposal is approved, is further evidence of the General Partner's self-dealing.

[7] While these proposals may seem generous to the General Partner, they are apparently within the normal range of executive compensation and the unitholders can take into consideration their propriety when they exercise their vote.

Plaintiffs have, therefore, failed to meet their burden that they have a reasonable probability of success on the merits on these claims.

## VIII

[8] The terms of the conversion plan that plaintiffs claim are unfair, i.e., the method of determining the allocation ratio and the treatment of the General Partner, are fully set forth in the Proxy materials. These terms are sufficiently explained so that a reasonably astute unitholder may form his own business judgment about the economic desirability of the allocation ratio and the benefits he or the General Partner will receive from the proposed transaction.

Delaware case law holds that shareholders of a corporation, if fully informed, may ratify actions of the directors which would otherwise constitute breaches of fiduciary duty. *Lewis v. Hat Corp. of Am.*, Del. Ch., 150 A.2d 750 (1959). Such ratification precludes judicial scrutiny of those actions. *Gottlieb v. Heyden Chem. Corp.*, Del. Supr., 91 A.2d 57 (1952). Only actions which rise to the level of an illegal gift of assets or fraudulent, illegal or *ultra vires* action may not be ratified by fully informed shareholder vote. *Fidanque v. American Maracaibo Co.*, Del. Ch., 92 A.2d 311 (1952).

Case rulings construing statutory corporation law are not necessarily binding precedents as to issues arising under contractual partnership agreements but they may often be helpful by analogy.

Where the issue is primarily an economic question, those who will have to bear the economic consequences of the decision are obviously in a better position to make what is essentially a business judgment than is a court.

Here the decision whether the Preference Unitholders should trade what may be an illusory right to receive a distribution arrearage for a certain number of common shares in a new corporation is primarily an economic judgment that has and should be left to them. At the least, an affirmative vote by the Preference Unitholders would shift the burden of proving the ultimate unfairness of the proposal to the objectors. *Gottlieb v. Heyden Chem. Corp.*, *supra.*

In any case, plaintiffs have not borne their burden of showing the reasonable probability of their ultimate success on this issue. *Joseph v. Shell Oil Co.*, Del. Ch., 482 A.2d 335 (1984).

IX

Additionally, there appears to be no possibility of any irreparable harm given the assertion that the new Texas corporation has agreed to submit to this Court's jurisdiction for the purpose of any adjustment to the allocation ratio if subsequent proceedings make it necessary.

X

In summary, plaintiffs' dissolution argument is without merit because the statements of the General Partner in the Proxy Statement do not constitute a written determination of dissolution.

The December 12, 1991, unitholder vote on the conversion should not be enjoined because the Proxy materials are not misleading and are sufficiently adequate that a reasonable unitholder can make an informed decision how to vote.

The plaintiffs have also not shown the reasonable probability that the proposed transaction is unfair.

The Motion For a Preliminary Injunction is, therefore, denied.

IT IS SO ORDERED.

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## *IN RE* RADIOLOGY ASSOCIATES, INC. LITIGATION

No. 9001 (Consolidated)

*Court of Chancery of the State of Delaware, New Castle*

November 1, 1991 (After Reargument)

In a prior action, defendants were held liable to plaintiff, a shareholder, for breach of fiduciary duty based on entire fairness

after defendants failed to fully disclose information regarding the merger of their corporation into another corporation, thereby eliminating plaintiff's interest in the corporation and freezing him out. One of the defendants, a majority shareholder in the corporation, was also held liable to plaintiff for causing the corporation to make loans to another entity in a manner not entirely fair to plaintiff, thereby entitling him to damages. The plaintiff brought this action for an appraisal of the fair value of his shares as of the date of the merger, a determination of the amount of damages plaintiff is entitled regarding the loans made to the other entity, and recovery of costs including expert witness fees.

The court of chancery, per Vice-Chancellor Chandler, held that the fair value of plaintiff's shares will be determined by the discounted cash flow analysis as advanced by plaintiff. However, the court also determined that an implicit minority discount adjustment and tax deductions or adjustments should not be made to the raw discount cash flow analysis, but that the discount cash flow should reflect the value of non-operating assets. The court gave no weight to defendants' determination of fair value under the Delaware Block Method and plaintiff's evaluation of the same under the comparable company approach. Plaintiff was entitled to an amount of damages equal to his proportional interest in the lost distributions caused by breach of fiduciary duty and was to bear the cost of his expert appraiser. Defendants were assessed the cost of the proceedings.

1. Corporations ⟹182.4(5)

The comparable company approach to valuation attempts to value companies first by finding comparable publicly-traded companies. After identifying a comparable company, this approach calculates the value of the company through the use of earnings and other multiples.

2. Corporations ⟹182.4(2), 182.4(5)

Because the utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison, at some point, the differences become so large that the use of the comparable company method becomes useless for valuation purposes.

3. Corporations ⟹182.4(2), 182.4(5)

The discounted cash flow method of valuation entails an estimation of net cash flows that the firm will generate over some period, a terminal or residual value equal to the future value, as of the end of the projection period, of the firm's cash flows beyond the projection period, and the cost of capital with which to discount to a present value both the projected net cash flows and the estimated terminal or residual value.

4. Corporations ⟹182.4(2), 182.4(5)

Projections are reliable and should be used in applying the discounted cash flow approach where management had direct and indirect input with their creation, where the projections were created for a business purpose unrelated to matters at issue, and where such projections were created by making adjustments to and applying a growth rate to historical earnings.

5. Corporations ⟹182.4(2), 182.4(5)

In determining the fair value of a shareholder's shares, the court first must determine the company's fair value as a whole.

6. Corporations ⟹182.4(2), 182.4(5)

The discounted cash flow analysis fully reflects value without need for an implicit minority discount adjustment; plaintiff/shareholder is entitled not to the proportionate sales value of the company, but rather, a proportionate value of the company as a continuing shareholder.

7. Corporations ⟹182.4(2), 182.4(5)

A proposed adjustment made to the raw discounted cash flow analysis to reflect the S-Corporation tax status of the company is not an adjustment to valuation generally considered acceptable in the financial community and must be so rejected for the purpose of applying the discounted cash flow approach.

8. Corporations ⟹ 182.4(2), 182.4(5)

The discounted cash flow approach does not include a deduction for taxes or an adjustment for taxes.

9. Corporations ⟹ 182.4(5)

The value of non-operating assets such as excess working capital must be added to an earnings based valuation analysis.

10. Corporations ⟹ 182.4(5)

The Delaware Block Method, a combination of three generally accepted methods for valuation, namely, the asset approach, the market approach, and the earnings approach, is an acceptable procedure for valuing a company.

11. Corporations ⟹ 182.4(5)

The asset prong of the Delaware Block Method which does not include the value of a company's goodwill, in order to reflect the value of the company as a going concern, will be given no weight in determining the value of the company.

12. Corporations ⟹ 182.4(5)

The market valuation prong of the Delaware Block Method, as based on sale and purchase parameters set by offeree lacking competency to set a price reflecting company's market value, will be given no weight in determining the value of the company.

13. Corporations ⟹ 182.4(5)

The calculation of the earnings value prong of the Delaware Block Method does not require a reliance on historical earnings if reliable earnings projections are available.

14. Corporations ⟹ 320(12)

Director's breach of fiduciary duty to plaintiff/shareholder entitled such shareholder to damages equal to shareholder's proportional

interest in the amount of lost distributions caused by director's breach of fiduciary duty.

15. Corporations ⟹182.4(5)

Damages ⟹70

Plaintiff/shareholder should bear the cost of his expert in an appraisal proceeding.

16. Corporations ⟹320(12)

Damages ⟹70

It was more equitable to assess the cost of proceedings to defendants liable for breach of fiduciary duty. DEL. CODE ANN. tit. 8, § 262(j) (1991).

Stephen E. Jenkins, Esquire, of Ashby, McKelvie & Geddes, Wilmington, Delaware, for plaintiff.

Howard M. Handelman, Esquire, and John H. Newcomer, Jr., Esquire, of Bayard, Handelman & Murdoch, P.A., Wilmington, Delaware, for defendants.

CHANDLER, *Vice-Chancellor*

This lawsuit, which began in the spring of 1987, asserted claims by plaintiff, Robert M. Kurtz, M.D. ("Dr. Kurtz"), against the defendants based on breach of contractual and fiduciary duties. *See Kurtz v. Papastavros*, Del. Ch., C.A. No. 9001, Hartnett, V.C. (May 9, 1988). The defendants in this case are Christos S. Papastavros, M.D. ("Dr. Papastavros"), Papastavros Associates, P.A. ("Papastavros Associates"), Radiology Associates, Inc. ("Radiology"), Radiology Imaging Corporation ("New Radiology"), John S. Piendak, M.D. ("Dr. Piendak"), Garth A. Koniver, M.D. ("Dr. Koniver"), and Thomas W. Fiss, Jr., M.D. ("Dr. Fiss"). In addition, plaintiff seeks an appraisal remedy for the fair value of his 250 shares of the 9950 outstanding shares of Radiology that he owned as of May 6, 1987, which was the date that Radiology merged into New Radiology.

After a trial on the issue of liability, this Court held for defendants as to the contractual claims. *See In re Radiology Associates, Inc.*,

Del. Ch., C.A. No. 9001, Chandler, V.C. (May 16, 1990), slip op. at 36. However, this Court held that the defendants' failure to fully disclose information as to the merger into New Radiology, which eliminated Dr. Kurtz's interest in Radiology and froze him out of New Radiology, and failure to use due care in effectuating the merger, entitled plaintiff to damages for his breach of fiduciary duty claims based on entire fairness. *See id.* Further, this Court held that Dr. Papastavros' use of Radiology, in his capacity as majority shareholder of Radiology, in effectuating certain transactions (loans from Radiology to Limestone Professional Building, to Dr. Papastavros and to the Land-Ho partnership) in a manner not entirely fair to plaintiff entitled plaintiff to damages.

Following the trial on liability, the parties have settled the issue of what represents the proper amount of damages for the entire fairness breach relating to the failure to fully disclose and to use due care and for the loans from Radiology to Limestone Professional Building and to Dr. Papastavros. Thus, this Court must decide what amount represents the fair value of plaintiff's Radiology shares as of May 6, 1987 (his appraisal claim) and what amount represents the damages plaintiff suffered from the Land-Ho loans in order to compensate plaintiff for Dr. Papastavros' failure to act in an entirely fair manner in regards to these loans. Finally, this Court must decide plaintiff's claim for costs, including expert witness fees.

Testimony on the damages and fair value phase of this case was heard over two days in November 1990. Part I of this opinion provides a brief statement of the facts. Part II addresses the issue of the fair value of plaintiff's shares as of May 6, 1987. Part III addresses the issue of the amount of damages to be awarded to plaintiff as a result of the Land-Ho loans. Part IV deals with plaintiff's claim for costs and expert witness fees.

## I. FACTUAL HISTORY

Papastavros Associates was a professional corporation which provided direct radiological services to patients in New Castle County, Delaware and the surrounding areas. Papastavros Associates employed the radiologists that provided these services, paid their salaries and also billed patients for services performed. Drs. Papastavros, Alden and later Piendak owned all of the Papastavros Associates' stock.

Radiology was a separate corporate entity that owned the radiological machines and employed all of the nonmedical personnel

utilized by Papastavros Associates. Radiology solely dealt with Papastavros Associates and billed it on a cost plus basis. Initially, Radiology issued all of its stock to Drs. Papastavros and Piendak. Over time, Dr. Papastavros, who owned the majority of Radiology stock, permitted doctors employed by him to purchase shares of Radiology stock. Radiology's shareholders would receive a return on their investment in the form of a "salary."

Drs. Papastavros and Piendak hired Dr. Kurtz to work for Papastavros Associates in July of 1973. In 1979, Dr. Papastavros permitted Dr. Kurtz to purchase 2.5% of Radiology's class A and B stock for $33,000. It is uncontested that the books of Radiology show that for several years Dr. Kurtz, Koniver and later Fiss all received income from Radiology representing their proportionate stock ownership. During the time Dr. Kurtz was a shareholder, the record shows that payments to him from Radiology increased from $4,800 per year to more than $40,000.

At various times, Dr. Papastavros used his position as majority shareholder of Radiology to effectuate certain loans. One of these loans was actually a series of loans referred to as the "Land-Ho" loans. Land-Ho was a partnership of which Dr. Papastavros was the capital partner. The Land-Ho partners had formed the partnership to develop New Jersey beach houses. In 1984 and 1985, Radiology loaned Land-Ho a total of $715,000. A mortgage secured $267,500 and a receipt certified $150,000 of this loan.

In 1984, a group consisting of Drs. Koniver, Fiss and later Mansoory formed New Radiology. In the early spring of 1987, Drs. Papastavros, Koniver, Fiss and Mansoory transferred their shares of Radiology to New Radiology for a corresponding percentage of New Radiology's shares. On May 6, 1987, Radiology merged into New Radiology pursuant to the short form merger statute, and Dr. Kurtz's shares were eliminated, for which he was paid $400 per share. *See* 8 *Del. C.* § 253. Drs. Konover, Fiss and Mansoory were directors of New Radiology at the time of the merger.

On May 8, 1987, Dr. Kurtz received three documents informing him that he had been merged out of Radiology, that he had been fired as an officer of Radiology and that Papastavros Associates was being dissolved as of September 30, 1987. The new entity, Papastavros Associates Medical Imaging, that consisted of Drs. Koniver, Fiss and Mansoory, did not employ or offer employment to Dr. Kurtz. As of the date of the merger, Dr. Kurtz held 250 of the 9950 outstanding shares of Radiology.

## II. THE FAIR VALUE OF DR. KURTZ'S SHARES

Plaintiff, Dr. Kurtz, challenges the fairness of the merger price. Plaintiff contends that Radiology's fair value was $2300 per share on May 6, 1987, the merger date. Plaintiff's conclusion rests primarily on the testimony of his valuation expert, Anne Danyluk, who is manager of Valuation Services at Coopers & Lybrand's Philadelphia office. Defendants dispute this conclusion and contend that the fair value was $457 per share on the merger date. Defendants' conclusion rests primarily on the testimony of their valuation expert, Charles Stryker, who is a business valuator for the "Benchmark" subsidiary of KPMG Peat Marwick.

At the outset of the valuation analysis, plaintiff insists that this Court may consider defendants' breach of fiduciary duty in determining Radiology's fair value. Defendants argue that the parties' settlement agreement compensates plaintiff for the breach of fiduciary duty. Plaintiff contends that the settlement agreement explicitly carved out an exception that allows plaintiff to discuss the breach of fiduciary duty in the valuation analysis.

I believe the phrase "we are not prevented from mentioning" is ambiguous. (*See* Pl. Exh. B at 2.) Thus, I look to the parties' intent. I conclude that the parties intended the settlement agreement to compensate plaintiff for whatever damage he incurred as a result of the breach of fiduciary duty. To further consider this breach in the fair value analysis possibly would result in a double recovery for plaintiff. It is nonsensical to believe that defendants agreed to pay plaintiff twice for his injury from the breach. Thus, I ignore defendants' breach of fiduciary duty in determining Radiology's fair value.

### *A. Plaintiff's Valuation Methodology*

Plaintiff's expert attempted to value Radiology by using two different methods: (1) a comparable company approach and (2) a discounted cash flow approach. Further, after determining the outcomes from the methods, plaintiff's expert argued that adjustments to the results were necessary in order to account for Radiology's S-Corporation status; in order to include Radiology's non-operating assets; and in order to alleviate the minority discount implicit in its valuation methods.

#### 1. The Comparable Company Method

[1] The comparable company approach attempts to value companies first by finding comparable publicly-traded companies. *See Harris v.*

*Rapid-American Corp.*, Del. Ch., C.A. No. 6462, Chandler, V.C. (Oct. 2, 1990), slip op. at 19. After identifying a comparable company, this approach calculates the value of the company through the use of earnings and other multiples. *See id.*, slip op. at 19-20. This Court has affirmed the general validity of this approach. *See id.*, slip op. at 21.

"The first step in doing a comparable companies analysis is to compile a list of comparative companies." *Id.*, slip op. at 19. In this case, Ms. Danyluk chose two companies with which she wished to compare Radiology: MEDIQ Incorporated ("MEDIQ") and MMI Medical ("MMI"). The companies chosen for comparison by plaintiff's expert differ significantly from Radiology. First, MMI derives its revenue from the operation of mobile radiological units, from the leasing of such units and from providing maintenance and repair services for radiological equipment. MEDIQ derives only 24% of its revenues from diagnostic imaging services, and MEDIQ provided these services through mobile units. On the other hand, Radiology derives its revenue solely from providing non-mobile radiological services. Further, defendants point out significant differences in revenues, size, profitability, and growth rates:

| | *Radiology* | *MEDIQ* | *MMI* |
|---|---|---|---|
| Revenues | $4.8 million | $187.7 million | $28.2 million |
| Total Assets | $3.4 million | $239.9 million | $30.9 million |
| Pre-tax Profit Margin | 22.4% | 7.6% | 3.7% |
| Revenue Growth Rate | 7.2% | 38.2% | 35.5% |
| Earnings Growth Rate | 10.4% | 34.4% | 13.4% |

Finally, MEDIQ and MMI cover much larger geographic areas than Radiology.

[2] The utility of the comparable company approach depends on the similarity between the company the court is valuing and the companies used for comparison. At some point, the differences become so large that the use of the comparable company method becomes meaningless for valuation purposes. *See Neal v. Alabama By-Products Corp.*, Del. Ch., C.A. No. 8282, Chandler, V.C. (Aug. 1, 1990), slip op. at 21, *aff'd*, Del. Supr., 588 A.2d 255 (1991); *Citron v. E.I. DuPont de Nemours & Co.*, Del. Ch., 584 A.2d 490, 510 (1990).

In this case, the differences between Radiology and MMI and MEDIQ as to product mix, revenues, profit margins, revenue and earnings growth rates, assets and geographic markets combine to make any comparison with Radiology meaningless.

2. The Discounted Cash Flow Method

[3] The second method Ms. Danyluk used in attempting to value Radiology was the discounted cash flow method.

> In theory, the value of an interest in a business depends on the future benefits discounted back to a present value at some appropriate discount (capitalization) rate. Thus, the theoretically correct approach is to project the future benefits (usually earnings, cash flow, or dividends) and discount the projected stream back to a present value.

S. Pratt, *Valuing a Business* 25 (2d ed. 1989). The Delaware courts have affirmed the validity of this method of valuation repeatedly. *See Neal, supra*, at 16; *Cede & Co. v. Technicolor*, Del. Ch., C.A. No. 7129, Allen, C. (Oct. 19, 1990), slip op. at 17.

> The DCF model entails three basic components: an estimation of net cash flows that the firm will generate and when, over some period; a terminal or residual value equal to the future value, as of the end of the projection period, of the firm's cash flows beyond the projection period; and finally a cost of capital with which to discount to a present value both the projected net cash flows and the estimated terminal or residual value.

*Id.*, slip op. at 17-18. The quality of the projection as to the future benefits over some period and the residual or terminal value is central to the reliability of the underlying methodology of the discount cash flow method. *See Harris, supra*, at 14.

(a) Projected Revenues and Terminal Value

[4] In *Harris*, this Court declined to use the discounted cash flow method because the projections on which petitioners relied were too speculative. *See Harris, supra*, at 15. The projections in *Harris* were rejected because management did not create them and did not have any input with the third party who created them. In this case, Ms. Danyluk used projections prepared by the Delaware Trust Company for its internal purposes of assessing an application for a multi-million

dollar loan for an ESOP. It is not as important that management itself did not create the projections as much as management had input with their creation. That is, although management itself did not do the "number crunching," it had input directly and indirectly (via Radiology's accountant, Barry Crozier, who worked with Delaware Trust in creating the projections). Further, Delaware Trust created the projections for a business purpose (the propriety of a loan) completely unrelated to this lawsuit. Also, Delaware Trust's projections began from fact: they created the projections by making adjustments to and applying a growth rate to *historical* earnings. For all of these reasons, I believe that the projections are reliable and should be used in applying the discounted cash flow approach.

Ms. Danyluk, however, did not use the exact projections of the Delaware Trust Company. She adjusted the five-year revenue projection of 5% growth annually to 7% annually. Ms. Danyluk did use the 5% growth figure used by the Delaware Trust Company in her terminal year calculation.

Ms. Danyluk justified a change in the five-year revenue projection by relying on three factors: historical earnings, an analysis of the industry and an analysis of other projections. The parties argue over exactly what the historical earnings growth rate was. However, the Delaware Trust Company had the information both sides put forth to argue their respective positions available when they made their projections. Thus, Ms. Danyluk's reliance on this factor for adjusting the growth rate upward is without merit since the Delaware Trust Company undoubtedly considered historical earnings in projecting a future earnings growth rate. Similarly, Ms. Danyluk's second factor, an industry analysis, reflects information available to the Delaware Trust Company when they made their projections and information to which they undoubtedly referred in creating the earnings growth rate projections. Finally, Ms. Danyluk relied on the fact that other projections predicted higher growth rates. Ms. Danyluk did not explain who made these projections, how they were different, and why they were different. The concept of "other projections," in my opinion, is too amorphous and insufficient to warrant a deviation from the Delaware Trust Company's projections as to the growth rate.

Since I have adjusted the proper growth rate in the discounted cash flow analysis down to 5%, I also must adjust expenses projected on a percentage of net sales basis (e.g., general administrative expenses and adjusted depreciation).

In determining the projected net cash flows for years 1987 through 1991 and the terminal year, Ms. Danyluk also made an adjustment for officer's salaries. Ms. Danyluk added back as income the distributions made to the doctors as salaries and as part of the general and administrative expenses. However, she does allow a deduction for the reasonable salaries of two administrators adjusted for a nominal raise each year. Defendants argue that the salaries were not earnings.

This Court specifically stated that the distributions were earnings:

> Dr. Kurtz understood that the vast bulk of Radiology's income would be distributed to the shareholders in accordance with their proportionate ownership of stock. Part of these distributions would come to the stockholders in the form of a "salary" that was in actuality a form of return on equity. It is uncontested that the books of Radiology show that for several years Drs. Kurtz, Koniver and later Fiss all received income from Radiology representing their proportionate stock ownership.

*In re Radiology Associates, Inc.*, *supra*, at 9-10. Any claim by defendants that the salary expenses do not represent, at least in part, a return on equity is wholly without merit. If the salaries do not represent entirely a return on equity, they represent, at least, a partial return on equity. Thus, Ms. Danyluk's calculations which, in effect, treat the salaries as part salary expense and part return on equity is much more appealing than defendants' desire to treat the distributions entirely as salary expenses and general and administrative expenses.

Defendants claim that if I treat some of the salary and general administrative expenses as returns on equity and not expenses, I also must adjust revenue. That is, defendants argue that Radiology bills Papastavros on a cost plus basis. Thus, if I reduce the amount of costs (expenses), I also must reduce Radiology's revenue.

Defendants' argument is without merit. They fail to distinguish the difference between how Radiology treats an item and how Radiology should treat an item. That is, Radiology should treat some or all of the salary distributions as returns on equity. However, this does not mean that Radiology will change its treatment of the distributions as expenses. In fact, Radiology most likely will continue to treat it as an expense and, as such, will bill Papastavros Associates on a cost (including the salary distributions) plus basis. Thus, I make no further adjustment to the treatment of salary distributions.

Having made the adjustments to the projected growth rate, the expenses as a percentage of net sales and "salary" expenses, I am able to determine the projected net cash flows for years 1987 through 1991 and the terminal year. These projections of net cash flow are $744,000,000 for 1987; $1,218,000 for 1988; $1,301,000 for 1989; $1,388,000 for 1990; $1,480,000 for 1991; and $1,556,000 for the terminal year.

(b) Discount Rate

Having decided what are the proper projected revenues for 1987 through 1991 and for the terminal year, the third element that this Court must calculate in applying the discounted cash flow method is the proper discount rate. The discount rate attempts to reduce the projected future revenues to present value. *See Cede & Co., supra,* at 68.

Ms. Danyluk applied a 14% discount rate. On the other hand, defendants argue that 17% or 16.5% is the proper discount rate. Ms. Danyluk arrived at her discount rate by using the Capital Asset Pricing Model ("CAPM"). "That model estimates the cost of company debt (on an after tax basis for a company expected to be able to utilize the tax deductibility of interest payments) by estimating the expected future cost of borrowing; it estimates the future cost of equity through a multi-factor equation and then proportionately weighs and combines the cost of equity and cost of debt to determine a cost of capital." *Id.* at 68. This Court has affirmed the general validity of this approach for estimating the cost of capital component in the discounted cash flow model. *See id.* at 70.

The first step in applying the CAPM is to determine the expected future cost of equity. Ms. Danyluk determined the expected future cost of equity (re) by utilizing the CAPM equation of: re = rf + B (rm-rf). The letters rf symbolize a risk free rate of return. Ms. Danyluk used 8.82% which was the U.S. government long-term bonds average for the week ending May 6, 1987, as her rf. The market risk premium, rm-rf, is equal to the excess of the market rate of return, rm, over the risk free rate of return. Ms. Danyluk used a market premium of 13.5% that research conducted at the University of Chicago by Ibbotson Associates determined to be the mean for small (i.e., less than $100 million) capitalization stock interests for the period 1926 through 1986. (Pl. Exh. 74 at 13). Finally, the B is the Beta factor which represents "the nondiversified risk associated with the economy as a whole as it affects this firm."

*Cede, supra*, at 69. In this case, Ms. Danyluk used a Beta of .95. After plugging these numbers into the equation, Ms. Danyluk calculated the cost of equity to be 21.6%.

The second step in applying the CAPM is to determine the after tax expected future cost of borrowing. Ms. Danyluk determined the future cost of debt by taking the interest rate of A-rated industrial bonds for the week of May 6, 1987, according to Standard & Poors' bond guide (9.8%) and reducing it by a tax rate (34%) in order to take account of the tax deductibility of interest expenses. The outcome of this calculation was 6.47%.

As discussed later, Radiology was a nontaxable entity. Thus, Radiology does not deserve its cost of debt to be reduced by taxes since it paid no taxes. Therefore, I use 9.8% as Radiology's cost of debt. To the extent plaintiff argues that I must adjust the Beta factor and the cost of equity if I make no deduction for taxes in determining the cost of debt, his arguments are, at best, conclusory and afford no basis for these adjustments.

The final step in the CAPM is to determine the weighted average cost of capital (WACC). The WACC is the weighted average of the cost of debt and equity which represents the average cost of capital. In this case, Ms. Danyluk determined that the cost of debt should carry a 49% weight and that the cost of equity should carry a 51% weight. However, Ms. Danyluk did not use Radiology's debt to equity ratio, which was 21% to 79%, in calculating the WACC. Instead, she used a hypothetical debt to equity ratio of 49% to 51%. Ms. Danyluk's justification for the use of the hypothetical ratio was that the hypothetical ratio reflected the industry average capital structure, that Radiology's deviation from the industry average reflects a hidden value (i.e., underleveraging) in the company, and that the company could and should maximize shareholder value by attaining the optimal capital structure (i.e., the industry average debt to equity ratio). Thus, Ms. Danyluk argued that this Court should employ the hypothetical rather than the actual debt to equity ratio in attempting to value the company.

Defendants attack Ms. Danyluk's use of the industry average in two ways. First, they argue that the hypothetical capital structure that Ms. Danyluk used was not the industry average. Ms. Danyluk calculated the hypothetical capital structure by taking a weighted average of the capital structures of MEDIQ and MMI. Defendants argue that the use of MMI's and MEDIQ's capital structures as representative of the industry average was inappropriate because of their noncomparability to Radiology. However, defendants fail to

recognize that the choice of companies for the comparable company valuation approach is a much more comprehensive analysis than the choice of companies for the decision of whether they belong to the same industry. Indeed, there is little doubt that the proper Standard Industrial Classification ("SIC") for all three of these companies falls within the same industry: SIC Code 807-1, which is the medical services or medical laboratory services industry. Further, the WACC of MMI and MEDIQ more likely represent a figure that is closer to the "industry average" than Radiology's own capital structure because the average of two companies within the same industry is, for the most part, a better indication of an industry average than one company's figures; because they are much larger than Radiology; and because they are publicly traded.

Even if Ms. Danyluk's hypothetical capital structure represents a debt to equity ratio that is closer to the industry average, defendants argue (and I agree) that the use of the industry average rather than Radiology's actual capital structure was improper. The entire focus of the discounted cash flow analysis is to determine the fair value of Radiology. I am not attempting to determine the potential maximum value of the company. Rather, I must value Radiology, not some theoretical company. Plaintiff has introduced no evidence (e.g., Radiology's debt to equity ratio trends or goals) that implies that Radiology will mimic the industry's debt to equity ratio. Given the lack of evidence as to the applicability of the industry average to Radiology, I will use Radiology's own debt to equity ratio in determining its WACC. Thus, I use 18% ([29.63% x 9.80%] + [70.37% x 21.65%] = 18.14%) as the discount rate in applying the discounted cash flow method.

In applying the discount rate to the terminal year, Ms. Danyluk subtracted her terminal growth rate (5%) from her discount rate (14%). Ms. Danyluk then reduced the terminal value to present value using her discount rate of 14%. The financial community and this Court recognizes these valuation mechanics for the terminal year as acceptable. *See* R. Brealy & S. Myers, *Principles of Corporate Finance* 64 (2d ed. 1988). Given any prior findings as to the growth rate, the net income adjustments and the discount rate, I adjust the terminal value to equal $6,020,000.

### 3. Adjustments

The final facet of Ms. Danyluk's analysis are her adjustments to her valuation analyses. Given my rejection of Ms. Danyluk's

comparable company analysis, I will focus on the adjustments as she applied them to the discounted cash flow analysis. In deriving her final calculation of Radiology's value under the discounted cash flow method, Ms. Danyluk made three adjustments to the raw discounted cash flow calculation: the implicit minority discount adjustment, the S-Corporation adjustment and the adjustment for non-operating assets.

(a) Implicit Minority Discount Adjustment

[5] In determining the fair value of a shareholder's shares, the Court first must determine the company's fair value as a whole. *See Cavalier Oil v. Hartnett*, Del. Supr., 564 A.2d 1137, 1144 (1989). In the second step, the Court determines plaintiff's share by merely using his proportionate interest (i.e., the number of shares plaintiff owns divided by the number of shares outstanding). This Court will not weigh valuation factors at the shareholder level. *See Harris, supra*, at 29. *See also Cavalier Oil, supra*, at 1144.

Ms. Danyluk argued that the raw discounted cash flow calculation includes an implicit minority discount. She argued that the discounted cash flow analysis assumes a required rate of return for a minority interest and this Court must adjust from that basis to a controlling (100%) basis. That is, the discounted cash flow analysis fails to value fully the company as a whole with a premium over market price. Thus, she increased her raw discounted cash flow calculation by 30%, which purports to represent a fair estimate for premiums over market price.

[6] Defendants argue that no matter if the plaintiff labels the 30% as a premium or recompense for a discount, the excess over the discounted cash flow calculation is inappropriate in this case. I agree. The discounted cash flow method purports to represent the present value of Radiology's cash flow. The calculation arguably may have left out a premium that normally accrues when shareholders sell a company. However, "the appraisal process is not intended to reconstruct a pro forma sale but to assume that the shareholder was willing to maintain his investment position, however slight, had the merger not occurred." *Cavalier Oil, supra*, at 1145. Plaintiff is not entitled to the proportionate sales value of Radiology. Plaintiff is entitled to the proportionate value of Radiology as a *continuing shareholder*. The discounted cash flow analysis, as employed in this case, fully reflects this value without need for an adjustment.

(b) The S-Corporation Adjustment

The second adjustment Ms. Danyluk made to her raw discounted cash flow calculation was an adjustment to reflect the S-Corporation status of Radiology. That is, Ms. Danyluk argued that her valuation analysis calculated Radiology's value as a C-Corporation (a taxable entity). Thus, she argued that this Court must adjust the value of Radiology upward by 51.7% in order to properly account for its status as a nontaxable entity.

[7] Plaintiff has failed to prove that the adjustment is "generally considered acceptable in the financial community." *Weinberger v. UOP, Inc.*, Del. Supr., 457 A.2d 701, 713 (1983). Plaintiff's only authority for adjusting a valuation analysis in order to account for S-Corporation status is one article: Shackelford, *Valuation of "S" Corporations*, 7 Business Valuation Rev. 159 (1988). Whatever "generally considered acceptable in the financial community" means, plaintiff clearly has not met this standard by relying on one article by a relatively unknown author. Indeed, the one other author that Shackelford cites suggests a modest (9%) increase in the value of an entity as an S-Corporation rather than a C-Corporation which is quite different from the 51.7% increase Ms. Danyluk suggested. *See id.* (citing Leung, *Tax Reform Act of 1986: Considerations for Business Valuations*, 6 Business Valuation Rev. at 60-61). Thus, I reject Ms. Danyluk's adjustment to reflect Radiology's S-Corporation status.

[8] Although I reject Ms. Danyluk's S-Corporation adjustment, I believe that her ultimate goal of treating Radiology according to its nontaxable nature is meritorious. That is, I agree with Ms. Danyluk's goal but disagree with her methodology. Ms. Danyluk deducted an amount for taxes then added back that amount to the cash flows. Although it is not entirely clear, it seems that she did this in order that I would deem Radiology comparable to the companies she used in calculating the industry average debt to equity ratio and in calculating the adjustment for the implicit minority discount. However, I believe that Ms. Danyluk and plaintiff should have seen the extreme weaknesses of the implicit minority discount argument and of the argument for the use of the industry average debt to equity ratio. Thus, I believe that Ms. Danyluk and plaintiff never should have argued that I deduct taxes in the first place. Therefore, in applying the discounted cash flow approach, I use cash flows that neither include a deduction for taxes nor a corresponding adjustment (i.e., an addition) for taxes.

In holding that I should ignore taxes under the discounted cash flow approach because of Radiology's nontaxable status, I rely on a number of factors. First, Ms. Danyluk's treatment and my treatment of taxes ultimately parallel each other. Second, Mr. Stryker made no deduction for taxes in his earnings valuation analysis. (Stryker Vol. II at 124.) Finally, and most importantly, under an earnings valuation analysis, what is important to an investor is what the investor ultimately can keep in his pocket. *See* S. Pratt, *Valuing Small Businesses and Professional Practices* 36 (1986). Thus, I believe that ignoring taxes altogether is the only way that the discounted cash flow analysis can reflect accurately the value of Radiology's cash flows to its investors.

(c) Non-Operating Asset Adjustment

The final adjustment Ms. Danyluk made to her raw discounted cash flow calculation was her adjustment for Radiology's non-operating assets. That is, Ms. Danyluk contends that I must add the value of Radiology's non-operating assets to her valuation analysis to find the total value of the company. Ms. Danyluk found Radiology's non-operating assets to be "other investments" ($1,621), the cash surrender value of officers' life insurance ($54,249), and excess working capital ($1,355,000).

[9] This Court clearly must add the value of non-operating assets to an earnings based valuation analysis. *See Neal, supra,* at 38-39, 49. Defendants do not dispute the propriety of a non-operating asset adjustment to an earnings based valuation analysis. However, they contend that the amount of Ms. Danyluk's adjustment for the non-operating assets, specifically the non-operating asset of excess working capital, is incorrect.

Excess working capital is the amount of working capital beyond the amount an entity needs to fund its business. *See Neal, supra,* at 38-39. Ms. Danyluk calculated Radiology's year-end working capital to be $1,724,000. Ms. Danyluk used Robert Morris Associates statistics to determine the industry average ratio of revenue to required working capital. She computed this industry average ratio to be 13.1 to 1. Applying this ratio to Radiology's 1986 revenue of $4,838,000 results in a required working capital amount of $369,000. Ms. Danyluk then subtracted the required working capital ($369,000) from her calculation of year-end working capital ($1,724,000) to reach excess working capital of $1,355,000.

Defendants contend that Ms. Danyluk incorrectly calculated Radiology's year-end working capital by including in working capital

amounts appearing in Radiology's year-end financial statements that represented earnings to be distributed to shareholders after the company completed its year-end financial statements. Defendants argue that the subtraction of post year-end distributions would better reflect Radiology's exact amount of year-end working capital.

Although defendants' argument facially is appealing, I reject it. If I adjusted working capital only for post year-end distributions, I would undermine the consistency of the financial statements. That is, I believe that in order to consider the post year-end working capital distributions, I also would have to consider post year-end working capital accretions. Since I do not have the information regarding these accretions, I hold that it is best to value working capital completely as of December 31, 1986. Thus, I conclude that Ms. Danyluk's calculation of working capital of $1,724,000 is the more useful calculation, that Radiology's excess working capital equals $1,355,000, and that the value of Radiology's non-operating assets equals $1,410,870 ($1,621 + $54,249 + $1,355,000).

### *B. Defendants' Valuation Methodology*

[10] Defendants' expert, Charles Stryker, attempted to value Radiology by using one method: the "Delaware Block Method." Even though the Delaware courts have used the Delaware Block Method infrequently since *Weinberger*, the Delaware courts still consider it an acceptable procedure for valuing a company. *See Rosenblatt v. Getty Oil Co.*, Del. Supr., 493 A.2d 929, 940 (1985). The Delaware Block Method actually is a combination of three generally accepted methods for valuation: the asset approach, the market approach and the earnings approach.

#### 1. The Asset Approach

Mr. Stryker's valuation analysis began with a valuation of Radiology's assets. He adjusted the book value of assets to reflect their present value. He also added $294,000 for Radiology's work force. Finally, Mr. Stryker reduced the amount of an account payable from $100,000 to $62,000. Mr. Stryker did not add an amount to reflect Radiology's goodwill. He believed that all of Radiology's goodwill belonged to Papastavros Associates since he believed that patients came to Radiology because of the professional reputation of Papastavros Associates, not the reputation of Radiology's x-ray technicians.

Plaintiff argues that Mr. Stryker's failure to include any amount for goodwill and the 60% weight he used in combining the three

approaches under the Delaware Block Method (i.e., the asset approach, the market approach and the earnings approach) were inappropriate. As to the failure to make an addition for goodwill, plaintiff argues that Radiology's expectation of future business was not so much the future business of patients but the future patronage of Papastavros Associates. Clearly, the twenty-one year relationship between the two companies justified this expectation. Thus, I agree that the failure to include an amount for goodwill was inappropriate.

[11] The unjustified failure to include an amount for goodwill affects my decision as to the proper weight of the asset prong of the Delaware Block Method. First, except for corporations with significant natural resource assets or with significant non-operating assets, the Delaware courts generally have refrained from weighing the asset prong heavily in applying the Delaware Block Method when the earnings valuation method appears reliable. *See Gibbons v. Schenley Indus., Inc.*, Del. Ch., 339 A.2d 460, 473 (1975); *Heller v. Munsingwear, Inc.*, Del. Ch., 98 A.2d 774, 777 (1953). Further, in this case, Mr. Stryker's analysis incorrectly did not include an amount for goodwill. This failure to include such an amount results in his asset value reflecting only the liquidation value rather than the going-concern value of Radiology. The use of liquidation value rather than going-concern value is inappropriate. *See Rosenblatt*, 493 A.2d at 942. Thus, I give no weight to Mr. Stryker's asset valuation because Delaware courts generally have not weighed the asset prong heavily and because Mr. Stryker calculated an asset value that more closely reflected Radiology's liquidation value than its going-concern value.

2. The Market Approach

[12] The second prong of the Delaware Block Method valuation analysis is the market value factor. Delaware courts have recognized offers for purchase as valid indications of value for purposes of appraisal. *See Application of Del. Racing Ass'n*, Del. Supr., 213 A.2d 203, 211 (1965). Mr. Stryker's market analysis focused on a sale of Radiology stock and two offers for the purchase of Radiology in calculating Radiology's market value to be $453 per share.

The first factor upon which Mr. Stryker relied in calculating Radiology's market value was the December 1986 sale of Radiology stock. In that transaction, Drs. Papastavros and Piendak sold 22.5% of Radiology stock to Drs. Koniver, Fiss and Mansoory at a price of $400 per share.

The May 4, 1984, offer of Diagnostek, Inc. of Alberquerque, New Mexico, was the first offer to purchase Radiology upon which