(1) The discount rate shall be calculated using Respondent's WACC, where the cost of common equity is 16.8% and is given a 98% weight, except that the actual cost of debt, which shall be given a 2% weight, shall be the same as that calculated by the parties for the interest award,

(2) the $10 million cash on FWI's balance sheet shall be treated as an operating asset,

(3) a 20% control premium shall be added,

(4) Petitioner Devine is entitled to an award of the fair value of his Class B shares,

(5) the financial data as of July 1, 1992 shall be used,

(6) the interest rate for the Industries common shares and the FWI Class B common shares shall be the average of the prudent investor rate and FWI's actual cost of debt in arm's length transactions since the merger date, adjusted and compounded monthly, and

(7) attorneys' fees and costs are not a part of the Court's award, but the parties may agree that Petitioners may have access to the funds awarded as fair value in this opinion and may use those funds to pay such fees and costs.

**IT IS SO ORDERED.**

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LE BEAU v. M.G. BANCORPORATION, INC.

No. 13,414

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

January 29, 1998

Defendant respondents, a parent corporation and its subsidiary, both Delaware corporations, executed a short form cash out merger. Neither the subsidiary's board of directors nor its minority shareholders voted on the merger transaction. Defendant respondents argued that addition of a control premium to the value of the subsidiary violated the requirement that a corporation be valued as a going concern. Plaintiff petitioners, shareholders of the subsidiary corporation, filed a stockholder's breach of

fiduciary duty damage action attacking the merger, contending that the merger price did not reflect the subsidiary corporation's fair value at the time of the merger, and that valuations offered by respondents to support the price were fundamentally flawed. Plaintiff petitioners further argued that defendant failed to apply a control premium to the resulting value of the target's subsidiaries. Plaintiffs sought compound interest on their appraisal award, plus costs, expenses, and attorney's fees.

The court of chancery, per Vice-Chancellor Jacobs, rejecting other valuation methodologies presented by both plaintiffs and defendants, found plaintiff's comparative acquisition approach to valuation supported by evidence presented, and independently determined plaintiff's valuation to be within the range of acceptable hypothetical values. The court further awarded compound interest on the award based on expectations of prudent investors, but denied award of attorney's fees and expenses absent a showing of bad faith.

1. Corporations ⟹ 584

The objective of a section 262 appraisal is to value the corporation itself, as distinguished from a fraction of its shares as they may exist in the hands of a particular shareholder. DEL. CODE ANN. tit. 8, § 262 (1994).

2. Corporations ⟹ 584

Valuation of a minority block of target company's shares is an impermissible method of valuation. DEL. CODE ANN. tit. 8, § 262 (1994).

3. Corporations ⟹ 584

A proper fair value determination based upon a going concern of an entire company would significantly exceed a fair market valuation of only a minority block of its shares.

4. Corporations ⟹ 189(12), 584

A party disputing valuation of a merger bears the burden of persuasion regarding the fair value of the target company.

5. Corporations ⟹ 189(12), 584

An merger market valuation method must be generally accepted in the target company's financial community.

6. Corporations ⟹ 189(12), 584

Where a merger valuation rests upon data derived from companies comparable to the company being valued, the more comparable the company the more reliable will be the resulting valuation.

7. Corporations ⟹ 584

Where a bank's stock is being valued under the comparable publicly-traded company approach, financial multiples based on price-to-earnings and price-to-book value are generally accepted in the financial community for valuing banks and accepted by the court.

8. Corporations ⟹ 584

In performing bank valuations using comparative company approaches, five year historical information is typically used.

9. Corporations ⟹ 189(12), 584

Valuation of a merger by comparison of the target company's stock with stock prices of comparable companies is a valid method of valuation.

10. Corporations ⟹ 189(12), 584

The appropriate time for valuing a target company by comparison with comparable company stock prices is the valuation immediately before the public announcement of the merger.

11. Corporations ⟹ 189(12), 584

Data supporting valuation of a merger must be in existence as of the merger date.

12. Corporations ⟹ 189(12), 584

Factors affecting the valuation of a merger must exist contemporaneously with the merger, and cannot be introduced retrospectively during litigation.

13. Corporations ⟹ 189(12), 584

A merger valuation performed at the time of a merger that is prepared without the benefit of hindsight, when no litigation is pending, and accepted by management is more appropriate than a valuation based upon extremely conservative litigation driven assumptions.

14. Corporations ⟹ 189(12), 584

A holding company's ownership of a controlling interest in its subsidiaries is an element of valuation that must be taken into account in determining the fair value for the parent company.

15. Corporations ⟹ 584

A control premium is not the product of post-merger synergies, but rather, reflects an independent element of value existing at the time of the merger, flowing from the fact that the parent company owned a controlling interest in its subsidiaries at that point in time.

16. Corporations ⟹ 584

When valuation of a merger is at issue, the chancery court is to independently determine the fair market value. DEL. CODE ANN. tit. 8, § 262 (1994).

17. Corporations ⟹ 189(12), 584

When independently appraising the valuation of a merger, the chancery court should, where possible, test the soundness of its valuation against whatever reliable corroborative evidence the record contains.

18. Interest ⟹ 38(1), 60

The chancery court is empowered to award interest in an appraisal action at whatever rate, and whatever compounding interval, the court deems equitable. DEL. CODE ANN. tit. 8, § 262(h) (1994).

19. Interest ⟹ 38(1)

In deciding the interest rate applicable to an award, the chancery court may consider whether or not there has been undue delay.

20. Interest ⟹ 60

Whether or not to award simple or compound interest applicable to an award is a matter within the court's discretion.

21. Corporations ⟹ 189(14)
Interest ⟹ 60

An award of compound post-judgment interest on an award is the exception rather than the rule.

22. Interest ⟹ 60

An award of compound interest on an award is equitable and realistic when prudent investors expect to receive a compound rate of interest on their investments.

23. Corporations ⟹ 189(14)

Absent more than conclusory assertions that a party has acted in bad faith, the court will not award legal fees and expenses.

Bruce L. Silverstein, Esquire, and Martin S. Lessner, Esquire, of Young, Conaway, Stargatt & Taylor, Wilmington, Delaware; and Thomas E. Chomicz, Esquire, of Wilson & McIlvane, Chicago, Illinois, of counsel, for petitioners.

Wayne J. Carey, Esquire, and Ronald A. Brown, Jr., Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, Wilmington, Delaware; and Frederick V. Lochbihler, Esquire, and David S. Barritt, Esquire, of Chapman and Cutler, Chicago, Illinois, of counsel, for respondents.

JACOBS, *Vice-Chancellor*

This appraisal action, brought under 8 Del. C. § 262, arises out of a "cash-out" merger (the "Merger") of M.G. Bancorporation, Inc. ("MGB") into its corporate parent, Southwest Bancorp, Inc. ("Southwest") on November 17, 1993. The Merger consideration was $41 per share, which the Petitioners claim was inadequate because MGB's fair value as of the Merger date was at least $85 per share. The Petitioners also seek 10% compound interest on their appraisal award, plus their costs and expenses including reasonable expert witness and attorney's fees.

The Respondents contend that the fair value as of the Merger date was $41.90 per share and that 8% simple interest is appropriate.

For the reasons discussed below, the Court concludes that (i) the fair value of MGB's shares at the time of the Merger was $58,514,000, or $85 per share, (ii) the Petitioners are entitled to 8% interest compounded monthly, and (iii) the Petitioners are not entitled to an award of legal fees or expenses.

## 1. FACTS

### A. The Parties and the Merger

The Petitioners are shareholders who owned 18,151 shares of common stock of MGB before the Merger. The Respondents are Southwest Bancorp, Inc. ("Southwest") and its subsidiary, MGB. Before the Merger, MGB was a Delaware-chartered bank holding company headquartered in Worth, Illinois. MGB had two operating Illinois-chartered bank subsidiaries, Mount Greenwood Bank ("Greenwood") and Worth Bancorp, Inc. ("WBC"). Both banks served customers in the southwestern Chicago metropolitan area. MGB owned 100% of Mount Greenwood and 75.5% of WBC.

Before the Merger, Southwestern owned 91.68% of MGB's common shares. On November 17, 1993, MGB was merged into Southwest in a "short form" merger under 8 Del. C. § 253. Because the Merger was accomplished unilaterally, neither MGB's board of directors nor its minority shareholders were legally required to, or did, vote on the transaction. MGB's minority shareholders were offered $41 in cash per share in the Merger. The Petitioners rejected that offer, electing instead to pursue their statutory appraisal rights.

To assist it in setting the Merger price, Southwest engaged Alex Sheshunoff & Co. Investment Bankers ("Sheshunoff") to determine the "fair market value" of MGB's minority shares. In a report submitted to Southwest on or about October 28, 1993, Sheshunoff determined that the fair market value of MGB's minority shares was $41 per share as of June 30, 1993.[1] Thereafter, a stockholders breach of fiduciary duty damage action was filed attacking the Merger, and this appraisal proceeding was also commenced. On July 5, 1995, this Court issued an Opinion in the companion class action, holding that Sheshunoff had performed its appraisal in a legally improper manner. The basis for the Court's

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[1]Pet'rs Exhibit Number 5.

conclusion was that Sheshunoff had determined only the "fair market value" of MGB's minority shares, as opposed to valuing MGB in its entirety as a going concern and determining the fair value of the minority shares as a pro-rata percentage of that value.[2]

### B. The Petitioners' Valuation

The Petitioners commenced this appraisal proceeding on March 15, 1994. The case was tried on December 2-5, 1996. At trial the Petitioners' expert witness, David Clarke ("Clarke"), testified that as of the Merger date the fair value of MGB common stock was at least $85 per share. In arriving at that conclusion, Clarke used three distinct methodologies to value MGB's two operating bank subsidiaries: (i) the comparative publicly-traded company approach, (ii) the discounted cash flow ("DCF") method, and (iii) the comparative acquisition technique. Clarke then added a control premium to the values of the two subsidiaries to reflect the value of the holding company's (MGB's) controlling interest in those subsidiaries.[3] Lastly, Clarke then added the value of MGB's remaining assets to the sum of his valuations of the two subsidiaries, to arrive at an overall fair value of $85 per share for MGB.

What follows is a more detailed description of how Clarke performed his valuation(s) of MGB.

#### 1. Comparative Company Approach

Clarke's comparative publicly-traded company approach involved five steps: (1) identifying an appropriate set of comparable companies, (2) identifying the multiples of earnings and book value at which the comparable companies traded, (3) comparing certain of MGB's financial fundamentals (e.g., return on assets and return on equity) to those of the comparable companies, (4) making certain adjustments to those financial

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[2]Nebel v. Southwest Bancorp., Inc., Del. Ch., C.A. No. 13618, Mem. Op. at 9, Jacobs, V.C. (July 5, 1995).

[3]The Petitioners had instructed Clarke that Delaware law mandated such a premium at the subsidiary level, relying on Rapid American v. Harris, 603 A.2d 796, 804-05 (1992). In Rapid-American the Supreme Court of Delaware held that the trial court had erred by failing to include a 'control premium' in valuing the subsidiaries of a holding company that was the subject of an appraisal. "We disagree with the trial court's characterization of that 'control premium' in this case as an impermissible shareholder level adjustment. . . . The 'control premium' . . . represented a valid adjustment to its valuation model which 'applied a [bonus] at the company level against all assets. . . .'" (citing Cavalier Oil Corp. v. Hartnett, Del. Supr., 564 A.2d 1137 (1989)).

fundamentals, and (5) adding an appropriate control premium. After completing the first four steps, Clarke arrived at a value for WBC of $33.059 million ($48.02 per share), and for Greenwood of $20.952 million ($30.44 per share). Clarke next determined that during the period January 1989 to June 1993, acquirers of controlling interests in publicly-traded companies had paid an average premium of at least 35%. On that basis, Clarke concluded that a 35% premium was appropriate, and applied that premium to the values he had determined for Greenwood and WBC, to arrive at fair values of $43.3 million ($62.90 per share) for WBC and $27.1 million ($39.37 per share) for Greenwood, respectively. Clarke then valued MGB's 75.5% controlling interest in WBC at $32-691 million ($47.49 per share), and MGB's 100% interest in Greenwood at $27.1 million ($39.37 per share), under his comparative company approach.

2. Discounted Cash Flow Approach

Clarke's DCF valuation analysis involved four steps: (1) projecting the future net cash flows available to MGB's shareholders for ten years after the Merger date, (2) discounting those future cash flows to present value as of the Merger date by using a discount rate based on the weighted average cost of capital ("WACC"), (3) adding a terminal value that represented the present value of all future cash flows generated after the ten year projection period, and (4) applying a control premium to the sum of (2) and (3).

Clarke did not create his own cash flow projections. He used the projections made by Sheshunoff at the time of the Merger, because Southwest's own management had accepted those projections when they fixed the Merger price. Clarke also accepted Sheshunoff's ten year projection period, because he independently had concluded that it would require ten years for MGB's cash flows to stabilize. Based on a 1996 Ibbotson Associates ("Ibbotson") study of the banking industry, Clarke concluded that the appropriate "small stock" premium to be used in the capital asset pricing model ("CAPM) to determine MGB's discount rate (WACC), was 1%, and that the appropriate discount rate (WACC) for MGB was 12%. Applying that 12% discount rate, Clarke calculated the present value of WBC's future cash flows to be $17.251 million, and WBC's terminal value to be $14.824 million. Applying that same 12% discount rate, Clarke arrived at a present value of $10.937 million, and a terminal value of $9.138 million, for Greenwood.

Applying the same 35% control premium to those values of the two subsidiaries, Clarke calculated MGB's 75.5% interest in WBC at $33.824

million or $49.14 per share; and MGB's 100% interest in Greenwood at $28.3 million, or $41.11 per share.

### 3. Comparative Acquisition Approach

Clarke's third valuation approach, the comparative acquisition method, focused upon multiples of MGB's last twelve months earnings and its tangible book value. Those multiples were determined by reference to the prices at which the stock of comparable companies had been sold in transactions involving the sale of control. Unlike the comparative company and DCF valuation approaches, this method did not require adding a control premium to the values of the subsidiaries because under that methodology, the parent holding company's controlling interest in the subsidiaries was already accounted for.

In valuing MGB under his third approach, Clarke identified three transactions involving community banks in the relevant geographic area that occurred within one year of the Merger. He also considered data published by The Chicago Corporation in its September 1993 issue of Midwest Bank & Thrift Survey.[4] From these sources, Clarke determined that (i) control of WBC could be sold for a price between a multiple of 14 times WBC's last twelve months' earnings and 200% of WBC's tangible book value, and that (ii) control of Greenwood could be sold for a price between a multiple of 12 times Greenwood's last twelve months' earnings and 175% of its tangible book value. Giving equal weight to these two sets of values, Clarke valued MGB's 75.5% interest in WBC at $28.8 million (75.5% x $38.1 million) or $41.84 per share, and MGB's 100% interest in Greenwood, at $22.9 million, or $33.27 per share.

### 4. *MGB's Remaining Assets*

Having valued MGB's two subsidiaries, Clarke then determined the fair value of MGB's remaining net assets, which included (i) a $6.83 million note payable by Southwest, (ii) certain intangibles that Clarke did not include in his valuation, (iii) $78,000 in cash, and (iv) other assets worth $2000. These assets totaled $6.91 million, from which Clarke subtracted liabilities of $96,000 to arrive at a net asset value of $6.814 million ($9.90 per share) for MGB's remaining assets.

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[4]That data reflected an analysis of 137 bank acquisitions announced from January 1, 1989 to June 1, 1993.

### 5. *Fair Value Computation*

Clarke then added the values he had determined under each of his valuation methodologies, for (i) MGB's 75.5% interest in WBC, (ii) MGB's 100% interest in Greenwood, and (iii) MGB's 100% interest in its remaining assets. Under his comparative publicly-traded method, Clarke concluded that MGB's value was $76.59 per share with no control premium, and $96.76 per share with a control premium. Under his DCF approach, Clarke determined that MGB's value was $74.75 per share with no control premium, and $100.15 per share with a control premium. And under his comparative acquisitions method, Clarke concluded that MGB's minimum fair value was $85 per share, which represented the median of the values described above.

## C. The Respondents' Valuation

At trial the Respondents did not call the Sheshunoff firm as a witness, even though its valuation had served as the basis for the $41 per share Merger price. Instead, the Respondents relied upon the testimony of Mr. Robert Reilly ("Reilly"),[5] who opined that as of the Merger date, the fair value of MGB common stock was $41.90 per share -- only 90 cents per share more than Sheshunoff's $41 valuation. Reilly arrived at that result by performing two separate valuations: a DCF analysis and a "capital market" analysis. Reilly did not include any control premium, having determined that a control premium was inappropriate in valuing a holding company such as MGB.

### 1. *DCF Analysis*

Reilly's DCF analysis consisted of: (1) projecting MGB's future net cash flows available to shareholders for a period of five years after the Merger date, (2) determining an appropriate discount rate and discounting those future cash flows back to the Merger date, and (3) adding a terminal value that represented the present value of all future cash flows beyond the

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[5]Reilly is an expert in performing business valuations. He was formerly the National Director of Valuation Services for Deloitte and Touche and is an accredited senior appraiser and a certified public accountant. The Petitioners claim that Reilly's entire valuation should be rejected because Reilly had no significant experience in valuing banks or bank holding companies, and was therefore not competent to value bank holding companies. Although the Court ultimately rejects Reilly's valuations, it is for reasons that concern the merits of his valuation approaches, not his expertise.

five year projection period. Reilly used a five year period, because in his opinion any longer interval would be too speculative. Relying on a 1992 Ibbotson study that was not specific to the banking industry, he also concluded that 5.2% was the appropriate small stock size premium to use in the CAPM for purposes of determining the WACC for MGB.

In determining an appropriate discount rate, Reilly concluded that MGB was subject to certain company-specific risks, namely, litigation involving its data processor (BYSIS) and MGB's dependence upon a single key supplier. Reilly quantified those risks at four percentage points, and on that basis concluded that the appropriate discount rate for MGB was 18%. Applying that 18% discount rate to MGB's future cash flows, Reilly valued MGB at $29.220 million, or $42.45 per share, on the basis of his DCF approach.

### 2. *Capital Market Method*

Reilly's second method for valuing MGB was the "capital market" method, which involved: (1) identifying a portfolio of guideline publicly-traded companies, (2) identifying appropriate pricing multiples for those companies, (3) using the multiples for the guideline companies to calculate the appropriate pricing multiples for MGB[6] and (4) applying the multiples to the corresponding financial indicators for MGB. By this method, Reilly concluded that MGB was worth $28.4 million, or $41.26 per share, at the time of the Merger.

Reilly then averaged his DCF and capital market valuations, to arrive at an ultimate fair value for MGB of $41.90 per share.

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For ease of reference, the parties' respective valuation conclusions are summarized in the chart below. At the trial, Petitioners introduced evidence of what MGB's value would be if Sheshunoff's valuation were updated to the merger date and if its minority discount were eliminated. Because of its importance to the analysis, that updated and revised valuation is also summarized below.

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[6]Reilly's pricing multiples were all related to the market value of invested capital ("MVIC"). Reilly computed the ratios of MVIC to: (1) earnings before interest and taxes ("EBIT"); (2) earnings before interest, depreciation and taxes ("EBIDT"); (3) debt free net income ("DFNI"); (4) debt free cash flow ("DFCF"); (5) interest incomes; and (6) total book value of invested capital ("TBVIC").

| Valuation in $'000's: | WBC | 75.5% of WBC | Greenwood | Other Assets | Total | Per Share |
|---|---|---|---|---|---|---|
| Petitioners (Clarke) | | | | | | |
| Comparative Publicly-Traded Method: | 33,059 | 24,960 | 20.952 | 6,814 | 52,726 | 76.59 |
| With Control Premium: | 43,300 | 32,692 | 27,100 | 6,814 | 66,606 | 96.76 |
| DCF Method: | 32,075 | 24,217 | 20,079 | 6,814 | 51,110 | 74.25 |
| With Control Premium: | 44,800 | 33,824 | 28,300 | 6,814 | 68,938 | 100.15 |
| Comparative Acquisitions Method: | 38,100 | 28,800 | 22,900 | 6,814 | 58,414 | 85.00=fair value |
| Respondents (Reilly) | | | | | | |
| Capital Market Method: | | | | | 28,400 | 41.26 |
| DCF Method: | | | | | 29,220 | 42.45 |
| | | | | | Average: | 41.90=fair value |
| Sheshunoff (Updated) (Without Control Premium) | | | | | | |
| Adjusted Book Value: | | | | | | 64.13 |
| Adjusted Earnings Value: | | | | | | 76.80 |

## II. THE PARTIES' VALUATION CONTENTIONS

### A. The Petitioners' Contentions

The Petitioners contend, for various reasons, that the $41 Merger price did not represent MGB's fair value at the time of the Merger, and that the valuations offered by the Respondents' trial expert to support that price are fundamentally flawed. The Petitioners argue that Reilly's "capital market" approach and DCF analysis are legally deficient because Reilly failed to apply a control premium to the resulting values of the MGB subsidiaries, as Rapid-American requires.[7] The Petitioners also claim that the Court should reject Reilly's "capital market" approach in its entirety because it is not recognized and accepted in the financial community. Alternatively, Petitioners argue that even if Reilly's capital market approach is accepted, the values he arrived at by that method must be rejected, because the MVIC-related ratios upon which Reilly relied are irrelevant and inappropriate measures to value bank holding companies. Finally, the Petitioners contend that Reilly's comparative publicly-traded company approach is flawed because Reilly's "comparable" companies were banks located outside the relevant geographic region (the Chicago suburbs) and (in certain cases) outside MGB's field of business.[8]

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[7]See n. 3, supra.

[8]The Petitioners assert that MGB's fair value is even greater than what Clarke determined it to be, because Clarke's valuation omits the value of MGB's breach of fiduciary duty claims against the Respondents. The Petitioners claim that (1) Southwest engaged in self-dealing loans and usurped corporate opportunities that rightly belonged to MGB; (2) Southwest

The Petitioners also claim that Reilly's DCF analysis is deficient because it is a form of a minority stock valuation that is prohibited under Delaware appraisal law.[9] Reilly's DCF analysis is also flawed, Petitioners assert, because Reilly and Southwest seized upon the "key supplier dependence" risk and the litigation risks involving MGB's former data process service provider ("BYSIS"), as a contrivance to support an unfairly low valuation of MGB. The Petitioners further contend that Reilly erroneously relied on the 1992 Ibbotson study to determine the WACC for MGB, because the financial data contained in the more recent 1996 Ibbotson study was specific to the banking industry and, thus, more reliable. Finally, the Petitioners claim that Reilly's use of five year projections, rather than the ten year projections Sheshunoff employed, was erroneous.

### B. The Respondents' Contentions

Not surprisingly, the Respondents dispute these arguments and take the position that the Petitioners' valuation methodologies are improper and must be disregarded, on several grounds.

The Respondents first argue that it is improper to add a control premium of any kind to the value of MGB's subsidiaries, because that approach violates the requirement that the corporation be valued as a going concern. Respondents contend that Rapid-American -- the authority upon which Petitioners rely -- does not mandate the application of a control premium in this case, because in Rapid, the holding company subsidiaries at issue were involved in unrelated industries, whereas here MGB's two subsidiaries were both banks. The Respondents also argue that Clarke's inclusion of a control premium is proscribed by the command of 8 Del. C. § 262(h) that "fair value" be determined exclusive of post-merger events or other possible speculative post-merger business combinations. Respondents urge that increasing each subsidiary's value by adding a control premium, amounts to valuing MGB on the basis of the subsidiaries' acquisition value, rather than as a going concern. For these reasons,

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engaged in a self-dealing allocation of expenses that favored itself at the expense of MGB; and (3) Southwest wrongfully caused MGB's subsidiary banks to enter into contracts with BYSIS, its former data processing service provider, to their detriment. Because the Petitioners did not include these claims in their valuation, the Court does not address them.

[9]See n. 2; supra, Cavalier Oil Corp. v. Hartnett, Del. Supr., 564 A.2d 1137, 1144 (1989) ("In rejecting a minority or marketability discount, the Vice Chancellor concluded that the objective of a section 262 appraisal is 'to value the *corporation* itself, as distinguished from a specific fraction of its *shares* as they may exist in the hands of a particular shareholder' [emphasis in original].").

Respondents conclude that the control premia Clarke employed in performing his DCF and comparative company valuations are legally erroneous and must be rejected.

The Respondents next attack Clarke's DCF valuation on the basis that it employs a ten year projection period that, Respondents say, is inherently speculative and unreliable. Clarke's DCF valuation was also flawed (Respondents argue) because the "small stock" premium Clarke used to arrive at a 12% discount rate was derived not from the 1992 Ibbotson study that existed on the Merger date, but from a 1996 Ibbotson study that was compiled three years after the Merger had occurred. Therefore, the 12% discount rate, which is based on impermissible post-Merger data, must be rejected. Finally, the Respondents claim that in any event, Clarke's 12% discount rate was too low because it improperly failed to take into account the "key supplier dependence" risk and the risk of litigation involving MGB's former data process server, BYSIS, confronting MGB at the time of the Merger.

The Respondents also attack Clarke's comparative publicly-traded company approach. They argue that Clarke considered only two multiples -- price-to-earnings and price-to-book value -- both of which involved distortions in the debt-to-equity ratios of Clarke's selected comparable companies and MGB. Respondents further criticize Clarke for (i) relying upon comparable company stock prices as of September 30, 1993 -- six weeks before the November 17, 1993 Merger date -- rather than as of the date immediately before the Merger was announced; and (ii) using historical financial averages for the five years preceding the Merger, rather than for the 2.75 year period before the Merger, as Reilly did.[10] Finally, the Respondents contend that Clarke's valuation improperly failed to take into account the fact that MGB's subsidiaries (i) had poor prospects for growth or expansion, (ii) were located in geographic areas that did not have significant population growth, and (iii) faced significant competition.

These contentions are now addressed.

## III. ANALYSIS

To determine the fair value of MGB's shares as of the Merger date, this Court must decide three issues.

The first is whether Reilly's "capital market" valuation approach is legally permissible in this case. The specific question is whether that

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[10]Reilly concluded that the banking industry had changed too dramatically to justify a longer projection period.

valuation method is generally accepted or recognized in the financial community for purposes of valuing a bank or bank holding company.

Neither side contests the validity per se of either the comparative publicly-traded company or the DCF valuation approaches. Both sides claim that the other improperly applied those methodologies to MGB. That frames the second set of issues regarding Clarke's publicly-traded company analysis, which are: (i) did Clarke use the proper financial indicators, (ii) did Clarke erroneously rely upon stock price quotes for the six weeks preceding the Merger, and (iii) was five years an appropriate historical period to compare the financial indicators and to make future growth projections? Respecting each side's DCF analysis, the issues concern (i) the appropriate discount rate and (ii) the appropriate projection period.

The third issue is whether Clarke's comparative acquisition approach -- in which a control premium is inherent -- is legally permissible in this case.[11]

For the reasons next discussed, the Court determines that (a) Reilly's "capital market" approach is legally impermissible, but even if valid, was improperly applied, thereby requiring the rejection of the values Reilly derived by that method; (b) both Clarke's and Reilly's DCF analyses were improperly applied, thereby requiring the rejection of the values both experts derived by that approach; (c) Clarke's comparative acquisition approach was a legally valid method to value MGB, and (d) the credible evidence of record supports Clarke's $85 per share determination of MGB's fair value as of the Merger date.

### A. MGB's Fair Value

[1-2] It is a well-established principle of Delaware law that "[t]he objective of a section 262 appraisal is 'to value the *corporation* itself, as distinguished from a fraction of its *shares* as they may exist in the hands of a particular shareholder' [emphasis in original]."[12] Based on that principle, this Court determined in its earlier Opinion that Sheshunoff's $41 valuation was impermissible under 8 Del. C. §262, because it was an appraisal not of the entire corporation as a going concern but only of a minority block of its

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[11]The specific control premium issue is whether Rapid American requires including a control premium as an element of the value of operating subsidiaries whenever the parent holding company is the corporation being appraised (as the Petitioners urge), or whether a control premium is appropriate only where the subsidiaries are in different businesses (as the Respondents urge).

[12]Cavalier Oil Corp. v. Hartnett, Del. Supr., 564 A.2d 1137, 1144 (1989) quoting Cavalier Oil Corp. v. Hartnett, Del. Ch., C.A. No. 7959, Jacobs, V.C. (Feb. 22, 1988)).

shares.[13] Presumably that is why the Respondents chose not to rely upon the Sheshunoff valuation or to call Sheshunoff personnel as trial witnesses. Instead, Respondents elected to rely solely upon Reilly's valuation, which resulted in the same $41 per share value that Sheshunoff had arrived at by a valuation approach found to be improper.

[3-4] The fact that Reilly's per share fair value determination serendipitiously turned out to be only 90 cents per share more than Sheshunoff's legally flawed $41 valuation, cannot help but render Respondent's valuation position highly suspect and meriting the most careful judicial scrutiny. As a matter of plain common sense, it would appear evident that a proper fair value determination based upon a going concern valuation of the entire company, would significantly exceed a $41 per share fair market valuation of only a minority block of its shares. If Respondents choose to contend otherwise, it is their burden to persuade the Court that $41.90 per share represents MGB's fair value. The Court concludes that the Respondents have fallen far short of carrying their burden, and independently determines that the fair value of MGB at the time of the Merger was $85 per share.

## 1. The Validity of Reilly's "Capital Market" Approach

The Court first addresses whether Reilly's capital market approach is legally permissible. That valuation approach (to repeat) involved deriving various pricing multiples from selected publicly-traded companies, and then applying those multiples to MGB,[14] resulting in a valuation of $41.26 per share.

The Petitioners argue that Reilly's capital market valuation method is impermissible because it includes a built-in minority discount. The valuation literature, including a treatise co-authored by Reilly himself, supports that position,[15] and Respondents have introduced no evidence to the contrary. Nor did the Respondents establish that Reilly's capital market method is generally accepted by the financial community for purposes of valuing bank holding companies, as distinguished from other types of

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[13]See Nebel v. Southwest Bancorp, Inc., Del. Ch., C.A. No. 13618, Mem. Op. at 9, Jacobs, V.C. (July 5, 1995).

[14]See n. 6, supra.

[15]See S.P. Pratt, R.F. Reilly & R.P. Schweihs, Valuing a Business 194-95, 210 (3d ed. 1996) (explaining that comparative publicly traded companies produce a minority discounted valuation); C.Z. Mercer, Valuing Financial Institutions 198-200 and Chapter 13 (1992) (explaining that comparative publicly traded company valuation technique produces a minority valuation that requires adding a control premium to be accurate).

enterprises.[16] Reilly determined the ratio of MVIC to other financial measures such as EBIT, EBIDT, DFNI, DFCF, Interest Income, and TBVIC -- ratios that the record indicates are not used to value banks.[17]

[5] Because Reilly's capital market method results in a minority valuation, and the Respondents have failed to establish that that approach is generally accepted in the financial community to value banks or bank holding companies, the Court must conclude that in this specific case Reilly's capital market approach is improper, and must be rejected.[18]

## 2. The Parties' Respective Applications of the Comparative Publicly-Traded and DCF Valuation Methodologies

The Court next considers (i) whether Clarke properly applied his comparative company analysis to MGB, and (ii) whether both sides' experts properly applied their respective DCF analyses to MGB. The validity per se of these two valuation methodologies is not in dispute.

### a. Comparative Company Approach

A primary issue dividing the parties concerns the companies chosen as "comparable" to the corporation being appraised. A determination of that kind is necessarily fact intensive.

[6] In performing his comparative company analysis, Clarke selected as comparables, banks having financial ratios, geographic locations, and demographic factors similar to those of MGB's two bank subsidiaries. Reilly, on the other hand, included companies that operated outside MGB's geographic location, in different economic environments, and in different lines of business.[19] Where the valuation exercise rests upon data derived from companies comparable to the company being valued, it stands to reason that the more "comparable" the company, the more reliable will be the resulting valuation information. The Court concludes that in this case it was sounder practice to use as comparables suburban banks located in the

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[16]See Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701, 704 (1983).

[17]Indeed, one of Sheshunoff's witnesses had to ask for the definitions of EBIT and EBIDT, and Southwest's chairman and CEO testified that those measures are not used to value banks. LPC Dep. at 154:4-8.

[18]This conclusion should not be read as a categorical, matter-of-law determination that Reilly's capital market approach is an inappropriate method to value banks. The opposite may be true, but in this specific case the Respondents failed to discharge their burden of proof on that issue.

[19]Reilly also erred by including a Savings and Loan Institution as one of his comparable companies. MGB's two subsidiaries were commercial banks, not S&L's.

same geographic area (as Clarke did), rather than banks located outside of WBC's and Greenwood's immediate areas (as Reilly did). Accordingly, I find Clarke's comparable companies to be superior to Reilly's.

[7] Another key difference between the parties' comparable publicly-traded company approaches is that Clarke used the price-to-earnings and price-to-book value financial multiples, whereas Reilly used multiples based upon the market value of invested capital ("MVIC"). Relying upon various valuation authorities and publications, the Petitioners argue that where the enterprise being valued is a bank, the relevant ratios are price-to-earnings and price-to-book value.[20] Reilly disagreed. He opined that it is more appropriate to compare the different financial measures as a fraction of MVIC, because that approach eliminates the distortions inherent in Clarke's financial ratios. Reilly did not elaborate on what those distortions were, however, nor did he point to specific cases where MVIC was considered an appropriate financial measure of a bank or bank holding company. Given this record, the Respondents have not persuaded the Court that MVIC is widely accepted in the financial community as a measure of the value of a bank or bank holding company.[21] Clarke's financial measures are generally accepted in the financial community for valuing banks, and the Court accepts them.

[8] A third major difference between the parties' comparative company approaches is that Clarke used historical financial data going back five years before the Merger, whereas Reilly used historical financial data going back 2.75 years. In performing bank valuations, five year historical information is typically used. Reilly's position was that the banking industry had changed dramatically during the five years before the Merger, such that it was not appropriate to rely upon financial data going back that far.

At the heart of this dispute are the experts' differing assumptions about MGB's future growth prospects. The Respondents paint a bleak picture of MGB's future prospects for increasing its revenues; the Petitioners argue that MGB's future prospects were far brighter. Petitioners

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[20]Securities State Bank v. Ziegeldorf, Iowa Supr., 554 N.E.2d 884 (1996); BNE Mass. Corp. v. Sims, Mass. Ct. App., 588 N.E.2d (1992); Estate of Howard Winston Cook v. United States, 86-2 U.S. Tax Cas. (CCH) ¶ 13,678 (June 11, 1986); Valuing Financial Institutions, C.Z. Mercer, 219-221 (1992); The Journal of Bank Auditing and Accounting, L.C. Pettit, M.D. Atchison & R.S. Kemp, "The Valuation of Small or Closely Held Banks," (Spring 1991), at 28-31.

[21]The use of MVIC as a tool to value other kinds of enterprises is, of course, widely accepted. See, Rapid-American Corp. v. Harris, 603 A.2d 796 (1992). Again, the Court's conclusion that MVIC has not been shown to be an appropriate measure of a bank's value is fact-specific to this case, and by virtue of the Respondent's failure of proof.

agree that a company's more recent historical economic averages are a good indicator of its future growth rate, but emphasize that a firm's financial trends are often more reliably evidenced by its performance over the past five years. I concur. Petitioners have demonstrated that MGB's historical performance, whether over the past five years, three years, or twelve months before the Merger, indicated significant future growth.[22] Although MGB's subsidiary banks did face certain difficulties (specifically, a limited marketplace without high potential for growth or expansion and a primarily blue-collar residential population),[23] the Respondents have not persuaded me that this difficulty would likely prevent MGB's bank subsidiaries from maintaining their historical rates of growth.

[9-10] A fourth major difference between the parties' comparative company analyses is that Reilly relied upon comparable company stock prices on the day before the Merger, whereas Clarke used price quotations six weeks before the Merger. Because the merger date (more specifically, the date before the public announcement of a merger) is normally the time that is relevant, and because the Petitioners made no effort to justify Clarke's use of stock prices going back six weeks before the Merger, the Court cannot accept Clarke's comparative company valuation, despite the validity of the technique itself. Clarke's use of six week old pre-merger stock prices represents departure from the norm without demonstrated justification.

To summarize, Reilly's capital market approach must be rejected because it was not shown to be generally accepted in the financial community for bank valuation purposes. Clarke's comparable company valuation must be rejected because it was improperly applied in this specific case. Accordingly, the only valuation methodologies remaining to be considered are (i) Reilly's and Clarke's DCF valuations and (ii) Clarke's comparative acquisition analysis.

### b. The Parties' DCF Analyses

The parties' competing DCF analyses raise three questions. First, were the so-called "key supplier dependence" and "litigation risks" a proper basis for determining Reilly's 18% discount factor, or were those risks

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[22]See e.g., PX 1 at 10-26. The Petitioners also claim that the only reason MGB was not in a better position to expand was that Southwest had effectively drained MGB of its profits. (Pet'rs Reply Br. at 3.) ("Respondents do not dispute that their constant upstreaming of profits to Southwest left MGB and its subsidiaries with insufficient funds to carry on their operations, much less expand.")

[23]Trial Transcript at 942-43 (Meyer).

contrived solely for litigation purposes? Second, was it appropriate for Clarke to determine a 1% small stock size premium based on the 1996 Ibbotson study that was specific to the banking industry? Third, what cash flow projection period (five or ten years), and what growth rate after the fifth year, are appropriate assumptions for DCF valuation of MGB?

Specifically, the parties' DCF valuations differ with respect to: (i) how many years into the future cash flows should be projected (ten years versus five years), (ii) what growth rate assumption after the fifth projection year is appropriate for MGB, (iii) should the Court credit the assumptions Sheshunoff made in valuing MGB in 1993, and (iv) what discount rate is appropriate for MGB. As more fully elaborated below, the Court finds it appropriate (a) to project future cash flows for a period of ten years into the future at a constant 4% growth rate, (b) to assign a high degree of reliability to Sheshunoff's remaining DCF assumptions (except for its minority discount), and (c) to accept neither Clarke's 12% discount rate nor Reilly's 18% discount rate.

[11] The difference between Clarke's 12% discount rate and Reilly's 18% discount rate is attributable primarily to their different estimates of MGB's cost of equity capital, and their different assessments of the company specific risks confronting MGB at the time of the Merger. Reilly selected an equity risk premium based upon a 1992 Ibbotson study indicating that an appropriate small stock premium factor was 5.2%. Clarke relied on a 1996 Ibbotson study indicating that a premium of 1% was appropriate. The problem with the 1992 Ibbotson study was that it is not specific to the banking industry. The problem with the 1996 Ibbotson study is that although it was specific to the banking industry, the Petitioners have not shown that the data contained in that study (and relied upon by Clarke) was in existence as of the Merger date. The Court, therefore, is unable to accept the 1996 Ibbotson study, and the 12% discount rate derived therefrom.

[12] Reilly's 18% discount rate is also flawed, however, because it rests on the unsupported assumption that at the time of the Merger, MGB was subject to certain material risks that required a steep discount of MGB's projected future cash flow. Reilly placed great emphasis upon MGB's dependence upon one key supplier and upon the pending litigation involving BYSIS, MGB's data process server as a basis to conclude that MGB involved abnormal business risk to a potential acquiror. The underlying evidence that these "risks" were material is unpersuasive. No document contemporaneous with the Merger shows that Southwest's or MGB's management or boards viewed these developments as material risks. Importantly, nowhere in its valuation report did Sheshunoff allude to those risks. That fact significantly diminishes the credibility of a

Southwest employee's litigation-driven trial testimony that management viewed these risks as significant. Of considerable importance also is that Sheshunoff concluded that a 10% discount factor (2% lower than Clarke's) was appropriate, and management accepted that discount assumption. Accordingly, the Court concludes that Reilly's 18% discount rate is inappropriately high and not supported by the record.

[13] The final major difference between the parties' DCF analyses is that Clarke projected ten years of future cash flows at a constant growth rate of 4% using many of Sheshunoff's projections; whereas Reilly projected future cash flows for only five years, at a growth rate that decreased after the fifth year, using his (Reilly's) own projections. Sheshunoff used a ten year projection period for future cash flows, and assumed a constant rate of growth. Because Sheshunoff performed its valuation at the time of the Merger, without the benefit of hindsight and when no litigation was pending, and management accepted its assumptions, the Court accepts Sheshunoff's DCF assumptions (except for its minority discount) as more appropriate than Reilly's litigation-driven (and extremely conservative) assumptions.

Because neither side has supported certain key DCF valuation assumptions by a preponderance of persuasive evidence, the Court is unable to accept either Clarke's or Reilly's discounted cash flow valuations. That leaves Clarke's comparative acquisition approach, which the Court turns to next.

### 2. The "Control Premium" Question and the Validity of Clarke's Comparative Acquisition Approach

Having rejected Clarke's DCF and comparative company valuations, both of which involved directly adding a control premium to the values of MGB's two subsidiaries, the Court need not decide whether the direct addition of a premium is or is not mandated by Rapid-American. Nonetheless, the Court must address the control premium issue, but in a different context. That is, the Court must decide whether Clarke's comparative acquisition valuation, in which a control premium is implicit, is proscribed by § 262. I conclude that it is not.

In Rapid American Corp. v. Harris,[24] the Delaware Supreme Court held that in valuing a holding company for § 262 appraisal purposes, it was appropriate to include a control premium as an element of the fair value of the majority-owned subsidiaries. The Court said:

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[24]Del. Supr., 603 A.2d 796, 806-07 (1992).

> Rapid was a parent company with a 100% ownership interest in three valuable subsidiaries. The trial court's decision to exclude the control premium at the corporate level practically discounted Rapid's entire inherent value. The exclusion of a "control premium" artificially and unrealistically treated Rapid as a minority shareholder. Contrary to Rapid's arguments, Delaware law compels the inclusion of a control premium under the unique facts of this case. Rapid's 100% ownership interest in its subsidiaries was clearly a "relevant" valuation factor and the trial court's rejection of the "control premium" implicitly placed a disproportionate emphasis on pure market value.[25]

[14] The Respondents argue that Rapid-American turned on the "unique fact" that its subsidiaries were involved in three different industries. I do not read Rapid-American to hold that that "unique" fact was in any way critical to the result. The Respondents' construction of that case is too narrow. What the Supreme Court ruled is that a holding company's ownership of a controlling interest in its subsidiaries is an independent element of value that must be taken into account in determining a fair value for the parent company. Thus, the rationale of Rapid-American applies to MGB, and the Respondents have not shown otherwise.

[15] The Respondents also challenge Clarke's comparative acquisition approach on a different basis. Pointing to the command in 8 Del. C. § 262(h) that fair value must be determined "exclusive of post-merger events or other possible business combinations," the Respondents urge that any valuation method that includes a control premium as an element of "fair value" necessarily represents post-merger synergies proscribed by § 262(h). I cannot agree. The (implicit) control premium at issue here is not the product of post-merger synergies. Rather, that control premium reflects an independent element of value existing at the time of the merger, flowing from the fact that the parent company owned a controlling interest in its subsidiaries at that point in time. Therefore, Clarke's comparative acquisition valuation cannot be invalidated on that basis either.

Because the Respondents have not challenged Clarke's comparative acquisition approach on any valid ground, and because the Court has rejected the parties' valuations based on their other methodologies, by process of elimination the only evidence of MGB's fair value is that $85 per

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[25] Rapid-American, 603 A.2d at 806-07 (emphasis in original).

share Clarke arrived at by the comparative acquisition method. Having no other adjudicated basis to value MGB, the Court would be justified in accepting $85 per share as the fair value of MGB, and does so -- but not by default or uncritically.

[16-17] The Court is mindful that $85 per share is more than double the Merger price. The Court is also aware of its rule under § 262, which is to determine fair value *independently*.[26] In discharging that institutional function as an independent appraiser, the Court should, where possible, test the soundness of its valuation conclusion against whatever reliable corroborative evidence the record contains. On that score the record falls far short of perfection. Limited corroborative evidence is available, however, in the form of Sheshunoff's 1993 fair market valuation, (i) adjusted by Clarke to exclude Sheshunoff's minority discount and (ii) updated by Clarke to reflect value data as of November 17, 1993, the date of the Merger.[27] When Sheshunoff's 1993 valuation is adjusted in that manner, the resulting value of MGB is $48,504,664 or $70.46 per share with no control premium. If (for purposes of illustration) a 20% control premium were added, the resulting value would be $56,842,796.80 or $82.57 per share; and if the premium were 35%, the resulting value would be $63,096,394.40, or $91.66 per share.[28] The $85 per share fair value based upon Clarke's comparative acquisition approach fits comfortably within that (hypothetical) range of values.

### B. Interest

[18-19] Next addressed are the appropriate rate of interest and compounding interval. Under § 262(h), this Court is empowered to award interest in an appraisal action at whatever rate (and compounding interval, where relevant) the Court deems equitable. Because MGB's cost of debt capital at that time was 8%, the Court finds that to be the appropriate interest rate. Because the legal rate of interest had risen to 10% as of the

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[26]Gonsalves v. Straight Arrow Publishers, Del. Supr., 701 A.2d 357 (1997).

[27]The Sheshunoff valuation, as thus revised, is objective in the sense that Southwest's management accepted Sheshunoff's DCF projections, and Southwest's management accepted Sheshunoff's valuation as the basis for the Merger price.

[28]PX 38 shows that the updated (to reflect information available as of the Merger date) and modified (to exclude a minority discount) valuation of MGB using Sheshunoff's methodology is $70.66 per share, which when multiplied by MGB's 688,400 shares, yields $48,504,664 as a total value for MGB. Subtracting the $6,814,000 of other assets, multiplying the remaining value by 1.2 to include a 20% control premium, and then adding back the $6,814,000 of other assets, yields a valuation of $56,842,796.80, or $82.57 per share. Using the same arithmetic, a 35% control premium would yield a value of $63,096,394.40, or $91.66 per share.

date of the trial, the Petitioners urge the Court to award them interest at that rate. The Court declines to do so.[29] A 10% interest rate might arguably be appropriate had the Court found undue delay on the Respondents' part, but there has been no undue delay here.

[20-22] Whether or not to award simple or compound interest is a matter within the Court's discretion. While it may be true, as the Respondents point out, that "[a]n award of compound post-judgment interest is the exception rather than the rule,"[30] in today's financial markets a prudent investor expects to receive a compound rate of interest on his investment. Therefore, it is equitable and realistic for the Court to award compound interest in this case.[31]

Turning to the compounding interval, the Petitioners argue that it should be monthly. The Respondents do not address the issue. Having been furnished no reason to do otherwise, the Court concludes that a monthly compounding interval is appropriate.

### C. Fees and Expenses

Lastly, the Petitioners request an award of legal fees and expenses, but provide no meaningful support for that claim. In a single conclusory sentence in their opening brief, the Petitioners state: "[i]n addition, and on account of Respondents' evidenced bad faith (before, in connection with, and following the merger), Petitioners urge the Court to assess all of their reasonable costs and expenses of the litigation, including attorneys' fees and expert fees, upon Respondents." In their Reply Brief, the Petitioners expand upon their bad faith claim by arguing that the Respondents sought to conceal MGB's fair value by "withdrawing Sheshunoff as their expert . . . keeping Mr. Campbell away from Court . . . proffering Mr. Reilly . . . and trumping up a story about litigation risks."[32]

[23] Without more evidence than these conclusory assertions, the Court is unable to conclude that the Respondents acted in bad faith. Accordingly, the Court rejects the Petitioners' request for fees and expenses.

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[29]Although the Court does not rest its decision on that ground, it notes that the legal rate of interest as of the Merger date was also 8%.

[30]Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 302; see also Ryan v. Tad's Enterprises, Inc., Del. Ch., C.A. 10229, Jacobs, V.C. (April 24, 1996) aff'd by Order, Del. Supr., 693 A.2d 1082 (1997) (stating that compound interest is also the exception and not the rule with respect to prejudgment interest).

[31]See Grimes v. Vitalink Communications Corp., Del. Ch., C.A. 12334, Chandler, C. (Aug. 28, 1997) (holding that a monthly compounding interval is appropriate to force the Respondent to give up his gain and to fully reimburse Petitioner).

[32]Pet'rs Reply Br. at 33.

## IV. CONCLUSION

The parties shall confer and submit an appropriate form of order.

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*IN RE* McKINNEY-RINGHAM CORP.

No. 15,071

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

February 25, 1998

Petitioner and respondent formed a Delaware corporation to act as a general partner for a limited realty partnership. Petitioner and respondent were each fifty percent shareholders in the corporation. Petitioner sought dissolution of the corporation pursuant to section 273 of the Delaware Code. Respondent opposed the dissolution on several grounds, including that the corporation was not a joint venture, the principals were not deadlocked, petitioner sought dissolution in bad faith, and the dissolution would harm respondent disproportionately.

The court of chancery, per Vice-Chancellor Steele, concluded that the corporation was a joint venture for dissolution purposes under section 273, the fifty percent shareholders were unable to agree on whether dissolving the joint venture and disposing of its assets was desirable, and that petitioner did not seek dissolution in bad faith. The court thus concluded that the corporation must be dissolved and that the parties shall submit letters to the court proposing the next step in the process.

1. Corporations ⟹ 592
   Joint Adventures ⟹ 1.14

The dissolution of a corporation under section 273 is proper only where (1) two fifty percent shareholders (2) are engaged in the prosecution of a joint venture and (3) are unable to agree upon the desirability of discontinuing such joint venture and disposing of its assets. DEL. CODE ANN. tit. 8, § 273 (1997).

2. Joint Adventures ⟹ 1.10

Section 273 does not require that an enterprise be designated explicitly as a joint venture in the certificate of incorporation or anywhere else. DEL. CODE ANN. tit. 8, § 273 (1997).

3. Joint Adventures ⟹ 1.2(4)

The intent to form a joint venture need not be evidenced by a written or oral agreement.

4. Joint Adventures ⟹ 1.2(4)

A court may infer that the parties intended to create a section 273 joint venture from the circumstances surrounding the business relationship. DEL. CODE ANN. tit. 8, § 273 (1997).

5. Joint Adventures ⟹ 1.2

The elements of a joint venture are: (1) a community of interest in the performance of a common purpose, (2) joint control or right of control, (3) a joint proprietary interest in the subject matter, (4) a right to share in the profits, and (5) a duty to share in the losses which may be sustained.

6. Corporations ⟹ 592
Joint Adventures ⟹ 1.2(9), 1.11

Simply because a Delaware corporation may have interests in or responsibilities related to other non-Delaware entities of differing structure does not mean the corporation may not be considered a distinguishable, independent joint venture enterprise for purposes of dissolution.

7. Joint Adventures ⟹ 1.2(9), 1.14, 5(1)

The fact that one or more entities are managed by a joint venture Delaware corporation and/or the parties act as general partners, and that the parties have interests in foreign business organizations, does not mean the law strips a partner of his right to seek dissolution of the Delaware corporation.

8. Joint Adventures ⟹ 1.14, 5(1)

Under Delaware law, either of two fifty percent shareholders in a joint venture corporation has a statutory right to seek the dissolution of the corporation under certain circumstances.

9. Joint Adventures ⟹ 1.14

Under section 273, a fifty percent shareholder in a Delaware joint venture corporation may waive the statutory right to seek dissolution if provided in the certificate of incorporation or in a written agreement between the shareholders. DEL. CODE ANN. tit. 8, § 273 (1997).

10. Corporations ⟹ 592, 611

Although the court has the discretion to dissolve a joint venture corporation once the requirements of section 273 have been met, the court has interpreted the scope of this undefined statutory discretion very narrowly. DEL. CODE ANN. tit. 8, § 273 (1997).

11. Joint Adventures ⟹ 1.14, 5(1)

Once the requirements of section 273 are met, the exercise of the court's discretion to dissolve a corporation is limited to a determination of whether or not a *bona fide* inability to agree exists between the two shareholders and where the court so finds, the petitioner is entitled to relief provided by the statute. DEL. CODE ANN. tit. 8, § 273 (1997).

12. Corporations ⟹ 611

The only basis upon which a court may refuse to dissolve a joint venture corporation under section 273 is if the actual foundation for the action is something other than a genuine inability to agree upon the desirability of discontinuing the joint venture. DEL. CODE ANN. tit. 8, § 273 (1997).

13. Joint Adventures ⟹ 1.14

The fact that a shareholder in a joint venture corporation, who seeks his statutory entitlement to dissolve the enterprise in order to extract his investment from it and incidentally benefits from the dissolution, cannot be

a basis for the court to deny an otherwise appropriate petition under section 273. DEL. CODE ANN. tit. 8, § 273 (1997).

14. Joint Adventures ⟹ 1.14

Since section 273 states that if parties cannot agree to a plan of dissolution, the court may appoint a trustee or receiver who will ensure an equitable division of the proceeds, the potential for an inequitable result is not a basis to deny dissolution. DEL. CODE ANN. tit. 8, § 273 (1997).

Samuel A. Nolen, Esquire, of Richards, Layton & Finger, Wilmington, Delaware; and Joseph F. McDonough, Esquire, and James G. McLean, Esquire, of Manion, McDonough & Lucas, P.S., Pittsburgh, Pennsylvania, of counsel, for petitioner.

Michael D. Goldman, Esquire, James F. Burnett, Esquire, Peter J. Walsh, Jr., Esquire, and Eileen M. Filliben, Esquire, of Potter, Anderson & Corroon, Wilmington, Delaware; and Leo A. Keevican, Jr., Esquire, Leonard J. Marsico, Esquire, and John J. McCague, III, Esquire, of Doepken, Keevican & Weiss, Pittsburgh, Pennsylvania, of counsel, for respondent.

STEELE, *Vice-Chancellor*

Petitioner seeks to dissolve McKinney-Ringham Corporation ("MRC"), a Delaware corporation, pursuant to 8 *Del. C.* §273 ("section 273").

Respondent opposes the petition and contends the entity sought to be dissolved is not a joint venture, the principals are not deadlocked, Petitioner filed simply to enhance his family's position in a broader business enterprise, and the consequences flowing from a dissolution would so favor the Petitioner's interests that I must conclude he filed in bad faith and exercise my discretion to deny the petition. After trial, I find that MRC is a joint venture corporation, that its two 50% shareholders clearly disagree on the desirability of dissolving the venture and disposing of its assets, and that the Petitioner did not file in bad faith either to enhance unfairly his family's business position or to leave the Respondent in such an unfavorable position relative to the broader complex of business arrangements that this Court should deny an otherwise appropriate petition in its discretion solely because the result of dissolution may impact disproportionately disadvantageously upon Respondent. Thus, all of the requirements for dissolution pursuant to section 273 have been met, MRC

must be dissolved, and any approved plan of dissolution will address the equities presented by the situation.

## BACKGROUND

Petitioner, J. Donald McKinney, and Respondent, William O. Ringham, formed MRC in 1985 to serve with each of them as the third general partner of M&R Realty Partners, a Pennsylvania limited partnership. MRC is now the general partner of six Pennsylvania limited partnerships.[1] Petitioner and Respondent are, and always have been, MRC's only two directors and shareholders, and each owns 50% of MRC's stock. In 1995, the parties elected Respondent President of MRC. MRC's by-laws state that an officer may be replaced only by a majority vote of the directors.[2] There has been no election of officers since 1995 because it has continued to be clear that Respondent would vote for himself, and Petitioner would not support that result.

Both parties have presented considerable evidence that their relationship has been deteriorating since 1995. The extensive evidence of the parties' poor relationship need not be listed here because the record so clearly supports that obvious conclusion that there can be no genuine dispute about it. Suffice it to say, the parties have disagreed on nearly every significant issue confronting MRC since 1995. Respondent has been able to operate MRC as he sees fit, however, in his capacity as MRC's President. Petitioner, meanwhile, has objected to nearly every decision Respondent has made. Petitioner has been presenting alternative proposals to Respondent concerning almost every aspect of MRC's administration, and Respondent has rejected them all. The testimony of Michael Dvorsky, Vice President and Assistant Secretary of MRC, summed up the situation between the parties in this way: Petitioner "totally objected" to Respondent's changes at MRC, Respondent "totally disagreed" with Petitioner's proposed changes, and the parties had not resolved their disputes as of trial.

Petitioner filed this petition for dissolution on June 18, 1996, alleging that all of the prerequisites for dissolving a corporation under section 273 had been satisfied. Respondent has vigorously opposed the petition. He contends: (1) that MRC is not a joint venture, (2) that the parties have no dispute of the type required by section 273, (3) that if MRC

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[1]These limited partnerships are: Colony West Partners, Greenbriar Partners, M&R Realty Partners, M/R/N Realty Partners, M/R/S/N Realty Partners and M/R/S Realty Partners. Petitioner and Respondent are also general partners of M/R/S Realty Partners.

[2]Restated By-Laws of McKinney-Ringham Corporation, art. V, sec. V.

is a joint venture, this Court should exercise its discretion and deny Petitioner's request for dissolution because he has acted "in bad faith," and (4) that the Court should exercise its discretion and refuse to dissolve MRC because the consequences of dissolution would inequitably affect Respondent. I address each of Respondent's concerns below.

## DISCUSSION

[1] The dissolution of a corporation under section 273 is proper only where (1) two 50% shareholders, (2) are engaged in the prosecution of a joint venture and (3) are "unable to agree upon the desirability of discontinuing such joint venture and disposing of [its] assets...."[3] In this action, Respondent claims the last two elements have not been satisfied.

Respondent argues that MRC is not a joint venture because the parties did not intend to create a joint venture. Respondent argues that he and Petitioner "entered into two real estate enterprises that they expressly designated as 'Joint Ventures,'"[4] implying that if the parties had intended MRC to be a joint venture, they would have explicitly designated it as such. Respondent explains that MRC is not labeled a joint venture in its certificate of incorporation and that neither he nor Petitioner have ever told their lawyers, employees or lenders that MRC is a joint venture. Respondent also notes that a 1996 MRC shareholders' agreement, signed by both parties, did not refer to MRC as a joint venture.

[2-4] Section 273 does not require that an enterprise be designated explicitly as a joint venture in the certificate of incorporation or anywhere else.[5] The intent to form a joint venture need not even be evidenced by a written or oral agreement.[6] A court may infer that the parties intended to create a section 273 joint venture from the circumstances surrounding the business relationship.[7] The two real estate projects Respondent refers to could not qualify for dissolution under section 273 merely because the

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[3]*In re Coffee Assocs., Inc.*, Del. Ch., C.A. No. 12950, 1993 WL 512505 at *3, mem. op., Jacobs, V.C. (Dec. 3, 1993).

[4]Respondent William O. Ringham's Answering Post-Trial Memorandum of Law at 4 (hereafter "R's Ansr. Br.").

[5]*Cf.* 8 *Del. C.* § 343(l)(term "close corporation" must appear in certificate of incorporation).

[6]"[N]o particular formality is required for the establishment of [a joint venture] relationship." *Wah Chang Smelting and Refining Co. v. Cleveland Tungsten, Inc.*, Del. Ch., C.A. No. 1324-K, 1996 WL 487941 at *3, mem. op., Chandler, V.C. (Aug. 19, 1996)(quoting *Consolidated Fisheries Co. v. Consolidated Solubles Co.*, Del. Supr., 112 A.2d 30, 35 (1955)).

[7]*See Wah Chang*, 1996 WL 487941 at *3 (citing *Sheppard v. Carey*, Del. Ch., 254 A.2d 260, 263 (1969) and *J. Leo Johnson, Inc. v. Carmer*, Del. Supr., 156 A.2d 499, 502 (1959)).

parties labeled them "Joint Ventures." They would also have to exhibit the judicially defined characteristics of a section 273 joint venture. Similarly, even though the parties did not call MRC a "joint venture," I must find MRC to be a joint venture if the parties intended to create a corporation with the attributes of a joint venture.

[5] Section 273 does not define the term "joint venture," but the Supreme Court stated, in ***Warren v. Goldinger Bros., Inc.***,[8] that the elements of a joint venture are:

> (1) a community of interest in the performance of a common purpose, (2) joint control or right of control, (3) a joint proprietary interest in the subject matter, (4) a right to share in the profits, [and] (5) a duty to share in the losses which may be sustained.[9]

Respondent argues that MRC is not a joint venture because elements 1, 3, 4 and 5 have not been satisfied. In his post-trial briefing, Respondent addressed each factor in turn, but all of his arguments in this regard are misplaced because Respondent does not apply the ***Warren*** factors to MRC alone. Petitioner clearly asks only that MRC be dissolved, but Respondent attempts to refocus the analysis by insisting that MRC is not the "joint venture" this Court must examine.

Respondent argues that *if* he is involved in a joint venture with Petitioner, that joint venture is the entire interlocking business relationship between the parties and entities in which they have varying degrees of interest, which he characterizes as "the web." "The web" is Respondent's collective name for (1) the six limited partnerships in which MRC serves as general partner and (2) several other entities, related to the parties' apartment rental business, in which the parties have interests. Respondent states that running "the web," comprised of fourteen partnerships and five corporations,[10] is the parties' joint venture. Then, Respondent contends that this joint venture, "the web," must apparently exist in perpetuity; he argues it cannot be dissolved under section 273 because it is not, as a whole or in its separate parts, a Delaware corporation.

[6] I cannot accept Respondent's argument. Clearly, the combined entities that make up "the web" cannot satisfy the legal definition of a single joint venture corporation under section 273. Petitioner, however, does not seek to dissolve "the web"-- he seeks to dissolve MRC. Simply

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[8]Del. Supr., 414 A.2d 507 (Apr. 8, 1980).
[9]*Id.* at 509.
[10]R's Ansr. Br. at 6.

because MRC may have interests in or responsibilities related to other non-Delaware entities of differing structures does not mean MRC may not be a distinguishable, independent joint venture enterprise. MRC is a Delaware corporation, and for the reasons that follow, I find that MRC meets all the requirements of a joint venture corporation for the purposes of section 273.

[7] Petitioner and Respondent "formed MRC to act as the corporate general partner for one limited partnership."[11] Over time, of course, MRC became the general partner of six limited partnerships. This increased, varied, and intertwining involvement may be evidence of a more complex series of endeavors, but it does not constitute such a sophisticated complex of interlocking relationships that MRC's separate identity is lost. Petitioner and Respondent share a joint proprietary interest in the subject matter of MRC, 1% general partnership interests in six limited partnerships, and they share a community of interest in the success of MRC as a managing entity. The evidence presented shows that each party has the *right* to share in any profits, and each has always recognized his duty to share equally in MRC's losses.[12] Both parties considered MRC "successful" even when it lost money because MRC's losses provided a mutual tax benefit to the parties.[13] Respondent concedes that each party has joint right of control over MRC.[14] The fact that one or more entities are managed by MRC and/or Petitioner and Respondent as general partners and that the parties have interests in foreign business organizations does not mean the law strips Petitioner of his right to seek dissolution of MRC, a Delaware corporation.

Respondent next argues that the parties do not disagree on the desirability of discontinuing MRC or disposing of its assets. More precisely, Respondent argues that the parties agree that it is *not* desirable to discontinue the joint venture and that the parties also agree on how to dispose of MRC's assets. Respondent's first argument can hardly be taken seriously. He argues that the parties both wish to continue the joint venture because the venture in this case, if there is one at all, is "the web" and not MRC. If "the web" is a joint venture, then Respondent may, plausibly at

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[11]R's Ansr. Br. at 2.

[12]"Factually, MRC did occasionally have operating profits which were 'bonused' in exactly equal amounts to its two stockholders. When losses were incurred, they were funded exactly equally. Moreover, while MRC generally sustained operating losses, its assets increased in value -- a profit which was accounted for monthly and has accrued exactly equally to both stockholders." Petitioner's Post-Trial Reply Brief at 8 (citations omitted)(hereafter "P's Reply Br.").

[13]*See J. Leo Johnson*, 156 A.2d at 502 ("[A] joint venture has been broadly defined as an enterprise undertaken by several persons jointly to carry out a single business enterprise ... for their mutual benefit....").

[14]R's Ansr. Br. at 27.

least, argue that neither Petitioner nor Respondent desires to dissolve the entire series of relationships at every level. That the parties disagree on the desirability of discontinuing MRC cannot be seriously disputed. Both parties agree that, on at least one occasion, Petitioner suggested that he and Respondent separate their "joint ownership of operations and assets," and that Respondent refused.[15] More illustrative of the point, however, is that Petitioner has petitioned to dissolve MRC and Respondent has vigorously opposed the petition.

Respondent also contends the parties' shareholders' agreement somehow supports the view they do not disagree on how to dispose of MRC's assets. In December of 1995, Petitioner and Respondent entered into a shareholders' agreement. Respondent argues that in the agreement, "the parties ... agreed upon a method of discontinuing their relationship in MRC should one stockholder no longer wish to continue."[16] The agreement states: "If either Stockholder wishes to sell all or any part of his capital stock to a third party and has not received the other Stockholder's prior consent to the sale, he may sell his capital stock only after offering it to the other Stockholder, on the terms and conditions set out in this agreement."[17] Respondent has offered to buy Petitioner's shares.

[8-9] Respondent misconstrues the agreement. It merely provides each shareholder a right of first refusal on the other's shares before his fellow shareholder may sell his interest to a "stranger." Under the agreement, MRC would continue to exist, whereas under section 273, MRC will be dissolved. One of the benefits of Delaware law is that either of two 50% shareholders in a joint venture corporation has a statutory right to seek the dissolution of the corporation under certain circumstances. Respondent concedes, as he must, that neither party has waived this statutory right to petition for dissolution under section 273 in the agreement.[18] The agreement does not support Respondent's reading of it, and section 273 did not even allow such a waiver until it was amended in 1996 to provide that a 50% shareholder in a joint venture corporation will not have a right to petition for dissolution under section 273 if "provided in the certificate of incorporation or in a written agreement between the stockholders."[19]

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[15]Petitioner's Opening Post-Trial Brief at 10 (hereafter "P's Open. Br."). Petitioner argues that he has proposed, and Respondent has rejected, dissolving MRC and distributing its assets many times since 1996. While Respondent disputes the number of times this exchange has occurred, it is clear that Petitioner and Respondent have disagreed on this point. P's Open Br. at 10-14; R's Ansr. Br. at 8; P's Reply Br. at 11 and n. 5.

[16]R's Ansr. Br. at 46-47.

[17]McKinney-Ringham Corporation Stockholder Agreement, para. 3.

[18]R's Ansr. Br. at 47.

[19]8 *Del. C.* § 273(a).

[10-12] Respondent next argues that even if MRC is a joint venture and the parties disagree about the desirability of continuing the venture, I should exercise my discretion and refuse to dissolve the venture. Section 273 states that if the requirements of subsections (a) and (b) have been met the Court of Chancery "may dissolve" the corporation.[20] However, this Court has interpreted the scope of this undefined statutory discretion very narrowly. "[W]hile Section 273 recognizes a power in this court to deny a petition that satisfies its minimum standards, such power should be sparingly exercised."[21] In *In re Arthur Treacher's Fish & Chips,*[22] Chancellor Marvel stated: "Once the requirements of §273 are met, the exercise of *such discretion is limited to* a determination of whether or not a bona fide inability to agree exists between the two shareholders. Where the Court so finds ... the petitioner ... is *entitled* to the relief provided by the statute."[23] Thus, the only basis upon which I may refuse to dissolve MRC is if "the actual foundation for this action" is something other than "a genuine inability to agree upon the desirability of discontinuing this joint venture."[24] I have already stated my finding that the parties genuinely and most vehemently disagree on this point.

[13] Respondent claims that Petitioner has acted in bad faith, but Respondent defines "bad faith" in a broader sense than I may when considering a petition for dissolution under section 273. Respondent states that Petitioner "brought the petition in bad faith as part of a scheme to marginalize [Respondent]" and to give greater control over MRC to Petitioner's sons.[25] The very narrow question before me, however, is whether Petitioner filed this action knowing that there is no bona fide disagreement between the parties justifying a basis for disagreement over the dissolution of MRC. The evidence presented by Petitioner *and* Respondent convinces me that "a genuine inability to agree upon the desirability of discontinuing this joint venture is the actual foundation for this action."[26] Thus, while the foregoing oft quoted phrase seems akin to a double negative, the real point is -- where the facts support a genuine dispute over the desirability of continuing the business enterprise as a joint venture, the inquiry ends. As noted above, the Respondent, as last duly

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[20] 8 *Del. C.* § 273(b).

[21] *In re Data Processing Consultants, Ltd.*, Del. Ch., C.A. No. 8907, 1987 WL 25360 at *4, mem. op., Allen, C. (Nov. 25, 1987).

[22] Del. Ch., C.A. No. 5357, slip op., Marvel, C. (Oct. 16, 1980).

[23] *Arthur Treacher's*, Del. Ch., C.A. No. 5357, slip op. at 8, Marvel, C. (Oct. 16, 1980)(emphasis added).

[24] *Id.* at 7.

[25] R's Ansr. Br. at 37.

[26] *Arthur Treacher's*, Del. Ch., C.A. No. 5357, slip op. at 7, Marvel, C. (Oct. 16, 1980).

elected President, controls the enterprise. As he continues to make decisions in that capacity, he offends the Petitioner and leads him to conclude MRC should cease operations. Of course, Respondent disagrees and wants to maintain the status quo because he is in control, is making all the decisions, and is doing so with no greater investment than Petitioner in the enterprise. What 50% shareholder who is in a position to exercise unfettered control over an enterprise entirely on his own terms *would* want to terminate the venture? Correspondingly, what 50% shareholder who has no influence over or control of the President of the jointly owned enterprise would want it to continue to operate under the same terms? The fact one who seeks his statutory entitlement to dissolve the enterprise in order to extract his investment from it may incidentally benefit from dissolution cannot be a basis for the Court to deny an otherwise appropriate petition. It frankly seems unlikely one would ever petition for dissolution until one concluded the benefits derived from the continued association with the enterprise were outweighed by the disadvantages flowing from the continued operation.

Respondent also argues that I should, in my discretion, decline to dissolve MRC because the result would cause him disproportionate harm. The root of the problem, in Respondent's view, is that the dissolution of MRC, the general partner of six limited partnerships, would be an event of default under the several limited partnership agreements sufficient to cause the dissolution of the limited partnerships themselves. Several of those limited partnerships have bank loans outstanding, and Respondent contends that the dissolution of those limited partnerships would be events of default under the existing loan documents sufficient to cause: "(i) an acceleration of the indebtedness in the approximate amount of $56 million; (ii) collection of cash collateral in the approximate amount of $27-28 million; (iii) pursuit in collection of personal guaranties of the indebtedness .... ; and (iv) a foreclosure and sale of [the underlying] properties."[27] Respondent claims he does not have the financial ability to withstand the potential acceleration and foreclosure, but Petitioner does. Respondent then argues that even if the banks do not accelerate and foreclose, if the limited partnerships dissolve and their assets are divided between the parties, both are likely to incur substantial taxes, which Petitioner can afford but Respondent cannot.

[14] First, it appears that the parties have the capacity to agree, in their mutual best interest, to elect a new general partner for the limited partnerships once MRC is dissolved to prevent the dissolution of the

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[27]R's Ansr. Br. at 45.

limited partnerships.[28] Second, Petitioner's trial expert explained, and Respondent did not contest the expert's conclusions, that the parties can agree to structure their dissolution so that taxes would be deferred and that if no agreement can be reached the worst case scenario would be that each party would wind up with $13 million in net after-tax proceeds.[29] Most importantly, however, the *potential* for an inequitable result is not a basis to deny dissolution under section 273 in any event because the statute provides a mechanism to *avoid inequity*. The statute states that if the parties cannot agree to a plan of dissolution, the Court may appoint a trustee or receiver who will ensure an equitable division of the proceeds.[30] This policy clearly cushions any negative impact dissolution may have on joint venturers. The complexity of what constitutes an MRC asset as opposed to an asset controlled by MRC but not held exclusively by MRC may be addressed in the plan of dissolution. I know of no case law which would prevent the Court from endorsing a plan broad enough in scope to encompass all of the parties' agreed concerns over MRC owned or controlled assets, regardless of any issue of original jurisdiction to dissolve a non-Delaware asset.

This Court finds little discretion to avoid dissolution where joint venturers are hopelessly deadlocked with no hope of an amicable resolution of their differences. "Once the requirements of §273 are met, the exercise of such discretion is limited to a determination of whether or not a bona fide inability to agree exists between the two shareholders. Where the Court so finds, and I do so here, then the petitioner, as here, is entitled to the relief provided by the statute."[31] The dissolution plan can guarantee equity to both parties if they each take a reasonable, measured approach.

The Court must now turn its attention to the manner in which the dissolution plan should be created. Although it seems to me that the best

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[28]R's Ansr. Br. at 45 ("[T]he partnerships will dissolve if McKinney and Ringham are unable to elect an individual successor general partner.").

[29]Petitioner's expert testified that *if* the dissolution of MRC led to the sale of the underlying properties for which it is general partner, each party would receive approximately $17.5 million in cash, upon which each would owe approximately $4.5 million in tax. P's Open. Br. at 22 (citing Trial Transcript 450-52). If the parties could agree to elect a successor general partner, however, the effect of dissolving MRC would be a total capital gains tax of approximately $270,000, which would be split equally between the parties. *Id.* (citing Trial Transcript at 459, 459, 460).

[30]8 *Del. C.* § 273(b)("[T]he Court of Chancery may dissolve such corporation and may by appointment of one or more trustees or receivers with all the powers and title of a trustee or receiver appointed under §279 of this title, administer and wind up its affairs."). *See also Arthur Treacher's*, Del. Ch., C.A. No. 5357, slip op. at 7, Marvel, C. (Oct. 16, 1980)("[T]he dissolution here sought is subject to being supervised by the Court, thus ensuring a fair price and an equitable division of the proceeds between the two shareholders.").

[31]*Arthur Treacher's*, Del. Ch., C.A. No. 5357, slip op. at 8, Marvel, C. (Oct. 16, 1980).

designed and most equitable dissolution plan would be one agreed to by the parties without Court intervention, an approach that also has the virtues of expediency and affordability, I understand only the Petitioner has submitted such a plan [as he must] along with his petition. I ask the parties to submit a letter to the Court, by March 18, 1998, describing what alternatives, if any, may be in the parties' best interests other than appointment of a master after submission of Respondent's plan of dissolution. I recognize Respondent has submitted no alternative plan of dissolution -- no doubt in anticipation of success on his legal theories opposing dissolution. He would be well served by an effort to reach agreement on a plan with Petitioner or submit an independent proposal.

## CONCLUSION

I find that MRC is a joint venture for the purposes of dissolution under section 273 and that its two 50% shareholders are unable to disagree on the desirability of dissolving the venture and disposing of its assets. I also find that Petitioner has not sought dissolution under section 273 in bad faith. Thus, I find that MRC must be dissolved. The parties shall submit letters to the Court by March 18, 1998 proposing the next step they desire to be taken in the process.

**IT IS SO ORDERED.**

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MOORE BUSINESS FORMS, INC. v. CORDANT HOLDINGS CORP.

No. 13,911

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

February 4, 1998
Revised March 5, 1998

Plaintiff, Moore Business Forms, Inc., brought action against the defendants, Cordant Holdings Corporation, its subsidiary, and directors, to enforce the terms of the preferred stock purchase agreement. Defendants had obtained equity financing from plaintiff to effect a management

corporate buyout in exchange for preferred stock convertible to common stock. The plaintiff claimed that the defendants: (1) violated the Delaware corporate law precepts by withholding information and denying plaintiff's right to participate in defendant corporation's board actions; (2) breached their implied contract to perform in good faith and express obligation not to incur new debt without plaintiff's approval; (3) breached their fiduciary duties; (4) breached the stock purchase agreement; (5) should be equitably estopped from terminating the parties relationship; and (6) breached the stockholders agreement. The defendants contended that: (1) they acted properly in all respects and that they were entitled to withhold information from plaintiff; (2) they did not violate the contractual covenant that prohibited them from incurring any new debt; (3) the plaintiff's equitable estoppel claim and fiduciary duty claim were previously dismissed in a prior adjudication; (4) plaintiff's preferred stock was appraised by a properly selected outside firm; (5) they validly terminated the strategic alliance and were no longer required to elect the plaintiff's director; (6) the ratification of its previous actions cured any deficiencies in the termination process of the strategic alliance; and the plaintiff is limited to the exclusive remedy of specific performance.

The court of chancery, per Vice-Chancellor Jacobs, concluded that the plaintiff continued to own the preferred stock and that the defendants' termination of the strategic alliance was legally invalid. The court also determined that the plaintiff's termination of the strategic alliance was legally effective and binding. The court, however, agreed with the defendants that the plaintiff could not assert claims of equitable estoppel and fiduciary duties, as those issues were adjudicated previously. The court further stated that the defendants' conduct violated Delaware corporate law precepts, the purchase agreement, and the shareholders agreement. Moreover, the court concluded that the defendants' termination vote was not ratifiable and that the plaintiff was not limited to the remedy of specific performance.

1. Corporations ⟹ 296, 297

It is well established that all directors of a corporation have equal rights of access to board information and to participate fully in board proceedings.

2. Corporations ⟹ 180, 310(1)

The right of directors to access board information and participate fully in board proceedings is not absolute and may be limited by agreement

of the shareholders expressed either as an amendment to the certificate of incorporation or as a private contract among the shareholders.

3. Corporations ⟹ 296, 297, 298(1), 310(1)

Absent a contractual limitation, the board had no legal power to withhold information from a director or to prevent the director's participation in board action relating to terminating a strategic alliance, without his consent.

4. Corporations ⟹ 298(2), 298(3), 310(1)

Where a director representing a partner in a strategic corporate alliance has a practice of recusing himself from board meetings as a courtesy to the other partner's directors, a board still has an affirmative duty to inform the director of any proposed actions affecting the alliance, so that the director can intelligently decide whether to recuse himself from the meeting, abstain from voting, or take some different course of action by reason of a conflict of interest.

5. Corporations ⟹ 298(1), 310(1)

A board is obligated to provide a director with accurate minutes of the meetings reflecting any deliberations and action taken in the director's absence.

6. Corporations ⟹ 298(3)

Delaware law is well settled that board action taken in the absence of a director, where the absence is obtained by trickery or deceit, or where notice of a special meeting was not given to a director, is void.

7. Corporations ⟹ 298(1), 298(3)

A special meeting held without due notice to all directors as required by the bylaws is not lawful and all acts done at such meeting are void.

8. Corporations ⟹ 298(3), 310(1), 316(1)

Because the decision to terminate a strategic alliance occurred at a board meeting of which a director was deliberately not given notice, the

actions taken by the board to terminate the strategic alliance were void *ab initio*.

9. Contracts ⟹ 275, 315
Corporations ⟹ 316(1)

A corporation breaches its contract with a preferred stock shareholder where it violates an implied obligation to perform a stock purchase agreement and a stockholders agreement in good faith.

10. Contracts ⟹ 168

Where a party bargains for the right to appoint a director to a corporation's board, implicit in that arrangement is that the party's designee would have the same information and participation rights as the other directors.

11. Contracts ⟹ 315
Corporations ⟹ 310(1), 316(1), 336

A material breach of contract occurs where a corporation fails to obtain a preferred shareholder's consent before incurring any new debt as required by a stock purchase agreement.

12. Contracts ⟹ 315
Corporations ⟹ 310(1), 316(1)

The board of a corporation breached its obligation to obtain shareholder's consent before incurring or assuming any indebtedness, pursuant to a purchase agreement, where the company pledged corporate assets as collateral to secure a new financing agreement and then drew on the new credit facility.

13. Corporations ⟹ 316(4)

To determine if a board's ratification vote was effective, a court must decide two questions: (1) were the board's actions void or voidable, and (2) what was the legal consequence of the board's ratification of those actions if they were (a) void or (b) voidable.

14. Corporations ⟹ 298(1), 310(1), 316(4)

Delaware law recognizes that a board may ratify its prior acts, but those acts determined to be void are not curable by ratification.

15. Corporations ⟹ 297, 312(1)

The essential distinction between voidable and void acts is that the former are those which may be found to have been performed in the interest of the corporation but beyond the authority of management, as distinguished from acts which are *ultra vires*, fraudulent or gifts or waste of corporate assets.

16. Corporations ⟹ 316(4)

Where a board intentionally failed to give a fellow director notice of a special board meeting, the board's actions at that meeting were rendered void; consequently, a vote to terminate a strategic corporate alliance was not ratifiable.

17. Specific Performance ⟹ 1, 36

The purpose of the specific performance remedy is to place the aggrieved party in the position that it would have been in but for the breach.

Richard D. Allen, Esquire, and Kurt M. Heyman, Esquire, of Morris, Nichols, Arsht & Tunnell, Wilmington, Delaware; and Steven S. Rosenthal, Esquire, Kenneth W. Irvin, Douglas A. Tucker, Esquire, and Jeffery A. Tomasevich, Esquire, of Morrison & Foerster, Washington, D.C., of counsel, for plaintiff.

Henry N. Herndon, Jr., Esquire, and Joseph C. Schoell, Esquire, of Morris, James, Hitchens & Williams, Wilmington, Delaware; Joseph M. Hassett, Esquire, John C. Keeney, Jr., Esquire, and David G. Leitch, Esquire, of Hogan & Hartson, L.L.P., Washington, D.C., of counsel; and Stephanie A. Wood, corporate counsel, Cordant, Inc., Reston, Virginia, of counsel, for defendants.

JACOBS, *Vice-Chancellor*

This is the Opinion of the Court, after trial, in an action brought by the plaintiff, Moore Business Forms, Inc. ("Moore"), to enforce the terms of a Preferred Stock Purchase Agreement dated March 23, 1990 (the "Purchase Agreement"). The parties to that agreement were Moore and the corporate defendants, Cordant Holdings Corporation ("Holdings") and Holdings' wholly-owned subsidiary Cordant Inc. ("Cordant"). Moore also seeks to enforce a Stockholders Agreement dated March 27, 1990 (the "Stockholders Agreement"). The parties to that latter Agreement were Moore, Holdings, and the Management Group Stockholders, who include the defendant directors Peter Kusek, C. Kenneth Michlovitz, Kenneth Casazza, and Stephanie Wood.[1]

At the heart of the dispute is who presently owns the class of Series B Noncumulative Convertible Redeemable Preferred Stock of Holdings (the "Preferred Stock"). Moore claims that it continues to own Preferred Stock, because (i) the defendants' attempted termination of a strategic alliance between the parties (the "Strategic Alliance") and (ii) the defendants' attempted repurchase of Moore's Preferred Stock, were invalid and should be so declared. For the reasons discussed below, the Court concludes that (a) Moore continues to own the Preferred Stock, (b) the defendants' termination of the Strategic Alliance was legally invalid, and (c) Moore's termination of the Strategic Alliance was legally effective and binding.

## I. FACTS

### A. The Parties and Their Contract

Many of the facts are undisputed, but where the facts are disputed, they are as found herein.

In March 1990, Messrs. Kusek, Michlovitz, and Casazza formed Holdings as a vehicle to effect a management buyout of Cordant. To finance the buyout, those defendants obtained $11 million of equity financing from Moore. In exchange, Holdings issued to Moore 11,000 shares of Holdings Preferred Stock, convertible into 24.07% of Holdings common stock.[2] Moore's rights and obligations as a Preferred stockholder

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[1]The directors of Holdings and Cordant were Peter Kusek ("Kusek"), C. Kenneth Michlovitz ("Michlovitz"), Kenneth Casazza ("Casazza"), Robert Jeffers ("Jeffers"), Gilbert Decker ("Decker"), and Robert Kimmit ("Kimmit"). As of October 3, 1995 Decker was no longer a director, and O. Gene Gabbard ("Gabbard") and Stephanie Wood ("Wood") had taken his place.

[2]PX-811, ¶ G at 16; Trial Transcript at 502:1-11 (Kusek).

were set forth in both the Purchase Agreement and the Stockholders Agreement. At the time Moore made its investment, Cordant's value was approximately $50 million.

Critical to the transaction was a new relationship called the "Strategic Alliance," whose terms were defined in the Purchase Agreement. The Strategic Alliance was a business development arrangement wherein Moore, Cordant, and Holdings would work together to identify and develop certain business opportunities. The Strategic Alliance would remain in effect until June 30, 1994, after which either Moore or Holdings would be entitled to terminate the Strategic Alliance by giving the written notice specified in the Purchase Agreement. If Holdings terminated the Strategic Alliance, that would trigger Section VII.F of the Purchase Agreement, and Holdings would become entitled (and required) to repurchase Moore's Preferred Stock for cash at a price equal to the greater of:

> (i) the per share value set forth in a fair market value appraisal of the common stock of [Holdings], made as of the end of [Holdings'] most recent fiscal quarter, by an accounting firm selected from among those firms formerly known as "the big eight" or their successors by a majority of the directors of [Holdings] other than directors who are executives of [Holdings] or affiliated with Moore, provided that the accounting firm selected will not be one which has audited the financial statements of either Moore or [Holdings] for the most recent three (3) years then ended, and (ii) the average price, if any, at which the common stock of [Cordantl or [Holdings] shall have been traded in any over-the-counter market or any stock exchange for the (30) days prior to the giving of notice contemplated in this section.[3]

The Stockholders Agreement and the Purchase Agreement provided that a special committee of independent directors of Holdings would select a "big eight" accounting firm to appraise[4] Holdings for stock repurchase purposes, and to act as a mediator between the parties during the stock repurchase process.

Under the Purchase Agreement Moore also had a contractual right to terminate the Strategic Alliance. Section VII.H entitled Moore to

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[3]JX-1 Purchase Agreement at 36.

[4]See Section VII.F of the Purchase Agreement (special committee of Holdings' board consisting of "the directors of [Holdings] or affiliated with Moore" charged with selecting the particular big eight accounting firm).

terminate the Strategic Alliance upon sixty (60) days prior written notice to Holdings and Cordant. Importantly, if Moore terminated the Strategic Alliance, (i) Moore would be entitled to retain its Preferred Stock, including the right to convert the Preferred Stock into common stock, and (ii) the defendants' contract right to repurchase Moore's Preferred Stock would be extinguished. Thus, under this contractual scheme, whether or not Moore remained a stockholder of Holdings would depend upon which side -- Moore or Holdings -- terminated the Strategic Alliance first.

To further protect Moore's $11 million investment, the Stockholders Agreement entitled Moore to elect one director to the boards of both Holdings and Cordant.[5] In addition, and at Moore's insistence, Holdings and Cordant were contractually prohibited from incurring any indebtedness without Moore's prior consent.[6]

From December 1992 until September 1995, Moore's designee to the Holdings board, was Ronald Rogers. After Mr. Rogers resigned in 1995, Moore designated Joseph Duane as his successor. The defendants refused to elect Mr. Duane, however, because by that point the defendants claimed they had terminated the Strategic Alliance and, consequently, had extinguished Moore's right to designate a director to the Cordant and Holdings boards.

To appreciate how this controversy arose, it is necessary to start from the time Holdings and its directors (other than Rogers) began to explore the possibility of terminating the Strategic Alliance.

### B. The Defendants' Plan to Terminate the Strategic Alliance

Some time during 1993, Holdings' senior management decided actively to explore terminating the Strategic Alliance. In late 1993, the defendants hired KPMG Peat Marwick, LLP ("KPMG") to perform an appraisal of Holdings for purposes of awarding stock options and bonuses. At a meeting held on February 21, 1994, KPMG opined to the Holdings

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[5]See Section 2.2(b)(iv) of the Stockholders Agreement (obligating defendants to elect Moore's designated director).

[6]Section VIII.A of the Purchase Agreement provided that "... [N]either [Holdings] nor [Cordant] shall: ... [w]ithout the prior written consent of Moore, create, incur, assume or suffer to exist any indebtedness except (i) indebtedness incurred in connection with the Acquisition, (ii) lines of credit for working capital and trade debt incurred in the ordinary course of business of [Cordant], or (iii) other indebtedness permitted by Section 10.8(d) of the Stock Purchase Agreement as in effect on the Closing Date. (JX-1 at 37-38)." To assure Moore that the value of its investment would not fall below $11 million, the Purchase Agreement also provided that the percentage of common stock into which the Preferred Stock could be converted would increase if the company performed poorly.

board that for those purposes, Holdings's value was $11,340,000. The board approved KPMG's valuation for those purposes, with Rogers' knowledge and approval.

Later during that same board meeting, Rogers excused himself. In Roger's absence the board appointed a committee of two directors, Messrs. Jeffers and Decker, to select an accounting firm to perform a separate appraisal of Holdings for purposes of terminating the Strategic Alliance. Jeffers and Decker selected KPMG.

Those actions were taken without Rogers' knowledge or consent, and were omitted from the minutes of the February 21 board meeting.[7] From this point forward, the defendants purposefully concealed from Moore and Rogers all actions taken by them to explore and plan for terminating the Strategic Alliance. When asked why Rogers was not told of the Board's discussions and actions on this subject, Michlovitz (a senior officer and a director of both Holdings and Cordant) candidly admitted that "... it was a combination of not to disrupt the negotiations on the contracts but also not to allow Moore any preemptive rights, if you will, with respect to their termination of the Strategic Alliance which they had rights to do as well."[8]

Over the next two months, the defendants reemphasized, in various telephone conversations,[9] the need to keep confidential their explorations of a possible termination of the Strategic Alliance. Mr. Kusek, Holdings' board chairman and Chief Executive Officer, authored a memorandum detailing the steps the board planned to take to terminate the Strategic Alliance. That memorandum was distributed to all directors except Rogers. Thereafter, the defendants engaged the accounting firm of Deloitte & Touche to advise the board about the accounting impact of terminating the Strategic Alliance. Deloitte & Touche's formal opinion, addressed to "the Board of Directors of Holdings,"[10] was shared with all directors except Rogers. The defendants also engaged KPMG to value Holdings as of March 31, 1994, in order to determine the repurchase price for Moore's Preferred Stock. Rogers was not invited to participate in KPMG's selection, nor was he told that KPMG had been retained. KPMG opined to the board that as of March 31, 1994, the value of Holdings was $10,850,000, but KPMG's opinion was not shared with Rogers. Kusek also informed the Board (again, unbeknownst to Rogers) that he projected that

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[7]On all other occasions, when Rogers had excused himself from the meeting, the (unexpurgated) minutes were later shared with him, and Rogers would often rejoin the meeting if the board needed additional discussion or to take action on other matters.

[8]Michlovitz Dep. at 97:22-98:13, 99:20-100:13.

[9]PX-39 and PX-59; and PX-38.

[10]PX 14.

Cordant's value would increase to between $21 and $28 million by the end of that same year (1994).

To finance the repurchase of Moore's Preferred Shares, Cordant and Holdings approached the Chase Bank and negotiated a modification of the companies' existing line of credit arrangement. As a condition, Holdings and Cordant were required to -- and did -- pledge as security a $3 million cash-equivalent asset and certain accounts receivable. Again, this was done without the prior knowledge and consent of Rogers and Moore.

In preparation for a May 17, 1994 board meeting, Kusek informed all the directors except Rogers that the termination of the Strategic Alliance would be discussed at that meeting.[11] At that time Moore knew that the corporate defendants were contractually entitled to repurchase its Preferred Stock, on sixty days notice, as of June 30, 1994. Moore also knew that Mr. Kusek had been complaining of a perceived "one-sided" nature of the strategic relationship with Moore. In an effort to resolve any problems, on May 9, 1994 Kusek met with Reto Braun, Moore's Chief Executive Officer, who specifically asked Kusek if he "wanted out of the joint venture."[12] Kusek responded in the negative, and explained that he wanted Moore "in all the way or out all the way."[13] Mr. Braun understood this to mean that Kusek did not intend to terminate the Strategic Alliance, but wanted only for it to be improved.

At the May 17, 1994 board meeting, Rogers offered to recuse himself, as he had done in past meetings when the subject of Holdings' relationship with Moore came up for discussion. Rogers did that as a courtesy to enable the other board members to discuss that relationship freely. Unbeknownst to Rogers, the subject of the discussion was how best to terminate the Strategic Alliance. The board's discussion and action taken on that issue was not shared with him.

Although Rogers never agreed to the board taking action in his absence at the May 17 meeting, the directors nonetheless adopted a resolution terminating the Strategic Alliance, without informing Rogers or Moore. That was done intentionally to prevent Moore from preemptively terminating the Strategic Alliance and cutting off Holdings' right to

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[11]Kusek admitted that he had "no intention' to "alert Mr. Rogers that a discussion of termination of the Strategic Alliance would be taking place at this board meeting." (Kusek's Dep. at 159:2-6).

[12]See Trial Transcript at 225:5-226:17, 245:7-246:21 (Braun); and Trial Transcript at 293:1-296:23 (Duane).

[13]Trial Transcript at 498:9-11 (Kusek); Kusek claims that what he was referring to was the "business relationship" between Holdings and Moore, not the Strategic Alliance (Kusek Dep. at 98:19-22). The Court refuses to make the same fine line distinction that the defendants claim would be "incredible" not to make. (Def's Br. at 17.)

repurchase Moore's Preferred Stock.[14] There was a second reason: the defendants did not want to alert Moore to their plans before an important contract with the Air Force (the "ARMS contract") was first negotiated and executed.

In July 1994, the defendants again engaged KPMG to value Holdings, this time as of June 30, 1994. On August 11, 1994, KPMG issued its formal opinion that the value of Holdings of June 30, 1994 was $11,060,000.[15] Because the ARMS contract took longer to negotiate and finalize than defendants had anticipated, the Holdings board met again on August 23, 1994 to consider terminating the Strategic Alliance.[16] In preparation for that meeting, Kusek circulated a memorandum to all directors except Rogers, informing them (inter alia) that (i) they should not alert Rogers to the upcoming meeting, and (ii) between June 30, 1994 and December 31, 1994 Kusek expected the value of Cordant to increase by 44% using KPMG's valuation methodology. Kusek added that if Moore's Preferred Stock was repurchased in August, the repurchase price would be about $4.48 million, but if the defendants waited until the end of the year to repurchase, the price would increase to $6.5 million, i.e., $2 million more.[17]

At the August 23, 1994 special board meeting, the board, in Rogers' absence, formally resolved to terminate the Strategic Alliance. The defendants did not give Rogers notice of that meeting. On August 30, 1994, the defendants sent a letter officially notifying Moore that they had terminated the Strategic Alliance. That was the first time that Moore learned that defendants intended to terminate the Strategic Alliance.

One week later, on September 8, 1994, defendants tendered to Moore a certified check for $4.48 million, representing KPMG's appraised value, and the repurchase price, of Moore's Preferred Stock. Moore promptly returned that check, taking the position that the defendants were not entitled to repurchase the Preferred Stock because their termination of the Strategic Alliance was legally invalid.

Thereafter, a special board meeting was held on September 27, 1994, at which Rogers was present. Over Rogers' dissent, the board adopted a

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[14]See Kusek Dep. at 306:22-308:18; see also Michlovitz Dep. at 143:18-144:13.

[15]Defendants did not inform KPMG that the purpose of the valuation was to comply with Section VII.F of the Purchase Agreement.

[16]Although the defendants claim that this was not a formal board meeting, all board members except Rogers were aware of and participated in that gathering (PX-7 at COR8028, Kusek Dep. at 341:15-342:12). The defendants admit that it was at this meeting that they decided to terminate the Strategic Alliance (Michlovitz Dep. at 189:10-190:18). The Court finds that the August 23, 1994 meeting was a duly constituted board meeting.

[17]PX-7 at COR8034.

resolution ratifying their actions, taken on August 23 and at earlier meetings, to terminate the Strategic Alliance. In response, Moore took the position that the August 23 board resolution was legally ineffective, and refused to deliver its Preferred Stock to Holdings. On December 5, 1994, Moore sent written notice to Holdings and Cordant that it (Moore) had terminated the Strategic Alliance.

This action followed.

## II. THE PARTIES' CONTENTIONS

Moore advances six separate claims in this action. The first is that the defendants violated Delaware corporate law precepts by not giving Rogers equal access to the same information that was furnished to the other Holdings directors, and by depriving Rogers of his right to participate in the board's deliberations and actions. Second, Moore contends that the defendants (i) breached their implied contract obligation to perform the Purchase Agreement and the Shareholders Agreement in good faith,[18] and (ii) breached their express contract covenant not to incur new debt without Moore's knowledge or approval. Third, Moore claims that the individual defendants breached their fiduciary duties to Moore by taking actions that benefited themselves at Moore's expense and by concealing material information from Rogers, Moore's designee to the Holdings board. Fourth, Moore claims that the defendants breached Section VII.F of the Purchase Agreement by selecting KPMG improperly and by not informing KPMG of the purpose of its valuation, and also by giving KPMG false valuation information, thereby causing it to perform an incompetent valuation. Fifth, Moore claims that the defendants should be equitably estopped from claiming that they terminated the Strategic Alliance, because Kusek misled Moore to believe that Holdings did not want to terminate that relationship, but only to improve it. Sixth, Moore claims that the defendants breached the Stockholders Agreement by not electing its designee, Duane, to the Holdings board as a director after Rogers resigned.

The defendants respond, first, that they acted properly in all respects, because Rogers had a conflict of interest that entitled the defendants to withhold the information furnished to Holdings' other directors relating to

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[18]The obligation to perform a contract fairly and in good faith is implied in every contract. Wilgus v. Salt Pond Inv. Co., Del. Ch., 498 A.2d 151, 159 (1985); Merrill v. Crothall-American, Inc., Del. Supr., 606 A.2d 96, 101 (1992); Ruger v. Funk, Del. Super., C.A. No. 93C-04-210, Lee, J. (January 22, 1996). Moore argues that the defendants violated their implied contractual obligation to act in good faith when Kusek misrepresented to Moore's CEO that Holdings and Cordant did not want to terminate the Strategic Alliance.