

# APPRAISAL RIGHTS: THE "FAIR" VALUATION OF SHARES IN CASE OF DISSENT

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**RESUMEN:** Este ensayo analiza un tema de derecho corporativo que en los Estados Unidos de América ha sido objeto de gran debate académico y que ha producido decisiones trascendentales por parte de cortes estatales estadounidenses. Se trata del derecho que tiene un accionista a votar en contra de resoluciones corporativas y a separarse de una sociedad, siéndole pagado el valor justo de sus acciones por la misma. La determinación del tipo de decisiones corporativas y de los supuestos en que se accionan estos derechos, así como establecer cuál es el valor justo de una acción y las técnicas de valuación con que se puede llegar a ello, mediante procedimientos internos o judiciales, son objeto de estudio en este artículo. Este trabajo aspira a destacar un tema importante en materia corporativa respecto a los derechos de accionistas minoritarios y al control que sobre una sociedad pueden ejercer los accionistas mayoritarios y/o miembros de los consejos de administración.

**ABSTRACT:** This article analyzes a corporate law topic that in the United States has been subject to a great academic debate and that in practice has yielded landmark decisions by U. S. state courts. It is the shareholder right to dissent from a corporate resolution and exit a corporation with the fair value of his shares. The corporate decisions and scenarios under which these rights are triggered, as well as the delicate issue of determining what the fair value of a share is and the valuation techniques afforded to corporations or, in its case, judicial courts, to yield such fair value, are subject of study and analysis in this article. This essay aspires to make evident a very important corporate topic, specially in connection with minority shareholders' rights and corporate governance.

## I. PRELIMINARY CONSIDERATIONS

One of the current most debated topics in the United states of America at both the general corporate and corporate finance levels is the

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regulation and practical exercise of appraisal rights. This article intends to fulfil the need of providing interested parties with an overall picture as to the rights to dissent and obtain a fair payment for the value of the dissenter's shares. Although the topic is far more complex than meets the eye and generalizations can hardly be made, specially with respect to the outcome of judicial appraisal proceedings, this article explains the nature, regulation, and evolution of appraisal rights in the United States of America.

This article mainly focuses on U. S. law but yet is divided into two parts. The first part covers such nature, regulation, and evolution of appraisal rights under U. S. law. The second part of this article briefly refers to the rationale behind minority shareholders' rights under Mexican law and the regulation of the right to dissent, which when compared to U. S. regulation shows simplicity but also impracticability.

In this order of ideas, Section II of this article discusses and analyzes appraisal rights as created and regulated by U. S. law. The analysis covers the origins and legal nature of the right to dissent and appraisal, the goals of appraisal rights and the proceedings to request payment of the fair value of shares both at the corporate and judicial levels, and the current purported amendment to the appraisal rights provisions of the Model Business Corporation Act. The chronological development of the different stages and valuation techniques that have been utilized in U. S. judicial appraisal proceedings, from the "Delaware Block Method" of valuation to the relatively generalized use of the "discounted cash flow method," are also discussed in Section II of this article.

Section III of this article marginally describes, by way of comparison, appraisal rights or "rights of withdrawal" under Mexican law evidencing the lack of regulation on and development of this matter in Mexico.

## II. APPRAISAL RIGHTS UNDER U. S. LAW

### 1. *Introduction*

Out of a sense of fairness, the Model Business Corporation Act (1984) (hereinafter defined as the "MBCA") creates the right of a

shareholder to dissent from corporate decisions and obtain payment of the value of his shares.<sup>1</sup> A shareholder is entitled to receive the "fair value" of his shares in case of dissent.<sup>2</sup> The simplicity of the term is misleading, as there are many questions to be answered and factors to be considered in order to reach such fair value. But, it is indeed nothing but fairness that needs to be considered when dealing not only with judicial appraisal proceedings but also with the corporate exercise of dissenters' rights in general.

There is no dispute as to the right of every individual to participate in a business in which he owns an interest, or to his right to end that participation when the venture no longer fulfills his expectations or takes a different direction than the one initially expected. A shareholder can disagree with the rest of the shareholders of a corporation on any matter raised during a shareholders' meeting. His disagreement might not make a difference in the outcome of the resolutions adopted during a meeting, but he is still entitled to vote in favor of or against any corporate issue.

It is said that majority shareholders have the right to control and that together with the board of directors of a corporation run the business. Minority shareholders,<sup>3</sup> on the other hand, have been granted a number of rights to protect their fragile position inside a corporation and advance their interests. One of those rights is the appraisal right, that is, the right to dissent and obtain payment of the fair value of their shares. Both corporate statutes and case law have recognized and enforced rights of minority shareholders not only to protect the minority from the oppression of the majority and management, but also to ensure that its interest is accompanied by

1 Model Bus. Corp. Act 13.02 (1984) (hereinafter MBCA).

2 California uses a "fair market value" standard; Kansas uses a simple "value" standard; Louisiana, Nevada and Ohio use "fair cash value"; Wisconsin uses a "market value" standard for business combinations and a "fair value" standard in other contexts. See Schwenk, Michael R., *Valuation Problems in the Appraisal Remedy*, 16 Cardozo L. Rev. 649, 653 (1994).

3 The concept of a minority shareholder is commonly used to refer to a stockholder who owns shares representing less than fifty percent of the capital of a corporation. However, minority shareholder status is not necessarily determined through a mechanistic count of stock ownership percentages but by a qualitative evaluation of the actual control a particular shareholder may exert on a corporation. In determining whether a particular shareholder can exercise statutory rights granted to minority shareholders, the focus must be on that shareholder's power-or the lack thereof. See *Berger v. Berger*, 592 A.2d 321 (N. J. Super. Ct. Ch. Div. 1991); *Bonavita v. Corbo*, 692 A.2d 119 (N. J. Super. Ct. 1996).

a corresponding right to participation in the course of the business.<sup>4</sup> In the event of a "squeeze-out"<sup>5</sup> of the minority by the majority shareholders and directors, or of a conventional corporate transaction, minority shareholders' rights may be exercised for the ultimate benefit of the corporation.

Among other rights of minority shareholders are (i) those considered to be "inherent," such as preemptive rights,<sup>6</sup> to which MBCA section 6.30 refers, and the right to share profits and (ii) those that are more related to corporate affairs, such as the right to elect directors through mechanisms like cumulative voting<sup>7</sup> and voting agreements and the right to call shareholders' meetings. But what makes appraisal rights remarkably special is the right to exit<sup>8</sup> in limited

4 For additional analysis of minority shareholders' rights. *see* Martel, John S., *Minority Stockholder Rights: Corporate Planning And Litigation Strategy* 235 (1st ed. 1978).

5 "By the term squeeze-out is meant the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants. By partial squeeze-outs must be understood any action which reduces the participation or powers of a group of participants in the enterprise, diminishes their claims or earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled." Hodge O'Neal, F., "Squeeze-Outs" Of Minority Shareholders, *Expulsion Or Oppression Of Business Associates I* (1st ed. 1975). With respect to the squeeze-out of the minority, Professor Richard Selden Harvey has asserted that the enrichment of the majority at the expense of the minority is a condition usually arising from the desire on the part of a few individual stockholders to secure the control of the enterprise, and to obtain benefits to which they are not entitled. *See* Selden Harvey, Richard, *Rights Of The Minority Stockholder* 78 (1st ed. 1909). Professor Robert W. Hamilton concludes that "oppression and freeze-outs are possible because of the combination of the power of controlling shareholders to exclude minority shareholders from participation in the affairs of the corporation and the absence of a meaningful right of exit by minority shareholders from a corporation." Hamilton, Robert W., *Business Organizations, Unincorporated Businesses And Closely Held Corporations* 231 (1st ed. 1996).

6 For a representative case of the traditional nature of a preemptive right. *see* *Stokes v. Continental Trust Co.*, 78 N. E. 1090 (N. Y. 1906), in which the court acknowledged the corporate principle that a stockholder has an inherent right to a proportionate share of new stock issued for money and that he can not be deprived of it without his consent. *See idem*. This right is essential for minority shareholders as, without it, the majority could dilute share holdings and the voting power of the minority. *See also* Stecher, Matthias W., *Protection Of Minority Shareholders* 7 (1st ed. 1997).

7 MBCA section 7.28(c) provides that a statement referring to the entitlement to cumulate votes for directors means that "the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates." MBCA 7.28(c) (1984).

8 It might arguably be the real nature of the appraisal right. In itself it does not constitute a right to exit; it is simply not aimed in that direction, and even if it were, it would be fair to say that the right to exit is then a limited one since it is only available under specific corporate-transactions scenarios.

circumstances, a right by which a shareholder to whom the fair value of his stock is given is allowed to separate himself from the corporation.<sup>9</sup> The very essence of appraisal rights lies in the determination of the "fair" value of the shares of those shareholders entitled to appraisal rights. Such determination is solely a matter of justice that involves an internal corporate proceeding on the one hand, and perhaps a judicial appraisal proceeding on the other.

## *2. The Right to Dissent and Appraisal*

### *A. Origins and Evolution*

Appraisal rights have not always existed in corporate law. They originated once unanimous consent was no longer required for shareholders to accept proposals for corporate actions. Once the shareholders of a corporation became entitled to adopt resolutions at shareholders' meetings by majority vote rather than a unanimous vote, a generalized concern emerged with regard to the fragile position of those who had voted against the specific proposals. In particular, the issue became important when the decisions made by the majority of the shareholders resulted in a fundamental change to the corporation or an indirect impairment to the holdings of the minority shareholders who had dissented from the decision at the shareholders' meeting. The theory was that a shareholder who dissented from a significant corporate action had the right to exit the corporation with the fair value of his shares because he could not be compelled to continue in a business that was no longer moving in the direction he wanted.

But it must be noted that, contrary to what might be thought, the appraisal rights, that is the right to dissent and obtain payment of the fair value of shares, were not the end in themselves. At best, they were nothing but a consequence of the accomplishment of the real goal which was the adoption of resolutions by majority vote. They constitute the relief given to those shareholders who under a

<sup>9</sup> A highly regarded "way-out" instrument for the minority is the buy-sell agreement which is "a contract by which the stockholders of a closely held corporation seek to maintain control over the ownership and management of their business by restricting the transfer of its shares." *Stephenson v. Drever*, 947 P.2d 1301 (Cal. 1997).

unanimous-vote approach would have been able to block the adoption of any resolution in a corporation. After the goal was accomplished, a legal right needed to be created to permit shareholders to walk away from a corporation in case of dissent. In that way, the majority shareholders would be able to make decisions, and the dissenting minority would be allowed to exit the corporation after being paid the fair value of its shares, if it dissented from certain major corporate transactions. Thus, appraisal statutes are not only an instrument of protection for the minority, but also a device permitting majority shareholders and directors to run a business with flexibility and control.<sup>10</sup>

The initial evolution of the appraisal remedy was primarily influenced by two ideas. First, a minority shareholder should not stand in the way of a transaction approved by the majority shareholders, and second, appraisal rights should assist the dissenters without creating a great burden for the corporation. Due to the latter, early appraisal statutes entitled shareholders to dissent and receive the fair value of their shares but were silent on the actual method of payment, in an effort to avoid a proliferation of appraisal proceedings. Subsequent statutes became long, complex, and intricate when they began providing for the means of collection of the actual value of the shares. However, courts up to 1962 tended to be increasingly stringent in enforcing appraisal statutes.<sup>11</sup>

It is fair to say that there has been an increasing tendency to accept appraisal actions into courts in the last decades, although not with successful results for the dissenters in every instance. However, currently, the path that leads to appraisal rights is being narrowed to the fullest extent possible, and courts are tending to avoid appraisal proceedings. The current trend is to limit appraisal rights to a number of particular transactions and specific circumstances. In other words, the majoritarianism legacy of appraisal rights is prevailing

10 "In political terms appraisal statutes fill a basic democratic need to protect a dissident minority from the overwhelming power of the majority. In fact, however, the major effect of these appraisal statutes has been quite different from the function generally attributed to them. Almost certainly the statutes have made their major contribution not in shielding the minority, but in giving greater mobility of action to the majority—that is, to corporate managements speaking in the name of the majority." Manning, Bayless, *The Shareholder's Appraisal Remedy: an Essay for Frank Coker*, 72 *Yale L. J.* 223, 226227 (1962).

11 See generally *idem* at 230231.

over the protective approach for the dissenting minority, which is actually fading away.

One Delaware court made the following explicit comment on the historical purposes of the appraisal statutes:

At common law it was in the power of any single stockholder to prevent a merger. When the idea became generally accepted that, in the interest of adjusting corporate mechanism to the requirements of business and commercial growth, mergers should be permitted in spite of opposition of minorities, statutes were enacted in state after state which took from the individual stockholder the right theretofore existing to defeat the welding of his corporation with another. In compensation for the lost right, a provision was written into the modern statutes giving the dissenting stockholder the option completely to retire from the enterprise and receive the value of his stock in money.<sup>12</sup>

In short, the current availability of public markets and the flexibility required to run a business successfully have adequately reduced the exercise of appraisal rights and will continue to do so in the near future.

### *B. Nature of a Dissenter's Right*

Majority stockholders have been known to systematically squeeze-out minority stockholders by removing them from their offices, eliminating cumulative voting, seeking corporate opportunities for the sole benefit of the majority, paying inadequate dividends or failing to pay them at all, and canceling preemptive rights.<sup>13</sup> Such a scenario, although feasible, is more likely extreme. More often than not, it results from deficient planning and counseling, rather than lack of rights or protection for the minority. The bottom line is that in the case of a decision undermining the rights of the minority such as the cancellation of preemptive rights, which would entail an amendment to the corporation's articles of incorporation, minority stockholders have the right to dissent from the resolution adopted at the

<sup>12</sup> *Chicago Corp. v. Munds*, 172 A. 452, 455 (Del. Ch. 1934). See also Manning, *supra* note 10, at 247.

<sup>13</sup> See *Dallas v. Bennett*, No. 92-0899-BH-S, 1993 U. S. Dist. LEXIS 10078.

corresponding shareholders' meeting and obtain from the corporation the fair value of their shares.

The right to dissent becomes a "last-shot" right, the final and conclusive opportunity for a shareholder to prevent himself from being associated with a business that he feels is heading in the wrong direction. The exercise of this corporate device may entail the failure of the rest of the rights awarded to the minority, which are purported not to give a "way out" from a corporation, but to make a difference on it and to some extent make minority shareholders' opinion prevail on the decisions of the corporation.

A shareholder is then entitled to vote, regardless of the effect it will have on the outcome of a shareholders' meeting. It is the right to dissent which allows a minority shareholder to disagree with the decision made by the majority, refrain from continuing any corporate activity, and obtain the fair value of his shares.<sup>14</sup>

A threshold issue that has to be addressed in order to accurately understand the legal nature of the right to dissent is when such right is triggered. Professors Catherine Habermehl and David R. Koepsell assert that in general the MBCA offers dissenters' appraisal rights for any situation in which the majority shareholders effect a fundamental change in the corporation such as an amendment to the articles of incorporation or a major corporate transaction.<sup>15</sup> The MBCA section 13.02 provides that a shareholder is entitled to dissent from, and obtain payment of the fair value of his shares in the event of, a consummation of a plan of merger to which the corporation is a party,<sup>16</sup> consummation of a plan of share exchange in which the cor-

14 This right is a shareholders' appraisal remedy and it has been noted that it has the following purposes: (i) to serve as a *quid pro quo* for the loss of the right to veto fundamental transactions; (ii) to provide liquidity to keep shareholders from being locked into an investment in a corporation that has been fundamentally changed; (iii) to remedy a potential constitutional problem with statutes that permit a majority of shareholders to decide whether to engage in a fundamental transaction; (iv) to free the majority from the "tyranny of the minority"; (v) to further "discovery" of corporate wrongdoing in connection with the approval of a fundamental transaction; (vi) viewed *ex ante*, to relieve shareholders from concerns arising out of coordination problems or problems associated with the appropriation of corporate value by insiders; (vii) to serve as a check on corporate managers; and (viii) to assure that shareholders whose investments are terminated by a cash out merger receive fair value for their shares. See Wertheimer, Barry M., *The Purpose of the Shareholders' Appraisal Remedy*, 65 Tenn. L. Rev. 661 (1998).

15 See Stecher, *supra* note 6, at 276.

16 This is in case shareholder approval is required for the merger pursuant to MBCA section 11.03 or the articles of incorporation, and the shareholder is entitled to vote on the



poration's shares are acquired; consummation of a sale or exchange of all, or substantially all, of the property of the corporation other than in the usual and regular course of business;<sup>17</sup> an amendment of the articles of incorporation that materially and adversely affects rights in respect of a dissenter's shares;<sup>18</sup> or any corporate action taken pursuant to a shareholder vote to the extent the articles of incorporation, bylaws, or a resolution of the board provide that shareholders are entitled to dissent and obtain payment for their shares.

Professor F. Hodge O'Neal concludes that the risk of hardship or injustice to minority shareholders from mergers<sup>19</sup> and certain other fundamental corporate changes is mitigated somehow by statutes, often referred to as "appraisal statutes" or "dissenters' rights statutes," which authorize a shareholder that dissents from such a transaction to demand that the corporation purchase his shares at their fair value. "Dissenters' rights statutes are designed to protect non-assenting shareholders against being forced to accept membership in an enterprise fundamentally different from the one in which they originally invested or to participate on a basis drastically different from the one they contemplated when they invested."<sup>20</sup>

*Good v. Lackwana Leather Company*,<sup>21</sup> the nature of the right to dissent was underscored by stating that the general reason for dissenters' rights is that shareholders should not be forced against their will into something fundamentally different from that for which they impliedly bargained when they acquired their shares.

merger, or if the corporation is a subsidiary that has merged with its parent under MBCA section 11.04. See MBCA 13.02(a)(1) (1984).

17 A sale pursuant to court order or a sale for cash pursuant to a plan by which the net proceeds of the sale will be distributed to the shareholders within one year after the date of sale is not considered to be included under this provision. See *idem* 13.02(a)(3).

18 For example, an amendment that alters or abolishes a preferential right of the shares, creates, alters or abolishes a right in respect of redemption, alters or abolishes a preemptive right, or excludes or limits the right of the shares to vote on any matter or to cumulate votes. See *idem* 13.02(a)(4).

19 Mergers under this context can be referred as cash-out mergers, which basically implies that there is a cash payment to some of the shareholders of a corporation in consideration of their shares, instead of an issuance of new shares as a result of the merger. It is also relevant to address the concept of freeze-out mergers, in which a minority shareholder is forced to accept cash or debt securities for his or her shares rather than stock in the surviving corporation. See Schwenk, *supra* note 2, at 649.

20 O'Neal, *supra* note 5, at 326.

21 *Good v. Lackwana Leather Co.*, 233 A.2d 201 (N. J. Super. Ct. Ch. Div. 1967).

The right is two-fold: a right to dissent and a right to obtain the fair value of the holding shares. It would be fair to say that the latter is nothing but the aftermath of the former, but it must be understood that a shareholder cannot only dissent from the corporate actions referred to by MBCA section 13.02, he can actually dissent from any corporate matter provided that he will have the additional right of payment of the value of his shares only if the dissent concerns one of the corporate matters specified in section 13.02. In other words, the right to dissent can be exercised regardless of what the matters of the agenda are at a shareholders' meeting (a shareholder can not be forced to agree with the rest of the shareholders), whereas the right to obtain fair-value payment of shares is linked to the right to dissent and can only be enforced pursuant to the specific provisions of the MBCA. Together, the right to dissent and the right to obtain fair value payment of shares shall be referred as dissenters' rights or appraisal rights.

The protection purported by dissenters' rights has two major gaps. First, they can only be exercised over a few transactions, which is fair and consistent with corporate control principles. And second, not all, but only a few, of those transactions utilized to drastically restructure a company or fundamentally change a shareholder's right to participation trigger dissenters' rights. In other words, the majority can often utilize a type of transaction that does not carry dissenters' rights to achieve a corporate restructuring that if attempted differently would give a dissenting minority shareholder the opportunity to have his shares purchased.

Just as in the case of buy-sell agreements,<sup>22</sup> dissenters' rights give a "way out" to the minority whenever its interests conflict with those of the majority or the business no longer fulfills its expectations. The importance of this right is more remarkable in the context of closely held businesses where there is a lack of marketability of shares. The market available to minority shareholders of a closed corporation to transfer their shares is minimal and often full of constraints. Hence, the possibility of selling shares owned by the minority in case

22 A typical buy-sell agreement provides for the mandatory or optional repurchase of a stockholder's shares by the corporation or by the other stockholders upon the occurrence of a certain event, such as the termination of employment. See *Stephenson v. Drever*, 947 P.2d 1301 (Cal. 1997).

of dissent is a significant achievement in the uphill battle to protect minority's interests.

One final point pertaining to the gaps and achievements of dissenters' rights bears mentioning. Such rights fail to keep the minority as shareholders, as owners of a corporation, as active entrepreneurs. Minority shareholders are moved to participate in a venture by their own business interests; in case of dissent their only feasible choice, if any, is to sell. Therefore, without actually wishing it to happen, their business interests are no longer being advanced. But then again, such misfortune is outweighed by the sound rule of law that the majority has the right to control.<sup>23</sup>

### *C. The "Fair Value" of Shares*

The payment of the fair value<sup>24</sup> of the shares owned by the dissenters pursuant to the provisions of MBCA section 13.02 is the material objective and consequence of the appraisal rights. Such payment must be carried out by the corporation. The controlling shareholders must make a tender offer to the dissenters to purchase their shares, an offer that is supposed to be the fair value of such shares. Unfortunately, the purported payment by the corporation may not be fair or even realistic, although it must be noted that the price offered to the dissenters might actually be higher than the real value of the shares. This is a consequence of the fact that the offer made to the minority is often based on prior sales of shares to new shareholders of the company or on the market price of the shares for publicly held corporations, rather than on an objective valuation of the shares based on experts' opinions and valuation techniques such as "discounted cash flow" or "stream of payments."

When dissenters become dissatisfied with the purchase prices tendered by the corporation, suits are brought seeking an appraisal remedy to determine the fair value of the shares. "Courts must convert the statutory fair value standard into one that is judicially adminis-

23. See *Southern Pac. Co. v. Bogert*, 250 U. S. 483, 487-488 (1919).

24. MBCA section 13.01(3) defines "fair value", with respect to a dissenter's shares, as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable." MBCA 13.01(3) (1984).

trable.”<sup>25</sup> “The appraisal remedy provides compensation for those shareholders who dissent from a merger, sale of assets, or change in structure decision by the majority. The right, now brought to court, aims to provide for an appraisal of the dissenting shareholders’ stock, and for the corporation to purchase such stock at the appraised price.”<sup>26</sup> However, as Professor Robert W. Hamilton points out, the following problems exist with this remedy: (i) the shareholders must litigate with the corporation as to the fair value issue; (ii) the shareholders must bear their own litigation expenses; and (iii) the method of valuation routinely used in most states may not yield a valuation that is realistic.<sup>27</sup> Thus, what proceeding guarantees a fair valuation? Is it the corporate proceeding or the judicial? And even more fundamentally, what does “fair” really mean under this valuation context? Is there any valuation technique that yields a completely fair result? “Fairness” can be reached both in corporate and judicial proceedings by implementing flexible valuation techniques in accordance with the particular situation of the corporation.

In *Lawson Mardon Wheaton Inc. v. Smith*,<sup>28</sup> two fundamental principles were restated by the court. First, the shareholder who disapproves of a proposed merger or other major corporate change gives up his right of veto in exchange for the right to be bought out, not at market value, but at fair value. Second, an appraisal proceeding is a limited legislative remedy intended to provide shareholders dissenting from a merger (or other major corporate change) on grounds of inadequacy of the offering price with a judicial determination of the intrinsic worth (fair value) of their shareholdings.

The “fair result” pursued by appraising the shares of the dissenters is definitely not readily calculated; conceptually, it is already hard to determine what is a fair result under this scenario. It can be said however, that at first glance, it all comes down to the following: (i) investment in a corporation is supposed to bring profits, the higher the risk in the venture, the higher the expected earnings; (ii) a bu-

25 Schwenk, *supra* note 2, at 649.

26 *Ibidem* at 657.

27 See Hamilton, Robert W., *Corporations Including Partnerships And Limited Liability Companies, Cases And Materials* 790791 (6th ed. 1998).

28 *Lawson Mardon Wheaton Inc. v. Smith*, No. A-5870-96T1, A-5879-96T1, 1998 N. J. Super. LEXIS 375.

siness can be successful or run out of luck; and (iii) the fair value of the shares paid to the dissenters must compensate shareholders for their investments, expectations, and results in a corporation.

#### *D. The Corporate Process to Exercise Appraisal Rights*

Sections 13.20 to 13.28 of the MBCA refer to the procedure for exercising appraisal rights within a corporation, that is, before resorting to the courts. The proceeding is summarized by Professors Harbermehl and Koepsell as follows:

a dissenter must, in order to prevail under the MBCA not have voted in favor of the proposed action and must, within thirty to sixty days of receiving notice of the proposed changes, file a written notice of his intent to demand payment. The dissenter's notice must be given before a vote is actually taken or else he becomes unable to be paid for his shares. Within ten days of the corporate action, the corporation must send a dissenter's notice to those who dissented from that action. This notice must indicate to the shareholder where and when his demand for payment must be sent and in what manner the shares will be exchanged. If the shareholder fails to comply with the requirements of the notice, he loses his rights as a dissenter. If the dissenter complies with the notice, then it must pay the dissenter the amount which it considers to be the fair value of the dissenter's shares and include with the payment corporate financial statements and other explanatory materials. If the dissenter does not agree with the corporate valuation he may then make his own determination of value and interest due and demand payment. If the parties are unable to compromise, the corporation must commence a judicial valuation proceeding.<sup>29</sup>

Under this proceedings it is not clear who has the responsibility of determining whether there is an entitlement to exercise the appraisal right. In other words, the statute fell short in its effort of asserting the corporation's or court's obligation of deciding when appraisal rights may be exercised.

<sup>29</sup> Stecher, *supra* note 6, at 276.

### *E. Goals of the Judicial Appraisal Remedy*

By providing for dissenters or appraisal rights, the MBCA has given the minority an opportunity to exit the corporation under certain limited circumstances. Actually, it cannot be said that appraisal rights are an absolute right to exit, as there are many corporate resolutions, such as those dealing with earnings and distributions of the corporation, that are of significant importance and that affect the interests of the shareholders, but that do not create appraisal rights. A corporation is prohibited from allocating dividends among its shareholders<sup>30</sup> but it may choose to distribute its profits as salaries among its directors and executive officers<sup>31</sup> who may happen to be controlling shareholders. This kind of corporate action effectively squeezes out the minority shareholders. Such actions seal the destiny of the minority in a closely held corporation, where by definition there is no market to sell stock.<sup>32</sup> Only under extreme circumstances is the minority allowed to dissent and receive payment for its investment in a venture.

Most of the provisions of Chapter 13 of the MBCA deal with the internal proceeding of a corporation when handling dissenters' rights, where the actual goal is to come up with a determination of the fair value of the shares of the dissenters without resorting to judicial proceedings. Unfortunately, the goal is not likely to be achieved in certain situations, so suits are brought into courts seeking an appraisal remedy.<sup>33</sup> The determination of the fair value of the shares then

30 It must be noted, however, that the Internal Revenue Service can impose tax penalties on any entity that stores too much of its profit. An active pursuit by the board of directors along with the squeezing-out of the minority could amount to federal securities violation as well. See Stecher, *supra* note 6, at 269.

31 By excluding the minority from salaried employment as officers or directors, refusing to declare dividends, or eliminating any other privileges that might flow to the minority from the corporation, the majority in use of its right to control is able to frustrate the minority's basic expectation to share proportionally in corporate gains.

32 In *Fulton v. Callahan*, the court stated that because of the limited marketability of the shares of closely held corporations and the right of the majority to control corporate decision-making, the minority depends on the majority treating it fairly, as it is restricted in its ability to realize the value of its investment. See *Fulton v. Callahan*, 621 So.2d 1235, 1245 (Ala. 1993).

33 "The origin of the appraisal remedy typically is tied to the move in corporate law to majority approval of fundamental corporate changes, and away from a requirement of unanimous shareholder consent. When unanimous approval was no longer required, and shareholders effectively lost their individual right to veto corporate changes, the appraisal remedy was provided to them in return. Thus, the historical explanation for the existence of the appraisal remedy is

shifts from the controlling shareholders to the plenary and exclusive jurisdiction of a court. It is important to keep in mind that by shifting the task of valuation<sup>34</sup> from the corporation to the courts, the possible squeeze-out of the minority is avoided. By definition, courts should yield fair resolutions. But, how effective are their valuation techniques in accomplishing that goal? To what extent is the exclusiveness of one court in dealing with these matters detrimental to the parties? To the minority? It is possible that, in certain circumstances, a judicial appraisal proceeding may not only fail to yield a fair valuation, but may also fail to be fair in itself:

The key to the effectiveness of the appraisal remedy in protecting minority shareholder interests lies in the way in which courts appraise minority shares. If courts do not appraise shares in a manner consistent with the appraisal remedy's purpose of protecting minority shareholders, such shareholders will ignore the appraisal remedy in favor of other means of challenging fundamental transactions, principally breach of fiduciary duty claims, which may be less efficient and more time consuming to resolve.<sup>35</sup>

In *Hansen v. 75 Ranch Co.*<sup>36</sup> the Supreme Court of Montana advocated the "fairness" with respect to dissenters' shares that must be present in any judicial appraisal proceeding. Pursuant to the Montana Business Corporation Act, dissenters' rights statutes enable shareholders who object to extraordinary corporate transactions to dissent from the corporate action and to require the corporation to buy their shares at fair value. In view thereof, the Court held that minority shareholders were entitled to statutory notice of dissenters' rights and fair value of their shares. A dissenting shareholder's position should

a *quid pro quo* for the loss of shareholders' right to veto fundamental corporate changes." Wertheimer, Barry M., *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L. J. 613, 614 (1998).

34 It must be noted that valuation tasks are carried out by courts not only in appraisal proceedings arising out of dissenters' rights but also under several other related corporate proceedings such as freeze-outs or oppression actions. The Supreme Court of North Dakota held in *Balvik v. Sylvester* that the appropriate remedy for a minority shareholder that had been squeezed-out by the majority was to order the corporation or the majority to purchase its stock at a price determined by the court to be the fair value. *Balvik v. Sylvester*, 411 N.W.2d 383.

35 Wertheimer, *supra* note 33, at 626.

36 *Hansen v. 75 Ranch Co.*, 957 P.2d 32 (Mont. 1998).

be the equivalent of what it would have been had the fundamental change not occurred, hence, fair value<sup>37</sup> shall be construed as the value of the shares immediately before the effectuation of the corporate action<sup>38</sup> to which the dissenter objects.

The basic concept of value under the appraisal statute is that the stockholder is entitled to be paid for that which has been taken from him, e. g., his proportionate interest in a going concern. The value of the stockholder's proportionate interest in the corporate enterprise is the true or intrinsic value of the stock that has been taken by the merger. In determining this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which could reasonably enter into the fixing of value.<sup>39</sup>

The primary purpose of an appraisal action is to assign an appropriate dollar value to the dissenting shareholder's stock.<sup>40</sup>

The real purpose of the remedy is not ex post protection of minority shareholders, but is instead to create an ex ante provision to raise the total value of all shareholders' holdings in the corporation.<sup>41</sup>

In sum, the real and exclusive goal of the appraisal remedy is the determination of the fair value of the shares in question. The relevance of the appraisal remedy is that it supersedes a duty that was originally held by the corporation. Its downside is that it is expensive and not always fair.

37 A relevant case on appraisal proceedings and fair value in case of dissent is *Steiner Corporation v. Benninghoff*, whereby the court, by analyzing a merger transaction that carried along the exercise of dissenters' rights, went into the task of explaining the process that shall be followed in the "fair value" appraisal of shares, stating that "fair value" would be determined by considering (i) the premerger market value of the shares, discounted for illiquidity; (ii) the premerger enterprise value of the corporation as a whole; (iii) the premerger net asset value of the corporation; and (iv) any other factor bearing on value. Each measure of value is given a certain weight, and then averaged appropriately. See *Steiner Corp. v. Benninghoff*, 5 F. Supp. 2d 1117 (U. S. Dist. 1998).

38 A corporation may rescind its corporate action after appraisal rights have vested only within a reasonable time after the effective date of the corporate action. See *Strasburgh v. Straubmuller*, 683 A.2d 818 (N. J. 1996).

39 See *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950).

40 Reid, David S., *Dissenters' Rights: An Analysis Exposing the Judicial Myth of Awarding Only Simple Interest*, 36 *Ariz. L. Rev.* 515, 517 (1994).

41 Schwenk, *supra* note 2, at 657.



The appraisal remedy encourages management to avoid the costs of appraisal—which can be quite large if a significant number of dissenters create a liquidity crisis at precisely the time when the demands of the transaction require that the corporation retain as much capital as possible—in certain situations, creating an incentive to maximize the value of the firm during transactions that might trigger the remedy.<sup>42</sup>

#### *F. The Statutory Process to Request Judicial Appraisal of Shares*

The judicial appraisal of shares in case of dissent is contemplated by the MBCA in sections 13.30 and 13.31. As stated previously, judicial appraisal is sought when controlling and dissenting shareholders are unable to agree on the payment of the value of shares. The corporation, rather than the affected shareholders, initiates the proceeding by petitioning the court to determine the fair value of the shares within sixty days after receiving the payment demand.<sup>43</sup> All dissenters whose demands remain unsettled are made parties to the proceeding. The jurisdiction of the court in which the suit is brought is plenary and exclusive.<sup>44</sup>

With respect to the valuation itself, the MBCA authorizes the court to appoint one or more appraisers to determine a fair value of the shares in question. The court will generally assess the costs of the proceeding to the corporation, but under certain circumstances, it may assess the costs to the dissenters.<sup>45</sup>

The MBCA does not address the issue of how the court actually conducts the valuation of the shares. It provides that the court may appoint appraisers to do the job, but it fails to establish guidelines

<sup>42</sup> *Idem*.

<sup>43</sup> If the corporation does not commence the proceeding within the allocated time, it must pay each dissenter whose demand remains unsettled the amount demanded.

<sup>44</sup> That a jurisdiction is plenary and exclusive means that there is no right to appeal the decision of the court and that there is no possibility of change of venue. However, it might be arguable the feasibility of bringing action against a judicial appraisal resolution. There is no reason to provide for an exception in these cases and that appraisal proceedings should be subject to regular civil procedure rules.

<sup>45</sup> The court may as well also assess fees and expenses of counsel and experts for the respective parties, against either the corporation or the dissenters. See MBCA sections 13.30 and 13.31 (1984).

as to the valuation process and the appraisal techniques that are available. Which valuation technique is more reliable? Under what circumstances it is recommendable to use one or another?

Certainly, it would be useless to assert that one valuation technique must be used in every case or that an average of the results of several valuations shall be the right answer. However, an indication of the valuation techniques available and guidelines for evaluating them pursuant to the circumstances of each business would be of great value. On the other hand, as will be shown, the trend with respect to valuation proceedings is to rely on the opinion of experts, and therefore, it might be a good idea to provide for such opinions in model statutes, rather than leave it to case law.

### *3. The Proposed Amendment of the MBCA*

The Committee on Corporate Laws of the Section of Business Law of the American Bar Association (hereinafter defined as the "Committee") has recently prepared a report covering proposed amendments to Chapter 13 of the MBCA, which deals with appraisal rights (hereinafter defined as the "Amendment").<sup>46</sup> The Committee has adopted the Amendment on third reading but its publication is still pending, therefore, the considerations and references made in this article in connection with this matter are based on the Amendment as adopted on second reading and duly published. In addition to the changes made to statutory provisions, the Committee has drafted changes to the Official Comment to Chapter 13, including an overview which sets forth the position of the Committee on basic issues of appraisal rights. The Amendment incorporates significant changes and new concepts, and shows a new trend in appraisal rights and judicial appraisal proceedings. Because of the Amendment's likely enactment, its analysis is essential for the purposes of this article.

The Amendment primarily limits (i) the corporate actions from which a shareholder is entitled to appraisal rights and (ii) the circumstances under which a shareholder is entitled to appraisal rights

<sup>46</sup> See Comm. on Corp. Laws, A. B. A., *Proposed Changes in the Model Business Corporation Act-Appraisal Rights*, 54 Bus. Law. 209251 (1998).

and to resort to the courts for a judicial appraisal of his shares. As to the judicial appraisal of shares, the proposed Official Comment provides that

Chapter 13 proceeds from the premise that judicial appraisal should be provided by statute only when two conditions co-exist. First, the proposed corporate action as approved by the majority will result in a fundamental change in the shares to be affected by the action. Second, uncertainty concerning the fair value of the affected shares may cause reasonable persons to differ about the fairness of the terms of the corporate action.<sup>47</sup>

Unfortunately, no express explanation is given with respect to the limitations on corporate actions from which a shareholder is entitled to appraisal rights, but it may be inferred that the limits are based on the flexibility sought by the majority shareholders and directors to run the business.

The Amendment provides for a new set of definitions under section 13.01 of the MBCA. By and large, the most important of those definitions is the definition of "fair value." While the Amendment maintains the concept that "fair value" is the value of the corporation's shares determined immediately before the effectuation of the corporate action to which the shareholder objects, it adds that "fair value" shall be determined (i) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and (ii) without discounting for lack of marketability or minority status, except when appropriate for amendments to the articles of incorporation.<sup>48</sup>

The new definition of "fair value" constitutes a significant improvement in the appraisal process inasmuch as it establishes for the first time a guideline to appraise shares in case of dissent. Of course, a reference to "customary and current valuation concepts and techniques" falls short in an attempt to guarantee a completely fair valuation because it allows the arbitrary use of any valuation technique regardless of the conditions of a business. However, the mere reference to valuation concepts and techniques is a significant achieve-

<sup>47</sup> *Ibidem* at 212.

<sup>48</sup> *See ibidem* at 210.

ment of the Amendment, and is likely to result in more detailed and thorough appraisals of shares. The proposed Official Comment sets forth that the new formulation of “fair value” is patterned on section 7.22 of the Principles of Corporate Governance promulgated by the American Law Institute. It further asserts that modern valuation methods normally result in a range of values, and that a court determining fair value should give great deference to the aggregate consideration accepted or approved by a disinterested board of directors for an appraisal triggering transaction.<sup>49</sup> From such assertion, an obvious question can be raised: where and when is a disinterested board of directors found? Excessive reliance on the aggregate consideration of a “disinterested board of directors” thwarts the goal of the appraisal remedy to yield an objective and fair value of the shares of the dissenter. The approach of the Amendment in this regard evidences two major issues on appraisal rights. First, in case of appraisal rights, the corporation shall attempt to determine the fair value payment of the dissenting shares without resorting to courts. Second, and most important, even in the event of judicial intervention in the appraisal process, great deference must be given to the tender offer made by the corporation to the dissenters for the value of their shares.

With respect to the provision stating that “fair value” is determined without discounting for lack of marketability or minority status, the proposed Official Comment states that such provision “is also designed to adopt the more modern view that appraisal should generally award a shareholder his or her proportional interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder’s shares when valued alone.”<sup>50</sup>

Section 13.02 of the MBCA deals with the corporate actions from which a shareholder is entitled to appraisal rights and to obtain payment of the fair value of his shares. Under section 13.02 of the Amendment,<sup>51</sup> the consummation of mergers remains the primary corporate action triggering appraisal rights. So long as shareholder approval is required for the merger and the shareholder is entitled to vote on the merger, the shareholder is entitled to appraisal rights.

49 See *ibidem* at 21516.

50 *Ibidem* at 216.

51 See *ibidem* at 21822.

The Amendment, however, denies appraisal rights to any shareholder of the corporation owning shares of any class or series that remains outstanding after consummation of the merger. Likewise, the consummation of a share exchange in which the corporation's shares will be acquired entitles a shareholder to appraisal rights, with the exception of shareholders whose shares are unaffected by the exchange. Such shareholders are similarly denied appraisal rights.

In short, section 13.02 of the Amendment provides for the following major changes: (i) it extends appraisal rights to any disposition of assets pursuant to MBCA section 12.02<sup>52</sup> if the shareholder is entitled to vote on the disposition; (ii) when the articles of incorporation are amended with respect to a class or series of shares, it limits the availability of appraisal rights to situations in which the number of shares of a class or series owned by the shareholder are reduced to a fraction of a share and the corporation has the obligation or right to repurchase the fractional shares so created;<sup>53</sup> (iii) it eliminates a shareholder's entitlement to appraisal rights in case of an amendment of the articles of incorporation that, *inter alia*, alters or abolishes a preferential right of the shares or a preemptive right of the holder of the shares to acquire shares or other securities, or eliminates or limits the right of the shareholders to vote on any matter, or to cumulate votes; and (iv) it limits the scope of appraisal rights to amendments to the articles of incorporation, mergers, shares exchanges, and disposition of assets to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors, rather than allow the exercise of appraisal based on any corporate action approved by a shareholder vote.

The last of the above-mentioned changes deserves particular attention because it sets out the framework of appraisal rights. Appraisal rights are only available in case of merger, share exchange, disposition of assets, or limited amendment of the articles of incorporation, and only to the extent provided by corporate instruments. The pro-

52 Minimally, shareholders of all classes or series of the corporation that are generally entitled to vote on matters requiring shareholder approval would be entitled to assert appraisal rights. See *ibidem* at 223.

53 The reasons for granting appraisal rights in this situation are similar to those for granting such rights in cases of cash-out mergers, as both transactions could compel affected shareholders to accept cash for their investment in an amount established by the corporation. See *ibidem* at 225.

posed Official Comment states that an express grant of voluntary appraisal rights is intended to override any of the exceptions to the availability of appraisal rights. It further asserts, in an unclear manner, that any voluntary grant of appraisal rights by the corporation to the holders of one or more of its classes or series of shares will thereby automatically make all of the provisions of Chapter 13 applicable to the corporation and such holders with respect to the particular corporate action.<sup>54</sup> It may be inferred that the proposed Official Comment is referring only to voluntary grants of appraisal rights provided by the appraisal statutes and not to any other corporate action because otherwise there would be no change from the approach of the current version of the MBCA. In any event, it would be important to clarify this issue before enacting the Amendment as law.

Additionally but most importantly, section 13.02 of the Amendment sets forth the so called "market exception to appraisal rights", which is an innovation in the appraisal statutes that excludes, under certain circumstances, the entitlement to appraisal rights for holders of shares traded in public markets. This is the most radical change proposed by the Amendment, and it has been influenced by two main ideas. First, public companies have a market to trade their shares and such a market is a ready exit for any shareholder who dissents from a corporate action. Second, the market price of shares represents in general terms a "fair value" for the shares, and therefore there is no need for appraisal rights. As stated by the proposed Official Comment, "this provision is predicated on the theory that where an efficient market exists, the market price will be an adequate proxy for the fair value of the corporation's shares, thus making appraisal unnecessary."<sup>55</sup>

In sum, the Amendment establishes a limited exception to the availability of appraisal rights for the holders of shares of any class or series of shares which is a) listed on the New York Stock Exchange or the American Stock Exchange or one designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc.; or b) not so listed or designated, but with at least 2,000 shareholders and with

<sup>54</sup> See *ibidem* at 225.

<sup>55</sup> *Ibidem* at 226.

the outstanding shares of such class or series with a market value of at least \$20 million (exclusive of the value of such shares held by its subsidiaries, senior executives, directors, and beneficial shareholders owning more than 10 percent of such shares). However, the above-mentioned exception is not applicable and appraisal rights are available for the holders of any class or series of shares who, by the terms of the corporate action requiring appraisal rights, are required to accept for such shares anything other than cash or shares or any other proprietary interest. Shareholders are therefore assured of receiving either appraisal rights, cash from the transaction, or shares or other proprietary interests in the survivor entity.

Similarly, section 13.02 of the Amendment limits the applicability of the market exception to appraisal rights in case of "conflict transactions." The provisions in this regard are:

designed to assure reliability by recognizing that the market price of, or consideration for, shares of a corporation that proposes to engage in a Section 13.02(a) transaction may be subject to influences where a corporation's management, controlling shareholders or directors have conflicting interests that could, if not dealt with appropriately, adversely affect the consideration that otherwise could have been expected.<sup>56</sup>

In the words of the proposed Official Comment, section 13.02(b)(4)(i):

covers two possible conflict situations: subsection (A) covers the acquisition or exchange of shares or assets of the corporation by a shareholder or an affiliate of the shareholder that could be considered controlling by virtue of ownership of a substantial amount of voting stock (20 percent); and subsection (B) covers the acquisition or exchange of shares or assets of the corporation by an individual or group, or by an affiliate of such individual or group, that has the ability to exercise control, through contract, stock ownership, or some other means, over at least one-fourth of the board's membership.<sup>57</sup>

<sup>56</sup> *Ibidem* at 227

<sup>57</sup> *Idem* It must be noted that under section 13.01 of the Amendment, an "affiliate" is "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with another person or is a senior executive thereof." *Ibidem* at 210. For the purposes of section 13.02(b)(4), a person is considered to be an affiliate of its senior executives. *See idem*.

Section 13.02(b)(4)(ii), on the other hand, “covers the acquisition or exchange of shares or assets of the corporation by a person, or an affiliate of a person, who is, or in the year leading up to the transaction was, a senior executive or director of the corporation.”<sup>58</sup> The market exception is also not available for transactions involving other types of economic benefits afforded to senior executives and directors in specified conflict situations, unless specific objective or procedural standards are met.<sup>59</sup>

The wisdom of the whole idea of the market exception to appraisal rights can be questioned particularly in cases where the market for the shares of a corporation is thin and unsophisticated. Under a market-exception approach, market price is equivalent to “fair value.” As mentioned, the theory is predicated on the idea of the existence of an efficient market, and thus, one should ask what circumstances create an efficient market, and then, even under efficient-market conditions, whether the market price can constitute a proxy for the fair value of the shares of the dissenters. In general terms, where there is a large number of investors and traders and reliable information available to them, an efficient market can exist and the market price of shares can be regarded as a fair value. However, where these conditions are not met, the market price is unlikely to represent the fair value of shares for appraisal rights purposes, and therefore appraisal rights should always be available to the dissenters. The bottom line is that, by providing for this exception, the Amendment is, under certain circumstances: (i) forcing minority shareholders to forego their right to a valuation; (ii) relieving controlling shareholders from incurring the cost of a corporate valuation; and (iii) thrusting market price as a valuation parameter for appraisal proceedings. Market price is taking and will continue taking a predominant position in the determination of the fair value of shares in appraisal proceeding. The limitations to the disputable wisdom of the market exception under the Amendment seem self-explanatory.

Section 13.02 of the Amendment provides for an additional change to appraisal rights. It gives a corporation the option to limit or

<sup>58</sup> *Ibidem* at 228. It must be noted that under section 13.01 of the Amendment, a “senior executive” is “the chief executive officer, chief operating officer, chief financial officer, and anyone in charge of a principal business unit or function.” *Ibidem* at 211.

<sup>59</sup> See *ibidem* at 228.



eliminate appraisal rights for any class or series of preferred shares, as long as it is provided in the articles of incorporation.<sup>60</sup> Section 13.02 additionally details the “exclusivity of appraisal rights,” as defined by the proposed Official Comment,<sup>61</sup> by saying that a shareholder entitled to appraisal rights may only challenge a completed corporate action for which appraisal rights are available in limited situations: when the action was not effectuated in accordance with the law or the corporation’s articles of incorporation, by laws, or board of directors’ resolution authorizing the corporate action, and when the action was approved as a result of fraud or material misrepresentation. In other words, a legal corporate transaction that triggers appraisal rights gives to the dissenting shareholders’ only one option, if any, to exit the corporation with the fair value of their shares.

The proposed amendment of section 13.20 of the MBCA expressly empowers the corporation to determine if appraisal rights are or may be available to shareholders in the voting of a corporate action. Such purported provision does not add any significant meaning to the current statute, but it does show a trend to limit the exercise of appraisal rights and reduce the protection of minority shareholders. Again, this provision and the one referring to the market exception to appraisal rights reflect the courts’ inclination to avoid dealing with appraisal rights unless strictly necessary.

Sections 13.20 to 13.26 of the Amendment<sup>62</sup> deal with the procedure for exercise of appraisal rights within the corporation. One provision of particular significance is section 13.22 of the Amendment. Pursuant to the Amendment, the appraisal notice, which must be delivered by the corporation to all shareholders when a proposed corporate action requiring appraisal rights becomes effective, must state,

60 “Any such limitation or elimination contained in an amendment to the articles of incorporation that limits or eliminates appraisal rights for any of such shares that are outstanding immediately prior to the effective date of such amendment or that the corporation is or may be required to issue or sell thereafter pursuant to any conversion, exchange or other right existing immediately before the effective date of such amendment shall not apply to any corporate action that becomes effective within one year of that date if such action would otherwise afford appraisal rights.” *Ibidem* at 221.

61 *See ibidem* at 22930.

62 *See ibidem* at 23247.

*inter alia*, the corporation's estimate of the fair value of the shares, as well as be accompanied by a copy of Chapter 13 of the MBCA.

A new provision has been included in section 13.23 of the Amendment. It is the right of a dissenting shareholder to withdraw from the appraisal process even after complying with a substantial part of the requirements to exercise appraisal rights. In order to decline to exercise appraisal rights and withdraw from the appraisal process, the shareholder must notify the corporation in writing by the date set forth in the appraisal notice pursuant to section 13.22. A shareholder who fails to so withdraw from the appraisal process may not thereafter withdraw without the corporation's written consent. The proposed Official Comment does not give an explanation as to the inclusion of this provision. It seems to be intended to give the shareholders and the corporation an additional opportunity to reach an agreement in order to avoid the burden of dealing with appraisal rights and judicial appraisal proceedings.

Under the Amendment, the procedure to actually obtain payment of the shares has been changed. The Amendment may be summarized in general terms. The appraisal notice sent by the corporation must supply a form that specifies the date that the principal terms of the proposed corporate action were first announced to the shareholders. In addition, the shareholder asserting appraisal rights must certify whether or not beneficial ownership<sup>63</sup> of the shares for which appraisal rights are asserted was acquired before the date and that the shareholder did not vote in favor of the transaction. The shareholder's certification must be received by the corporation no more than 60 days after the appraisal notice and form are sent. Within 30 days after the shareholder's certification is due, the corporation must pay, in cash, the amount that it estimates to be the fair value of the shares, plus interest. A corporation may elect to withhold payment from any shareholder who did not certify that beneficial ownership was acquired before the date set forth in the appraisal notice. The corporation must notify the corresponding shareholders of the information required and request that they accept the corporation's esti-

63 Section 13.01 of the Amendment defines a beneficial shareholder as "a person who is the beneficial owner of shares held in a voting trust or by a nominee on the beneficial owner's behalf." *Ibidem* at 210.

mate of fair value and notify it of such acceptance within 30 days after receiving the offer. Within 10 days after receiving the shareholder's acceptance and in full satisfaction of the shareholder's demand, the corporation must pay the agreed amount to each shareholder that accepted the corporation's offer. A shareholder dissatisfied with the suggested amount of the payment must notify the corporation in writing his estimate of the fair value and demand payment of that estimate plus interest. A shareholder who fails to notify the corporation of his demand for payment within 30 days after receiving the corporation's payment or offer of payment waives the right to demand payment and shall be entitled only to the payment made or offered. Finally, if the demand for payment remains unsettled, the corporation shall commence a proceeding within 60 days after receiving the payment demand and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the 60-day period, it shall pay in cash to each shareholder the amount the shareholder demanded. The remaining provisions on the judicial appraisal proceeding covered in the Amendment by section 13.30 remain relatively unchanged, except for the express mention in the Amendment that there shall be no right to a jury trial. The provisions of the Amendment on the procedure for exercise of appraisal rights are similar in essence to the current provisions of the MBCA, however the actual procedure has changed and several peculiarities have been included.<sup>64</sup>

Finally, section 13.31 of the Amendment has fairly provided that to the extent a corporation fails to make a required payment of shares, the shareholder may sue directly for the amount owed and, to the extent successful, shall be entitled to recover from the corporation all costs and expenses of the suit, including counsel fees.

<sup>64</sup> For a detailed review of the procedure for exercising appraisal rights and its peculiarities, see primarily sections 13.24, 13.25, 13.26 and 13.30 of the Amendment. See *ibidem* at 24148.

#### 4. *The Judicial Fair Valuation Process*

##### A. *Introduction*

There is general agreement that the fundamental goal of valuation is to determine the fair market value of a business, which in turn is defined as the price that would be established by a buyer and a seller in an arm's-length negotiation for the purchase and sale of the business, with both parties ready, willing, and able to enter into the transaction, under no compulsion to enter into the transaction, and having complete information about the relevant factors.<sup>65</sup>

In appraisal proceedings, the courts determine fair value as derived from different valuation techniques and not from speculation or added premium sale prices, although the latter may be taken into account in some cases. Not only one but many techniques and factors must be analyzed to assert the fair value of the dissenters' shares. Professors Jay W. Eisenhofer and John L. Reed, when referring to dissenters' rights arising out of mergers, consider that market value, asset value, dividends, earnings prospects, the nature of the enterprise,<sup>66</sup> and other facts<sup>67</sup> which cast any light on future prospects of the merged corporation must be considered when fixing the value.<sup>68</sup>

With respect to closely held corporations, Revenue Ruling 59-60<sup>69</sup> outlines and generally reviews the approach,<sup>70</sup> methods, and factors to be considered in valuing shares of those corporations. According

65 Hamilton, Robert W. *et al.*, *Business Basics For Law Students* 194 (2nd ed. 1998).

66 An accurate analysis of the company shall give insight into the nature of the enterprise. "Especially important for closely held companies is to look at their history, products, market and competition, ownership, management and employees, financial condition, and profit and loss statutes." Harnack, Donald S., *Valuation Of Closely-Held Businesses* 3738 (2nd ed. 1973).

67 Among other factors or facts that should be considered in a valuation process is the situation of comparative companies or businesses with similar purposes to those of the corporation whose shares are being valued. Although it is unlikely that the analysis of comparative companies may result in a proper appraisal of the shares of another, such standard of valuation can be remarkably useful to expert appraisers especially when the companies selected for comparison are publicly held and therefore have an active market for their shares.

68 See Eisenhofer, Jay W. *et al.*, *Valuation Litigation*, 22 Del. J. Corp. L. 37 (1997).

69 Rev. Rul. 59-60, 1959-1 C. B. 237.

70 The ruling provides that valuation is not an exact science and that therefore a sound valuation shall be based upon all the relevant facts, common sense, informed judgment, and reasonableness.

to this ruling, the following factors require careful analysis in a valuation process: the nature of the business and the history of the enterprise; the economic outlook of the specific industry; the book value and financial conditions of the business; the earning capacity and dividend-paying capacity; goodwill and other intangible value; sales of stock; and market price of stocks of corporations engaged in similar lines of business having their stock actively traded in a free and open market.

The essential point is that there are several different techniques that may be used to analyze value, and each technique may yield significantly different numbers. "It is considerably more accurate to envision the ultimate value of a business as a range than as a specific number."<sup>71</sup>

In the end, it must be understood that, as in the words of Professor Burton T. Lefkowitz, the only absolute certainty in valuing a going concern is that there is not any scientific method or specific formula available for determining the value of the business. Valuation is an art and not a science. There is no substitute for sound business judgment and experience.<sup>72</sup> "The valuation must be reasonable to both the willing buyer and the willing seller."<sup>73</sup>

The judicial fair valuation process has developed in a very interesting manner. The different chronological stages of judicial appraisal proceedings will be analyzed, *infra*, with reference to the valuation techniques that have been used by courts, or have influenced judicial decisions, and that have a primary role in the valuation of going businesses. The old Delaware Block Method of valuation and its accompanying techniques shall be reviewed first. From there, this article turns to the land-mark decision in judicial valuation and recent decisions, as well as to the analysis of other valuation techniques such as the "discounted cash flow method."

71 Hamilton, *supra* note 65, at 195.

72 Methods are useful as tools, but good judgment comes not from methods alone, but from experience. Experience often comes from bad judgment. See Hamilton *et al.*, Corporation Finance Cases & Materials (forthcoming 1999).

73 Harnack, *supra* note 66, at 127.

### B. *The Delaware Block Method of Valuation*

Until recently, courts were considered incapable of handling the valuation process and determining the fair value of shares in cases of dissent through a thorough analysis of different factors and valuation techniques. The Delaware Block Method of valuation resolved that problem inasmuch as it did not require an assessment of the shares, factors, and particular situation of the corporation, but rather the mere determination of values by using fixed valuation formulas applied by expert appraisers. The Delaware Block Method<sup>74</sup> of valuation prevailed in appraisal proceedings for a long time.<sup>75</sup> It was considered to yield the closest possible estimate of "fair value" of shares. The process itself, the results of the highly regarded valuation techniques that accompanied it,<sup>76</sup> and the attractiveness of a method that combines such techniques in determining a final value made the Delaware Block Method<sup>77</sup> the leading method used in corporate valuations and judicial appraisal proceedings. The weakness of this theorem is not the result of the factors utilized by it or the combination of them, but rather the weight given to each of those factors and the lack of consideration of other factors and circumstances particular to each corporation. As referred in *Brown v. Hedahl's-Q B & R, Inc.*,<sup>78</sup> the Delaware Block Method emerged because it appeared, as a matter of general law, that there were three primary methods used by courts in determining the fair value of shares of dis-

74 The Delaware Block Method calls for a determination of the market value, earnings value, and net asset value of the stock, and then a weighing of each element of value to ascertain the fair value of the stock. See *Chokel v. First Nat'l Supermarkets, Inc.*, 660 N. E. 2d 644 (Mass. 1996). Other courts have asserted that the Delaware Block Method of appraisal requires the consideration and weighing of four factors which are treated as independent "blocks:" book value, adjusted book value; market value, and investment value. See *Keeffe v. Citizens & Northern Bank*, 808 F.2d 246 (U. S. App. 1986).

75 In fact, it is still considered accurate in some jurisdictions. In *Boone v. Carlsbad Bancorporation*, it was held that the decision of an appraiser to choose the Delaware Block Methodology cannot be faulted, and that an appraisal under such circumstances is neither unreasonable nor arbitrary and capricious. Following a conventional approach shields the appraiser's results from judicial invalidation. *Boone v. Carlsbad Bancorporation*, 972 F.2d 1545 (10th Cir. 1992).

76 Asset valuation, market valuation, and valuation based on earnings and dividend.

77 For an accurate description of the Delaware Block Method and its elements, see *Using Capital Cash Flows to Value Dissenters' Shares in Appraisal Proceedings*, 111 Harv. L. Rev. 2099 (1998).

78 *Brown v. Hedahl's-Q B & R, Inc.*, 185 N. W.2d 249 (N. D. 1971).

senting shareholders. These three methods were the market value method,<sup>79</sup> the asset value method, and the investment or earnings value method.<sup>80</sup>

With respect to the asset value method, it is worth mentioning that it is perhaps the oldest valuation technique used by businesses. The valuation is based on what the assets of the business would bring if they were sold.<sup>81</sup> It seems to be the simplest and most intuitive method of valuation of a business. But businesses are not standardized. Each one is unique, and therefore the value of its assets cannot be fixed and the real value of the business cannot be found by reference to an active market. Asset valuation is often low, as it assumes that the pieces of a business are being sold to someone other than the current owner and a sale to a second-best user, therefore, is naturally lower.<sup>82</sup> Goodwill<sup>83</sup> is not taken into account in this valuation process.

The conclusion raised by a judicial appraiser quoted in *General Realty & Utilities Corp.*<sup>84</sup> reflects the approach of appraisers to valuation under the Delaware-Block-Method influence and the way this method works. The appraiser stated that he determined the value of stock “[o]n the basis of [his] appraisal of the value of the net assets and [his] estimate of the prospects for income in the future, and, after giving what seem[ed] to [him] to be proper weight to each of those elements and some weight to the stock market quotations.”<sup>85</sup>

Another case on point is *Coe v. Minneapolis-Moline*,<sup>86</sup> whereby an appraiser acting under the Delaware Corporation Law appraised

79 The market value method establishes the value of the share on the basis of the price for which a share is sold or could be sold to a willing buyer.

80 The investment value method relates to the earning capacity of the corporation and involves an attempt to predict its future income based primarily on its previous earnings record.

81 See generally Eisenhofer, *supra* note 68, at 119.

82 See Hamilton, *supra* note 65, at 198.

83 Goodwill “may be thought of as a number that represents the intangible capacity of well-managed assets to generate more in income than the assets are worth separately.” *Idem*. The general reputation of a company is also commonly referred to as goodwill. The more goodwill a business maintains, the higher the value assigned in the appraisal proceeding.

84 *General Realty & Utilities Corp.*, 52 A.2d 6 (Del. 1947).

85 *Ibidem* at 10. For an analysis of the development of the Delaware Block Method of valuation see Woo, Angie, *Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something BLUE*, 68 S. Cal. L. Rev. 719 (1995).

86 *Coe v. Minneapolis-Moline*, 75 A.2d 244 (Del. 1950).

the preferred and common stock of stockholders who chose not to accept the terms of a merger. The appraiser first determined net asset value, market value, and value derived from earnings and dividends. He then weighted these elements and arrived at his appraisal value.

The shortfall of this method of valuation was addressed in the leading case *Weinberger v. UOP, Inc.*,<sup>87</sup> which will be the subject of review *infra*. In *Weinberger*, the Supreme Court of Delaware described the Delaware Block Method or weighted average method as a technique employed wherein the elements of value, i. e., assets, market price, earnings, etc., are assigned a particular weight and the resulting amounts added to determine the value per share. The Court asserted that, to the extent it excludes other generally accepted techniques used in the financial community and the courts, the method is now clearly outmoded. It was further held that the time had come to recognize this shortcoming in appraisal and other stock valuation proceedings and to adjust the law accordingly.

The bottom line is that the Delaware Block Method presents two major problems. On the one hand, it lacks the integration of additional relevant factors and techniques that may bring a different but more realistic result as to the fair value of dissenters' shares. On the other hand, the flexibility afforded by it with respect to the weight that can be given to each of the factors or valuation methods comprising the Delaware Block Method remains an issue that is likely to be subject to the personal interests of the employer's appraisers or simply to arbitrary patterns. This weighted average method has been greatly criticized<sup>88</sup> because of these problems. As Professor Zenichi Shishido has asserted:

although Delaware courts may have believed that they could take into consideration all factors and elements, by using the Delaware Block Method, the method is equivalent to putting everything into a melting

87 *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983)

88 For further criticism of the Delaware Block Method, see McLean, John T., *Recent Development. Minority Shareholders and Cashout Mergers. The Delaware Court Offers Plaintiffs Greater Protection and a Procedural Dilemma Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), 59 Wash. L. Rev. 119 (1983) and Clardy, Don S., *Valuation of Dissenters' Stock Under the Appraisal Remedy: Is the Delaware Block Method Right for Tennessee?*, 62 Tenn. L. Rev. 285 (1995).



pot. By definition, the Delaware Block Method creates a weighted value: the lower of asset value or earnings value deflates the higher in a compromised result.<sup>89</sup>

While the Delaware Block approach may embody virtues of judicial economy, it fails to provide either an accurate hypothetical market value or a defensible fair value.

### *C. The Weinberger Case: Rethinking Valuation*

As discussed *supra*, *Weinberger* came to undermine the sound base of the Delaware Block Method of valuation. Such a method would no longer be considered, in general terms, the most suitable valuation technique available to appraisers, nor one that might bring reliable results. But *Weinberger* did not stop there. On the contrary, it restated corporate principles with respect to the fairness issue involving appraisal proceedings and the fiduciary duties owed by controlling shareholders. But most significantly, *Weinberger* established a new standard to be followed in appraisal proceedings by providing that they would no longer be limited to the assessment of only certain factors, but rather they would deal with a broader spectrum of elements and techniques. In the long-run, *Weinberger*<sup>90</sup> would become the seed of the proliferation of the "cash flow valuation technique."

In *Weinberger*, a former shareholder of UOP, Inc. ("UOP") challenged the elimination of UOP's minority shareholders by a cash-out<sup>91</sup> merger between UOP and its majority owner. The Supreme Court of Delaware concluded that the merger process did not meet

89 Shishido, Zenichi, *The Fair Value of Minority Stock in Closely Held Corporations*, 62 *Fordham L. Rev.* 65, 71 (1993).

90 "The court in *Weinberger* did three things. First, it eliminated the ability of shareholders to challenge a merger on the ground that it was not undertaken for a valid business purpose. Second, the court stated that the appraisal remedy should ordinarily be the exclusive remedy available to a shareholder objecting to a merger. Finally, and perhaps most importantly, in order to make this now generally exclusive appraisal remedy workable and fair, the court abandoned the inflexible Delaware Block Method of valuation as the exclusive means of establishing fair value." Wertheimer, *supra* note 33, at 616.

91 The term "cash-out" has been used to describe the situation that occurs when the majority forces the minority to accept a nonnegotiable price for their stock and, thus, involuntarily divests them of their equity in exchange for cash. See Eisenhofer, *supra* note 68, at 122.

the test of fairness<sup>92</sup> required in these transactions<sup>93</sup> and adopted a more liberal, less rigid, and stylized approach to the valuation process of shares in cases involving dissenters' rights, and approved such a process for cases coming after *Weinberger*.

Turning to the issue of price, the plaintiff in *Weinberger* challenged its fairness. He provided evidence showing that on the date the merger was approved, the stock was worth more than the price offered to the minority shareholders. In support, he offered the testimony of a chartered investment analyst who used two basic approaches to valuation: a comparative analysis of the premium paid over market in ten other tender offer-merger combinations and a discounted cash flow analysis.

The court rejected the Delaware Block Method of valuation that had been used for decades in appraisal proceedings on the grounds that it excluded generally accepted techniques used in the financial community, and moved by the arguments of the plaintiff, the court held that a more liberal approach to valuation should prevail in appraisal proceedings, which would include proof of value by any techniques or methods acceptable in the financial community.

The court left no doubt about its approach to future valuation proceedings. It held that fair value requires consideration of all relevant factors involving the value of a company and that the basic concept of value under the appraisal statute entitles the stockholder to be paid for that which has been taken from him, viz., his proportionate interest in a going concern. Market value, asset value, dividends, earning prospects, the nature of the enterprise, and any other facts related to the transaction in question are relevant for valuation purposes. Elements of future value, including the nature of the

92 It was asserted by the court in this regard that the concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of the company's stock. See *Weinberger*, 457 A.2d. at 709.

93 Material information necessary to acquaint the UOP's minority shareholders with the bargaining position of UOP and its majority owner was withheld under circumstances amounting to a breach of fiduciary duty. See *ibidem* at 703.

enterprise, which are known or readily proved as of the date of the merger and not the product of speculation, may also be considered.<sup>94</sup>

The court in *Weinberger*<sup>95</sup> set out a new standard for valuation proceedings, a new remedy available to dissenting shareholders. It opened the door to the new generation of cases in which a broader valuation process is conducted. As a result of the *Weinberger* case, new factors are taken into account and appraisals are no longer the result of "limited valuations." In theory, following the principles of *Weinberger*, courts are now able to handle a valuation process and yield a fair value by assessing all relevant factors and techniques. But, has the *Weinberger* legacy been successful in practice? Not necessarily. As discussed, the Delaware Block Method is still used in some jurisdictions, and most importantly, it seems that the principle of "fairness" to which *Weinberger* refers is sometimes ignored by courts when appraising shares. By and large, *Weinberger* came to restate, or perhaps to state for the first time, what the fairness element of valuation entails. Additionally, by means of its approach to valuation, it prompted the use of the cash flow technique, which is regarded as the most accurate in appraisal proceedings.

Since *Weinberger* called for the assessment of all relevant factors and the use of different valuation techniques, some of those valuation techniques deserve description. One such method is based on book value, that is, essentially the difference between assets and liabilities. From such a simple definition, the enormous problems associated with a valuation based solely on book value are obvious. Book value does not reflect the current value of the assets of the company, nor does it reflect earning capacity. It never reflects the goodwill of a business and is always subject to accounting manipulation and economic decisions such as the payment or withholding of dividends. "Book value is generally equal to the asset's acquisition costs, plus

94 When a trial court deems it appropriate, fair value also includes any damages, resulting from the taking, which the stockholders sustain as a class. If that was not the case, then the obligation to consider "all relevant factors" in the valuation process, under Delaware statutes, would be eroded.

95 See generally Schwenk, *supra* note 2; McLean, *supra* note 88; Murdock, Charles W., *The Evolution of Effective Remedies for Minority Shareholders and its Impact upon Valuation of Minority Shares*, 65 Notre Dame L. Rev. 425 (1990); Gardner, Steven D., *A Step Forward: Exclusivity of the Statutory Appraisal Remedy for Minority Shareholders Dissenting From Going-Private Merger Transactions*, 53 Ohio St. L. J. 239 (1992).

any basic increases, minus any depreciation expenses."<sup>96</sup> Book value is usually calculated as part of a valuation process because it is easy to calculate and tends to increase with the success of the business. Also, shareholders may view it as a floor and resist proposed sales for less than book value.<sup>97</sup> Despite these advantages, book value should by no means be the only or ultimate element of a valuation process.

Additionally, a relevant factor to be considered in the determination of the fair value of shares might be the execution of prior transactions within the company in question. Of particular importance are the stock purchase agreements entered into by shareholders of the corporation, as they refer to the value of the shares of the company. However, such value will not likely reflect the sole fair value of the shares, but rather the result of valuations, business negotiations, and stock premiums. Thus, courts should not take this factor into complete consideration, although it might be helpful in approximating the value of the dissenters' shares. Two additional valuation techniques will be discussed *infra*.

#### *D. Recent Decisions and the Cash Flow Method of Valuation*

What was the legacy of *Weinberger*? To what extent has this legacy influenced decisions in courts? Has it been felt only in Delaware courts or also in other jurisdictions?

Above all, *Weinberger* left one express gold rule: valuation shall take into account as many factors as are relevant to the particular circumstances of a company. Likewise, an implied, yet remarkable, principle of business and law emanated from *Weinberger*: valuation of a going business is far from being an exact science. Additionally, as has been mentioned, *Weinberger* stressed the tendency to use the discounted cash flow method of valuation in appraisal proceedings. It would be risky to say, though, that this landmark decision has shifted the courts' approach to appraisal proceedings in every case. On the contrary, its effects have probably not been felt as much as

<sup>96</sup> Eisenhofer, *supra* note 68, at 122.

<sup>97</sup> See Hamilton, *supra* note 65, at 199.

would have been desired. The decision certainly established a pattern for Delaware courts as to appraisals, but not necessarily for all U. S. courts, and this is because the valuation of a business, of its stock, is subject to many variables. As important as it is to come up with the fair value of shares in appraisal proceedings, the appraisal remedy finds its weakness in the proper valuation methodology. Unfortunately, it is not possible to have exact results in this field in every instance. Therefore, the most that one can expect is to obtain the most reliable results in every judicial appraisal action.

An estimate of the present value of the future earnings of a company is an adequate value measurement of its shares. The discounted cash flow method of valuation is indeed the valuation technique on which expert appraisers rely the most. It is also a method that courts consider trustworthy and that is currently being invoked in appraisal proceedings. Usually, a business' value lies in its ability to provide a future stream of net cash:

The most direct way of measuring value, therefore, is to estimate what this stream will be in the future and assign a value to it, using different techniques on discounting future payments to present value. This method of valuation is usually described as the capitalization of income or capitalization of earnings.<sup>98</sup>

It is a well-established method of estimating value.<sup>99</sup>

In support of this technique, professors Hamilton and Booth have asserted that an investor is primarily (and often only) interested in the cash return that a business will generate and that therefore, it is this cash flow that is ultimately most important to them. Free cash flow is the amount available to the owner and may be thought of as a firm's capacity to make distributions.<sup>100</sup> They further assert that, in the context of a going business, a value can be obtained simply by estimating the future income or cash flow of the business, select-

<sup>98</sup> Harnack, *supra* note 66, at 128. Historical earnings generally can be used to evaluate the projected earnings. The company's ability to generate earnings in the future and the amount of the earnings is of primary interest to the buyer. The ultimate realization of those earnings must justify the purchase price. See Harnack, *supra* note 66, at 128.

<sup>99</sup> Hamilton, *supra* note 65, at 200.

<sup>100</sup> See *ibidem* at 200.

ing a discount rate,<sup>101</sup> and multiplying the cash flow by the corresponding reciprocal.<sup>102</sup> "The riskier the business, the higher the discount rate, the smaller the multiplier, and the lower the value placed on the cash flow (or income)."<sup>103</sup> The adequate assessment of both anticipated cash flow and discount rate<sup>104</sup> is essential for the above-mentioned valuation purposes.

A recent decision by the Court of Chancery of Delaware, will exemplify the current tendencies of U. S. courts in appraisal proceedings and the use of the discounted cash flow method of valuation. In *Gonsalves v. Straight Arrow Publishers, Inc.*,<sup>105</sup> a case involving an appraisal action, the court directed the parties to appraise the shares in dispute in accordance with certain guidelines. It addressed that a decision to adhere to and rely upon the methodology and valuation factors of only one expert of one of the parties, to the exclusion of other relevant evidence, is error as a matter of law. The court concluded that a court should not accept the whole of one expert's opinion over another, because it forces the court to view aspects of the valuation process as an "either/or" process whereby the rejection of one expert's valuation automatically requires the acceptance of the other expert's conflicting views.<sup>106</sup> The appraisal process requires the court to consider all relevant factors and elements.<sup>107</sup>

101 The discount rate is subject to and the result of two variables: the market interest rate on loans that carry no risk and a risk premium, which is the additional amount of interest added to the first rate pursuant to the risk degree of the transaction or business.

102 The reciprocal of a discount rate is called the multiplier.

103 Hamilton, *supra* note 65, at 201.

104 For a thorough explanation of the estimation of cash flow and discount rates, see Hamilton, *supra* note 72, as well as Hamilton, *supra* note 65, at 20112.

105 *Gonsalves v. Straight Arrow Publishers, Inc.*, No. CIV.A. 8474, 1998 Del. Ch. LEXIS 45 (1998).

106 The court held in this case that the error was not that the Chancellor concluded that the going concern value of a company is properly represented by the valuation of an expert, but that the decision to accept one valuation over another, in  *toto*, was pre-determined. See *ibidem* at 11. "The court's ultimate valuation decision shall be based on considerations of the specific issues addressed in each expert's valuation analysis, rather than a conclusion that the entire valuation of one expert should be accepted on the theory that doing so serves certain larger institutional concerns." *Idem*.

107 In *Cede & Co. v. Technicolor, Inc.*, the court noted that failure to value a company as a going concern may result in an understatement of fair value and that speculative elements of value should be excluded from valuation calculus to eliminate "pro forma data", not to bar expert evidence of value based on the nature of an enterprise. See *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996).

In *Gonsalves*, the experts<sup>108</sup> of both parties based their valuations on a capitalized earnings model.<sup>109</sup> This model requires two basic inputs: a measure of the company's earnings<sup>110</sup> and a capitalization rate.<sup>111</sup> By applying the implied capitalization rate of the public companies to the earnings measure, the comparable private company's capitalization may be obtained. The court reasoned that the legitimacy of the formula depends on the validity of at least four key decisions: the choice of an appropriate earnings measure (e. g., EBIT, EBITDA); the selection of the historical time period on which the measure is based;<sup>112</sup> the determination of which adjustments, if any, should be made to the earnings measure to reflect items such as non-recurring expenses; and the determination of an appropriate capitalization rate.

The court expressly rejected the use of the asset<sup>113</sup> and market value<sup>114</sup> models in the case, although it acknowledged that both models may be used, in an appropriate situation, to provide a relevant estimate of fair value.<sup>115</sup>

An important issue that has not yet been addressed in this paper is the calculation of interest in appraisal proceedings. In *Gonsalves*,

108 Under certain circumstances, both parties' experts in a case use substantially the same valuation approaches and their results are similar in many respects. The significant differences in their approaches may usually lie for example in the discount rate used or the treatment of cash and cash equivalents or the control premiums considered. See *Hintman v. Fred Weber, Inc.*, No. CIV.A. 12839, 1998 Del. Ch. LEXIS 26 (1998).

109 Also known as discounted cash flow or cash flow method of valuation.

110 Measures of earnings frequently employed include the company's earnings before interests and taxes ("EBIT") or the company's earnings before interest, taxes, depreciation and amortization ("EBITDA").

111 The capitalization rate is obtained through a comparison with similar publicly traded companies whose market capitalization and earnings measures are publicly disclosed.

112 The court in *Gonsalves* concluded that five years is an appropriate time period over which to examine the earnings of the company. Such a length of time reflected the creation and elimination of more than one company's asset, and reflects the nature of the enterprise as an enterprise with a consistent history of attempts to diversify. See *Gonsalves v. Straight Arrow Publishers, Inc.*, No. CIV.A. 8474, 1998 Del. Ch. LEXIS 45 (1998) at 29.

113 It must be noted that the Court refused to take this method into account because *Straight Arrow Publishers, Inc.* was a company with few tangible assets. See *ibidem* at 39.

114 Market value did not deserve any weight in the appraisal action because of the company's thin market. See *idem*.

115 "In evaluating fair value in appraisal proceedings, a court is responsible for reviewing evidence and analysis presented by the parties in an attempt to determine the most accurate fair value of the company as to the date of the merger, recognizing that certain valuation methods may be more suitable for certain companies." *Gonsalves v. Straight Arrow Publishers, Inc.*, 22 Del. J. Corp. L. 1215 (1997).

the court said that an award of interest in an appraisal case is a statutory adjustment that serves two purposes. It is intended to compensate a petitioner for the loss of use of the fair value of his shares during the pendency of an appraisal process and to cause the surviving corporation to give up the benefit it obtained from the use of the fair value of petitioner's shares during that same period.<sup>116</sup>

Another recent Delaware case, *Le Beau v. M. G. Bancorporation, Inc.*,<sup>117</sup> shows that other valuation approaches besides cash flow can be taken into account by courts, although they might not always be successful. Here, one of the parties' expert used three distinct methodologies to value the companies involved in the case: (i) the comparative publicly-traded company approach,<sup>118</sup> (ii) the discounted cash flow method, and (iii) the comparative acquisition technique.<sup>119</sup> The other party's expert arrived at a result by performing two separate valuations: a discounted cash flow analysis and a capital market analysis.<sup>120</sup>

Although the court determined that the capital market approach was legally impermissible and relied in a conclusive manner on the discounted cash flow methods,<sup>121</sup> this case shows that valuation in

116 With respect to the interest rate, courts may refer to the prudent investor rate which is based on what a prudent investor would have done at the time, not what, on hindsight, appears to have been the best investment or what appears to have outpaced inflation.

117 *Le Beau v. M.G. Bancorporation, Inc.*, No. CIV.A. 13414, 1998 Del. Ch. LEXIS 9 (1998).

118 Pursuant to the court's opinion, this 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 financial fundamentals of the company to those of comparable companies, (4) making certain adjustments to those financial fundamentals, and (5) adding an appropriate control premium. See *ibidem* at 2. "A control premium is often paid to shareholders in order for the acquiring firm to obtain a controlling percentage of a corporation stock. This premium represents a value greater than the current value of the shares." Ratway, David J., *Delaware's Stock Market Exception to Appraisal Rights: Dissenting Minority Stockholders of Warner Communications, Inc. Are "Market-Out" of Luck*, 28 U. Tol. L. Rev. 179 (1996).

119 Pursuant to the court's opinion, this technique focused upon multiples of the company'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. See *Le Beau*, No. CIV.A. 13414, 1998 Del. Ch. LEXIS 9 (1998) at 7.

120 Pursuant to the court's opinion, this analysis involved: (1) identifying a portfolio of guideline publicly-traded companies, (2) identifying appropriate pricing multiples for those companies, (3) using the multiples of the guideline companies to calculate the appropriate pricing multiples for the merged company, and (4) applying the multiples to the corresponding financial indicators for the merged company. See *ibidem* at 11.

121 For a discussion of the use of the discounted cash flow method, see also *Gilbert v. MPN Enterprises, Inc.*, 709 A.2d 663 (Del. Ch. 1997).



appraisal proceedings is very much alive and subject to a number of elements, methods, and even personal interpretations. The active participation of the court in determining the fair value of the shares in both *Gonsalves* and *Le Beau* must be noted. The difference between the involvement of courts in the valuation process under the Delaware Block influence and the *Weinberger* influence is remarkable. The evolution from one system to the other must be viewed as a significant accomplishment of common law.

A majority of appraisal actions takes place in Delaware, and by now, the approach of Delaware courts in appraisal proceedings should be clear. However, appraisal actions are also brought in other jurisdictions in which the *Weinberger* principles are not so closely followed, and therefore courts may have different approaches with respect to valuation, dissenters' rights, and even "fair value."

The Supreme Court of Iowa addressed these approaches in *Sieg Company v. Kelly*.<sup>122</sup> Under Iowa law,<sup>123</sup> fair value with respect to a dissenter's shares means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. The objective of a fair value determination is to ascertain the actual worth of that which the dissenter loses as a result of his unwillingness to go along with the controlling stockholders.

The court asserted in this case that the approaches to stock valuation usually relied upon by the court are (i) market value of the stock; (ii) net asset value; and (iii) investment value. Certainly, the use of any particular approach depends on the facts and circumstances of each case. It further asserted that among the factors a court should consider in its analysis are the rate of dividends paid, the certainty that dividends will be regularly paid, the possibility that dividends will be increased or decreased, the size of accumulated surplus, the record of the corporation, the value of the assets of the corporation, book value, market condition, and goodwill.

The Iowa approach does comply with the *Weinberger* requirement of taking all the relevant factors of a going business into account,

122 *Sieg Co. v. Kelly*, 568 N. W.2d 794 (Iowa 1997).

123 See Iowa Code 490.1330(1).

but the valuation techniques used do not conform with Delaware's tendency to treat the discounted cash flow method as the primary method. This situation confirms the fact that the valuation of a going business is not an exact science and that there are many approaches to valuation which are subject to different factors, elements, and circumstances. One should bear in mind, though, that there is a "fairness" issue involved in every appraisal proceeding, and for that reason, every valuation process and factor or element considered must be aimed at yielding a fair value of the shares of dissenting shareholders, regardless of the approach taken. Now, the great problem that is faced when dealing with the fair value concept of the appraisal remedy should be clear. There is simply not a general formula to determine a "fair value," although the use of the discounted cash flow method of valuation is the best way to approximate it. As has been mentioned, experts' opinions are considered in many courts when it comes to valuation proceedings. In fact, it is the current tendency to rely upon this valuation technique. The parties to an appraisal proceeding will very often appoint expert appraisers with the specific task of yielding a fair value for the shares of the dissenters', which of course will vary greatly depending on which party the expert represents. Therefore, expert valuations shall be taken with a grain of salt. Unfortunately, this is not only the technique most often used in courts, but it is also one that is sometimes used in absolute terms. In other words, courts are tempted to accept the results brought by one of the experts or the other, without contemplating the possibility of taking the best aspects of each of them. Thankfully, as we have seen, there have recently been a number of decisions that acknowledge the necessity of combining the opinions of the appraisal experts and considering them in a broader context.

Among the many individuals and firms that consider themselves competent in business valuation matters are the following: (i) accountants and accounting firms; (ii) investment banking firms; (iii) securities brokerage firms; (iv) management consulting firms; (v) real estate brokerage firms or individual real estate brokers; (vi) auction or brokerage firms; and (vii) business brokers specialized in listing businesses for sale and in locating persons who are interested in acquiring businesses.<sup>124</sup>

124 Hamilton, *supra* note 65, at 19697.

### III. RIGHT OF WITHDRAWAL UNDER MEXICAN LAW

#### 1. *Minority Shareholders' Rights*

Mexican law provides for similar general principles as to the rights of minority shareholders than those of U. S. law. Rights such as preemptive rights, voting rights, or dissenters' rights are also contemplated by Mexican law. However, the approach is different in two essential aspects. First, Mexican law affords a greater degree of protection to minority shareholders because the rights of the minority are mandatory provisions and not opt-in elections. Second, Mexican law lacks the useful and practical view of mechanisms that have been implemented in U. S. law, such as cumulative voting and voting agreements.

Thus, in general terms, the degree of protection for the minority is greater under Mexican law, and therefore its participation in the course of a business is also greater. The role of the minority in the corporate governance of a company (*sociedad anónima*) can be substantial. Due to the protection afforded to minority shareholders, their battle to become involved in the governance of a company is not as difficult as it is in a U. S. corporation. Additionally, the manner of conducting businesses and the number of ventures are markedly different in Mexico and the United States. Therefore, Mexican law has not contemplated many of the corporate scenarios that are contemplated by U. S. law. For example, in Mexico derivative suits are extremely rare, shareholders' agreements are not always seen as instruments of control but rather as mere extensions of the by-laws of a Company, and judicial appraisal actions are seldom brought. Thus, the paradox is that a system with a stronger body of laws to protect the minority is not as useful for minority shareholders as in the United States, where the body of protective laws for minority shareholders is weaker. However, regardless of the relevance that the rights have for the minority, they will always be of major concern for controlling shareholders and directors. It is easier to find a minority shareholder in either a close or public company, frustrating the plans of the majority and directors, affecting the governance of the company, and becoming a real factor of power.

Among the rights of minority shareholders under Mexican law, perhaps the one that has been more left behind is the right of withdrawal or "Mexican appraisal right." It is simply there; regulated by a single provision of the General Law of Commercial Companies,<sup>125</sup> forgotten by academics and practitioners due to its lack of development and enforceability.

## 2. *Right of Withdrawal*

Mexican law provides for a minority shareholder's right similar in nature to the dissenter or appraisal right contemplated by U. S. law. However, the treatment of this right under Mexican law is insufficient and lacks the development, maturity, and thoroughness of the U. S. provisions. This right of withdrawal is covered by article 206 of the Law which states that whenever the general shareholders' meeting has adopted decisions on a change of the company's corporate purposes, a change of the company's nationality, or a transformation of the company,<sup>126</sup> any shareholder who voted in opposition has the right to withdraw from the company and be reimbursed for his shares, in proportion to the assets of the company reflected in the last approved balance sheet, provided that he make such request within the fifteen days following closure of the shareholders' meeting.

A closer look at this provision reveals not only its limitations but also its lack of seriousness, especially when compared to U. S. law. First, the availability of this right is radically limited to only three situations that are not likely to arise in companies in Mexico very often. The MBCA, in view of the principle of giving a shareholder an opportunity to end his participation in a corporation when it no longer responds to his interests provides that such right can be exercised in circumstances in which the expectations of a shareholder are affected.<sup>127</sup> This is a logical approach since the idea is to grant shareholders a right to exit the corporation in case of dissent.

<sup>125</sup> Ley General de Sociedades Mercantiles, *Diario Oficial de la Federación*, August 4, 1934.

<sup>126</sup> These matters are set forth in sections IV, V and VI of article 182 of the Law, and are, therefore, subject to adoption by a general extraordinary shareholders' meeting, as regulated by Mexican law.

<sup>127</sup> In short, the current text of the MBCA permits the exercise of appraisal rights in case

But most importantly, the provision in question lacks the philosophy, debate, and high consideration surrounding a true right to dissent. For example, there is not even an express right to resort to judicial authorities to request an appraisal of shares should the amount offered by the company be unsatisfactory to the dissenting shareholder.<sup>128</sup> Also, what valuation techniques should be used by the company and the courts to determine the value of the shares? Mexican law relies on an asset valuation method<sup>129</sup> to determine the value of the dissenters' shares, a method that should not be used exclusively but rather in conjunction with other techniques.<sup>130</sup> The likelihood of having a shareholder dissenting and requesting the value of his shares under these circumstances is negligible. It is almost impossible to fall within the scope of the provision and, even if possible, there is little or no benefit in exercising a right that will likely award the shareholder a small amount for his shares.

The MBCA and the U. S. common law in general have set an example with respect to the treatment of appraisal rights. The provisions are clear, thorough, and consistent with the legal and business purposes sought, namely, the payment of the "fair" value<sup>131</sup> of the dissenters' shares. It is true though that such remarkable development in U. S. law is a result of the development of the way of conducting business in the United States and of the size of U. S. companies. Mexico does not enjoy such privilege. Nevertheless, it is still recom-

of major corporate transactions or restructures and, in any event, as provided by the articles of incorporation or by-laws of the corporation. However, the proposed amendment to the MBCA is now limiting the scope of this right to a handful of corporate scenarios.

128 Although actions against the company, shareholders or directors claiming unfair valuations of shares would likely be permissible, the lack of a real judicial appraisal right diminishes the status of the minority in a company.

129 While, the asset valuation method is probably the oldest one in existence, it has proven to be ineffective in many circumstances. It is simply a technique that, by itself, does not yield a fair value of shares. The use of this standard by Mexican law is anachronistic and shows poor legislative knowledge of corporate affairs and lack of understanding as to concepts such as fair value or valuation methodology.

130 The traditional Delaware Block Method of valuation uses asset value in conjunction with market and earnings values. More developed appraisal approaches use asset value only as a reference and treat it as one among many factors and valuation methods that have to be considered to come up with a fair value. Above all, the cash flow method of valuation should prevail and be enriched by the results of other techniques such as asset or market values.

131 The determination of the "fair value," as previously demonstrated, is extremely difficult, but that is the standard that must be used when dealing with appraisal cases.

mendable that Mexico examine U. S. provisions and try to both implement the U. S. appraisal system in its law and, most importantly, understand the rationale of this right. As long as Mexican law does not recognize the relevance of the concept "fair value," the provisions will remain unenforceable regardless of the improvements made to the law.

#### IV. CONCLUSION

The right to dissent or appraisal is the minority shareholders' last line of protection. It is certainly not a legal right that permits them to continue in a business, but at least it gives them the "fair value" of their investment. The protection afforded by the MBCA is already weak and uncertain. The result of implementing the proposed Amendment to the MBCA will be less protection for the minority and more flexibility for controlling shareholders and directors. The fragile position of the minority will be undermined by providing that it has a right to exit only under extreme corporate scenarios. No longer will the minority be able to end its participation in a venture with relative ease. It is clear that granting more freedom to the majority and the directors will result in squeeze-outs of the minority. However, it must be noted that broader appraisal rights are not necessarily desirable for the benefit of a corporation and its shareholders. They might merely delay the consummation of corporate transactions without benefiting the minority at all. This is especially true when the corporation is publicly traded.

With respect to the valuation techniques used in U. S. appraisal proceedings, the use of the discounted cash flow method and of all relevant factors and elements of the particular corporation seems to be the most effective approach. *Weinberger* set the rules to be followed in these proceedings, and it is good to see that the approach of some courts is indeed more "liberal." Valuation is definitely not an exact science, and the fair appraisal of shares of a going business cannot be accurately calculated with a formula, but the approach of Delaware courts is close to perfection. Not all the courts have been influenced by *Weinberger*, and it is still possible to find the Delaware Block Method of valuation or even more unrealistic techniques being used in valuation proceedings. "Fairness" in these proceedings must

not be forgotten. The goal is to determine a fair value of the shares of dissenting shareholders. And as simple as it seems, such a task becomes an uphill battle for courts and shareholders. But then again, it is on the grounds of fairness that such a battle is worthy.

The market price exception to appraisal rights is questionable in cases of unsophisticated public companies with a thin market because market value is not necessarily equivalent to the real or fair value of a going business. Pursuant to the proposed Amendment, minority shareholders will only be able to dissent in a very limited number of cases, and even if they are in a situation that triggers dissenters' rights, they might only be entitled to a judicial appraisal if their shares are not publicly traded. This represents the conclusive end to the protection afforded to the minority in this area.

Mexican law has unfortunately nothing to contribute in this field. The single provision that regulates the right of a shareholder to withdraw from a company with the value of his shares falls short in its attempt of governing this complex topic. Legal practice has not helped to the end of making this provision a relevant issue. It is necessary to redeem this provision, update it, and keep it alive. Providing for an additional number of cases under which the right of withdrawal may be exercised, as well as for an express means of resorting to judicial courts for appraisal purposes and modern valuation techniques, would help to achieve those ends.

In sum, it seems that for very different reasons, the likelihood that shareholders will have the benefit of a judicial appraisal of shares in the near future, in both Mexico and the United States of America, remains an open question.