THE DISAPPEARING DISCOUNT: APPLYING THE MINORITY AND MARKETABILITY DISCOUNTS TO THE COST OF CAPITAL IN SHAREHOLDER APPRAISALS

A minority shareholder in a closely-held corporation usually expects an active role in the management of the corporation and relies on salary as the means to realize a return on his investment.[1] The minority shareholder faces the risk that realizing a return may be frustrated by oppressive actions of the controlling interest.[2] In response, many states have passed statutes allowing a dissenting shareholder to claim his appraisal rights and receive the "fair value" of his interest.[3] The remedy in a statutory buy-out is that the dissenting shareholder is compensated for his interest as a "continuing shareholder," or in other words, the value should reflect his share in a "going concern."[4] A similar remedy is prescribed in shareholder appraisal proceedings.[5]

Numerous factors regarding the structure of the corporation and the status of the parties can affect the value of the dissenter's shares.[6] This article will highlight how the courts deal with them and considerations that should be taken regarding valuing the interest with respect to the ongoing business. One question the courts have struggled with is the propriety of applying discounts based on a minority interest's lack of control and marketability.[7] The application of discounts is broadly banned in dissenting shareholder buy-outs absent exceptional circumstances.[8] However, in the case of a statutory appraisal proceeding in which unfavorable conduct by the majority interest has not been adjudicated, a broad ban on the application of discounts may serve to disadvantage the surviving enterprise.[9] In both cases, the ongoing business will have to deal with the burdens of the acquired share's minority status going forward.[10] From the remaining enterprise's perspective,

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1. Berreman v. West Publ'g Co., 615 N.W.2d 362, 368, 374-75 (Minn. Ct. App. 2000).
2. LEWIS D. SOLOMON & LEWIS J. SARET, VALUATION OF CLOSELY HELD BUSINESSES: LEGAL AND TAX ASPECTS 108-11 (1998).
3. Christopher Vaeth, *Propriety of Applying Minority Discount to Value of Shares Purchased by Corporation or Its Shareholders from Minority Shareholders*, 13 A.L.R. 5TH 840, § 2 (1993).
4. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).
5. *Id.*
6. Delaware Open MRI Radiology Assocs. v. Kessler, 898 A.2d 290, 338 (Del. Ch. 2006) ("Testimonial feuds about a discount rate often have the quality of debate about the relative merits of competing alchemists.").
7. *See* Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1, 4-6 (2007).
8. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989).
9. *See id.*
10. *See id.*

adjustments should be made to reflect the true value of the ongoing enterprise.[11]

Part I of this article outlines the nature of the closely-held corporation and includes a brief background on the development of the appraisal remedy. Part II provides a quick discussion of the finance behind the determination of "fair value," which is useful in order to analyze the rules in this area. Unfortunately, most opinions do not provide much discussion about what factors are included in each party's valuation models so a basic understanding of the methods used is the only tool available when studying most cases.[12] This discussion will thoroughly discuss the Discounted Cash Flow method, although other methods are used and mentioned throughout discussions of valuations in the litigation context.

Part III discusses how courts have dealt with the nature of a minority interest. This section tracks the courts' struggle in determining which financial models should be adjusted based on minority and marketability discounts. The courts' discussion in this area is based on public, freely traded companies and may not be applicable in the closely-held company context.[13]

Part IV analyzes what elements are included in the Discounted Cash Flow model and how the transaction can affect the value of the continuing enterprise. Part V follows with a discussion on which discount rate should be used to analyze the value of the continuing business.

I. THE NATURE AND VALUE OF A MINORITY INTEREST

A. *The Closely-held Company.*

There is no single definition of a close corporation that is generally accepted, though most emphasize the integration of ownership and management.[14] One court has even gone so far as describing a close corporation as one in which management and ownership are such that it is "unrealistic to believe the judgment of the directors will be independent of that of the stockholders."[15] In contrast to decision making power being in the hands of the board of directors, others have described this relationship as

11. *See infra* note 234.
12. SHANNON P. PRATT & ROGER J. GRABOWSKI, COST OF CAPITAL IN LITIGATION 162 (2010).
13. *See infra* note 108.
14. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975).
15. Landstrom v. Shaver, 561 N.W.2d 1, 13 n.15 (S.D. 1997).

being controlled by the "shareholders holding a majority of the voting power."[16] A closely-held corporation can be defined as an entity which has three basic characteristics: "(1) a small number of shareholders; (2) no ready market for corporate stock; and (3) active participation in the business."[17] Perhaps most importantly, shareholders derive their return on investment through salaries and other perquisites because dividends are rarely distributed.[18]

The shareholders holding a majority of the voting power yield virtually limitless power in the ability to control the company if they are to remain unchecked. For this reason, it is generally recognized that "majority stock is more valuable than minority stock" and is sometimes accompanied by a premium reflecting the amount an investor pays for the privilege of having such power in "influencing corporat[e] affairs."[19] Rationales for the accompanying premium generally fit into three categories: "(1) self-dealing opportunities; (2) reduction of investment risk due to superior information and control over the entity's actions; and (3) control over the distribution of the entity's cash flow to its owners."[20] First, a majority shareholder has the opportunity for self-dealing by electing to do business with other entities he may own or by employing family members.[21] Second, the majority shareholder can reduce his risk in an investment by accessing information through direct contact with management or attempts to improve the performance of the business by changing management.[22] A majority holder may also reduce his risk and avoid being oppressed as a minority interest owner by using his power to modify governing documents.[23] Third, a majority holder controls the disposition of cash and may steer cash towards interested parties, or may choose to liquidate the company if it would be a profitable endeavor.[24] But most importantly for this

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16. Douglas Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastardly Deeds in the Close Corporation,* 54 DUKE L.J. 293, 300-01 (2004) (citing Daniel Klienberger, *Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations*, 16 WM. MITCHELL L. REV. 1143, 1151-52 (1990)).

17. Berreman v. West Publ'g Co., 615 N.W.2d 362, 367 (Minn. Ct. App. 2000).

18. Moll, *supra* note 16, at 301-02.

19. Christopher Vaeth, *Propriety of Applying Minority Discount to Value of Shares Purchased be Corporation or its Shareholders from Minority Shareholders,* 13 A.L.R. 5TH 840, § 2 (1993).

20. LEWIS D. SOLOMON & LEWIS J. SARET, VALUATION OF CLOSELY HELD BUSINESSES: LEGAL AND TAX ASPECTS 109 (1998).

21. *See id.* at 109.

22. *See id.* at 110-11.

23. *Id.* at 111.

24. *See id.*

discussion, is a majority holder's ability to affect distribution of cash flows to other shareholders by electing how and when dividends will be distributed.[25]

A combination of these privileges can be used to "squeeze-out" minority shareholders.[26] Because a shareholder likely relies on a salary in order to enjoy a return on his investment, he is at the mercy of the majority's power to terminate his employment.[27] If the minority shareholder is terminated and no longer receives salary, the controlling interest may then cut off dividend distributions to the minority shareholder and instead reinvest free cash flows into new projects or an increased salary for the majority.[28] In order to realize any return on his investment, the minority shareholder will be forced to sell his shares at a highly discounted price representative of the lack of returns available to the position.[29]

Because of the risk associated with owning minority shares, discounts are applied in some contexts to determine the value of a minority's interest.[30] A minority discount is applied to reflect the lack of control in the corporation and possible frustrations to recovery of a return.[31] In addition, a separate discount for lack of marketability is often applied to minority interests to reflect the illiquid nature of a closely-held company's equity.[32] By definition, a closely-held company's stock is one without a ready market, and substantial costs may be incurred in trying to create a market.[33] In a situation involving oppressive actions by the majority, the value of a minority shareholder's interest may be substantially reduced by these discounts.[34] The daunting task of

25. *See id.*

26. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS, § 5.4 (2010).

27. *Id.*

28. *Id.*

29. *Id.* Alternatively, it can be argued that the lack of receiving dividends does not have an adverse effect on the shareholder's interest. The shareholder's interest will remain the same if the cash is reinvested into profitable projects which would lead to capital appreciation of the shares. *See* Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1015-16 (2001) (stating that minority shareholders can use management positions as an opportunity to ensure their corporation is moving away from "investment-threatening" projects).

30. *See* SOLOMON & SARET, *supra note* 2, § 4.3 at 107-08.

31. *See id.*

32. SOLOMON & SARET, *supra* note 2, § 4.27 at 140.

33. *Id.*; Berreman v. West Publ'g Co., 615 N.W.2d 362, 367 (Minn. Ct. App. 2000).

34. Empirical Studies on market transaction data have shown that minority interests are consistently traded at 30% to 50% under their fair value if they were freely traded. *See* PRATT & GRABOWSKI, *supra* note 12, at 56.

finding an elusive buyer is further complicated by the fact that the would-be buyer is stepping into a situation where realizing a return on the investment is unlikely considering the controlling interest's oppressive actions.[35] By allowing the controlling interest to apply these discounts to the minority's shares, the controlling party would be able to purchase the shares below their fair value and therefore receive a windfall for his offensive conduct.[36]

It is in this context that states rely on shareholder's rights statutes in order to protect the minority shareholder's interest.[37] In other states, the doctrine of shareholder oppression has been judicially created.[38]

B. *The Meaning of Fair Value*

Under the common law, unanimous consent of stockholders was needed in order to carry out major corporate transactions such as mergers and consolidations, sales of assets outside of the ordinary course of business, or amending the corporation's governing documents.[39] In response to this transactional burden, many states have enacted legislation that allows the corporation to proceed with the transaction if it garners approval from a specific percentage of the shareholders.[40] In order to protect the minority shareholder from the majority's new power to act without total approval, these statutes provide for compensation the minority's shares in return for his retirement from the enterprise should he dissent from proceeding in the transaction.[41]

Minority rights are further protected by the creation of a cause of action for oppression. Oppressive actions are ones which are increasingly defined as actions which "frustrat[e] . . . the reasonable expectations of the shareholders."[42] The remedies

35. *See* Moll, *supra note* 16, at 326 ("Implicit in the justification for the minority discount, therefore, is the critical assumption that the buyer, post-purchase, will lack control over the company's affairs.").

36. *See* Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989).

37. *See* Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 621 (1998) ("As federal securities law remedies became less available, shareholders more often turned to state court remedies, including the appraisal remedy.").

38. *See* Moll, *supra* note 16, at 310.

39. Vaeth, *supra* note 19, § 2a.

40. 19 Am. Jur. 2d, *Corporations* § 2246 (2011).

41. *Id.*

42. Moll, *supra* note 16, at 306; *see In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984); SOLOMON & SARET, *supra* note 2, at 110-11.

available for oppression vary depending on the jurisdiction.[43] Some states' statutes allow for dissolution of the company as well as a variety of other remedies, the most popular being a court-ordered buyout of the minority's interest.[44] Other states provide "elective" statutes that allow a corporation to elect to buy out the minority shares in order to avoid dissolution.[45] In states with only a dissolution remedy and states without any legislation, courts have relied on their inherent equity powers to protect minority rights while fostering a policy that encourages the continuance of productive business enterprises.[46]

One question that arises is at what price may the majority purchase the minority shareholder's interest? The Model Business Corporations Act defines the price as the "fair value" of the minority's interest.[47] Many state statutes define the remedy in terms of "fair value," and courts in jurisdictions without legislation have adopted the "fair value" standard as well.[48] The "fair value" definition for the remedy lacks substantive guidance on how to calculate the price to be paid for the shares.[49] Delaware courts have essentially set the standard regarding the methods available for determining "fair value" and have widely been followed by other jurisdictions in that respect.[50]

In a 1983 decision, *Weinberger v. UOP, Inc.*, the Delaware Supreme Court expanded the finance methods available for use in determining value in appraisal cases.[51] The Court interpreted the Delaware appraisal statute to expand the considerations of the court to include "all relevant factors involving [the] value of the company," subject only to the limitation that it may not take into account the speculative elements that may arise from the "accomplishment or expectation" of a merger.[52] The *Weinberger* court held that "all relevant factors" were necessary to determine fair value in appraisals as well as for rescissory damages for

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43. Moll, *supra* note 16, at 308-11.

44. *Id.* at 309 n.58.

45. *Id.* at 309 n.59.

46. *See* Davis v. Sheerin, 745 S.W.2d 375, 380, 383 (Tex. App. 1998) (concluding that courts may use their equity power to decree a "buy-out" in cases where other remedies are inadequate to protect the rights of the parties. Additionally, the "buy-out" would render "total control of the corporation" to the majority shareholder—the main aim of appellants in this case.).

47. *See* MODEL BUS. CORP. ACT §§ 13.01(4), 13.23(a), 13.24 (2010).

48. Moll, *supra* note 16, at 310.

49. *Id.* at 310-11 (noting the lack of definition of "fair value" in several appraisal statutes).

50. *See id.*

51. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 712-15 (Del. 1983).

52. *Id.* at 713 (citing DEL. CODE ANN. tit. 8, § 262(h) (2010)).

claims of unfair dealing.[53] In doing so, the Court abandoned the procedural standard "Delaware Block Method" of valuation and adopted the standard to be one that "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community."[54] At issue in that case was the use of the Discounted Cash Flow Method or DCF.[55]

II. DISCOUNTED CASH FLOW METHOD

After the *Weinberger* case, the Discounted Cash Flow Method, DCF, widely accepted in the financial community, became the favored valuation method of the courts.[56] One court even went on to herald the method stating:

> The DCF model of valuation is a standard one that gives life to the finance principle that firms should be valued based on the expected value of their future cash flows, discounted to present value in a manner that accounts for risk. The DCF method is frequently used in this court and, I, like many others, prefer to give it great, and sometimes even exclusive, weight when it may be used responsibly.[57]

The DCF method is the most important approach to business valuation because it reflects the value of the most important factor to the investor by focusing on the future income stream from the investment.[58] The DCF model measures the value of a company as its future cash flows discounted by that company's cost of capital.[59] In other words, a company's value to its shareholders is the future income provided by the investment discounted by the cost of capital required to produce that income.[60]

The Discounted Cash Flow method determines the value of the future free cash flows by using estimates from available

53. *Id.* at 714; *see* DEL. CODE ANN. tit. 8, § 262(h) (2010).

54. *Id.* at 712-13.

55. *See id.* at 712.

56. *See* Moll, *supra* note 16, at 310.

57. *Id.* (quoting Andalaro v. PFPC Worldwide, Inc., No. Civ. A. 20336, 2005 WL 2045640, at *9 (Del. Ch. Aug. 19, 2005)).

58. SOLOMON & SARET, *supra* note 2, § 2.26 at 46-47; *see generally* PRATT & GRABOWSKI, *supra* note 12, at 11 (citing *SBBI* Valuation Edition Yearbook (Chicago: Morningstar, 2009), 13-14.)).

59. *See* PRATT & GRABOWSKI, *supra* note 12, at 162-63.

60. *Id.*

income projections.[61] Estimates are made over a horizon time period for which estimates can reliably be made, and then discounted back to their present value using the company's cost of capital as the discount rate.[62] The next step is to determine a terminal value for the company to reflect the periods beyond the horizon which can be estimated by income projections.[63] This may be done by using the Gordon Growth Model to estimate the future free cash flows, growing at a constant rate into perpetuity.[64] The terminal value of the future free cash flow is then combined with the horizon period cash flow estimates.[65] All estimates are then discounted by the company's cost of capital to determine the present value of the company.[66] If the growth rate of cash flows is expected to grow at a constant rate from the period beginning after the present value into perpetuity, the Gordon Growth Model alone can be used to calculate the value of the enterprise.[67] If the growth rate of the future free cash flows is expected to change, a two-step model must be used incorporating the Gordon Growth Model with the DCF.[68]

A. *Free Cash Flows.*

Because the goal of valuation is to determine the future benefits to the shareholder, an income based approach is preferred because it measures the returns accessible to the shareholder.[69] The best measure of that income is by anticipating the future free cash flows of the company.[70] Free cash flows represent the portion of future income that is available to be paid out to the shareholders through dividends or reinvested in new projects with the intention of increasing the capital value of the shareholder's stake.[71] In order to calculate

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61. SOLOMON & SARET, *supra* note 2, § 2.27 at 48.
62. Hammermesh & Wachter, *supra* note 7, at 25.
63. *Id.*
64. *See* PRATT & GRABOWSKI, *supra* note 12, at 15-16.
65. *See id.* (referring to Formula 1.8).
66. *See id.* (referring to Formula 1.8).
67. *See id.* at 15.
68. *See id.* at 16-17.
69. *See* SOLOMON & SARET, *supra* note 2, § 2.26 at 46.
70. *Id.*
71. *See* PRATT & GRABOWSKI, *supra* note 12, at 11. When an appraiser uses the DCF approach and is valuing a minority or majority interest where discounts are allowed by law, most of the entire control premium or minority discount results from changes in the cash flows available to the shareholder due to power of the majority to control cash distributions. *Id.*; SOLOMON & SARET, *supra* note 2, § 4.4 at 112-13. A smaller portion is related to the changes in the denominator reflecting a change in the discount rate regarding shifting of risk. SOLOMON & SARET, *supra* note 2, § 4.4 at 112-13.

free cash flows, adjustments need to be made to accounting income for the cash flows necessary to keep the business going forward which do not represent wealth available to shareholders.[72]

B. *Cost of Capital.*

Cost of capital is a measurement of the expected return on investment.[73] It is the minimum return required in order to convince an investor to partake in the particular project and therefore reflects the company's ability to raise capital.[74] The cost of capital for a company depends on its capital structure which consists of three components: its equity capital, preferred capital, and debt capital.[75] Each component of the capital structure has its own cost depending on the risk associated with ownership of that entity.[76] In an appraisal proceeding, the goal of the court is to determine the value of a minority shareholder's pro rata share in the company, so although a shareholder owns a portion of the equity, the company's overall cost of capital is the appropriate measure to value the entire enterprise.[77] When valuing a business, all components of the company's ability to raise capital are included, in their respective proportion to the overall capital structure, to determine the company's weighted average cost of capital (WACC).[78] The formula for a company's after-tax weighted average cost of capital is:

$$WACC = (k_e * W_e) + (k_p * W_p) + (k_{d(pt)}[1-t] * W_d)$$

Where: WACC = weighted average cost of capital (after-tax)

k_e = cost of common equity
W_e = percentage of common equity in the capital structure, at market value
k_p = cost of preferred equity capital
W_p = percentage of preferred equity in the capital structure

72. *See* PRATT & GRABOWSKI, *supra* note 12, at 13-14 (citing SBBI Valuation Edition Yearbook (Chicago: Morningstar, 2009)); *see* SOLOMON & SARET, *supra* note 2, at 49. These additions include: (1) adding back adjusted income after taxes; (2) adding noncash expenses such as depreciation and amortization; (3) subtracting capital expenditures; (4) subtracting working capital increases (decreases); (5) debt principal payments; and (6) net cash flow to equity. *Id.*

73. *See* PRATT & GRABOWSKI, *supra* note 12, at 4.

74. *See id.* at 2.

75. *Id.* at 45.

76. *Id.*

77. *Id.*

78. *Id.*

$K_{d(pt)}$ = cost of debt capital (pre-tax)
T = income tax rate[79]
W_d = percentage of debt capital in the capital structure, at market value.[80]

When estimating a company's WACC, it is necessary to account for the cost of each element making up the capital structure based on the company's market value, not the book value.[81]

C. *Estimating the Cost of Equity.*

The cost of equity is the expected return required to compensate an investor for use of his funds and can best be conceptually explained by the build-up method.[82] The formula for the cost of equity is:

$$E(R_i) = R_f + RP_m + RP_s \pm RP_u$$

Where: $E(R_i)$ = the expected (market required) rate of return on security i

R_f = rate of return available on a risk free security
RP_m = expected risk premium for the market
RP_s = risk premium for smaller size
RP_u = risk premium attributable to the specific company or the industry.[83]

An investor will expect a return over the risk free rate for the use of his money over the investment period which is represented by the addition of the risk free rate to the formula.[84] He will also demand a risk premium to compensate him for investing in an equity which is traditionally a riskier investment than a government obligation.[85] Further, because studies have shown that smaller companies tend to be riskier, the investor will demand a higher return for taking on the extra risk.[86] Finally, a risk premium is added to the formula to compensate

79. The cost of debt capital is measured after taxes resulting from the interest tax shield. *Id.*
80. *Id.*
81. *Id.*
82. PRATT & GRABOWSKI, *supra* note 12, at 26.
83. *Id.*
84. *See id.*
85. *Id.* at 27-29.
86. *Id.* at 29 (citing *Ibbotson Stocks, Bonds, Bills, and Inflation Valuation Yearbooks*).

for company or industry specific risk factors such as volatility, high leverage levels, or other company-specific factors.[87]

The most popular method for estimating cost of equity capital is the Capital Asset Pricing Model (CAPM).[88] The CAPM model measures how a specific company is affected by changes in the overall market, which is measured by Beta.[89] The basic CAPM formula is:

$$E(R_i) = R_f + \beta(RP_m)$$ [90]

CAPM is based on the assumption that an investor is able to diversify away his unsystematic risk, and so when it is applied to value a particular entity, company specific risk premiums must be added in to the formula resulting in:

$$E(R_i) = R_f + \beta(RP_m) + RP_s \pm RP_u$$

Where: $E(R_i)$ = the expected (market required) rate of return on security i

R_f = rate of return available on a risk free security
β = Beta, the measure for the deviations of returns from the Securities Market Line
RP_m = expected risk premium for the market
RP_s = risk premium for smaller size
RP_u = risk premium attributable to the specific company or the industry.[91]

The CAPM model is useful in cases where specific company data is unavailable because a company's Beta can be estimated by comparing the Betas of like companies and adjusting the Beta for company specific risk such as leverage levels.[92] Valuation professionals may also estimate the Beta using the subject entity's fundamental financial factors.[93]

It is important to mention that regardless of the method used, CAPM or build-up model, the cost of equity is based on the market value of the company not the book value.[94] Cost of equity is the measurement of the ability of the company to raise capital on the open market, and therefore, the return required is based

87. *Id.*
88. SOLOMON & SARET, *supra* note 2, at 52.
89. *Id.* at 53.
90. *Id.*
91. PRATT & GRABOWSKI, *supra* note 12, at 26.
92. SOLOMON & SARET, *supra* note 2, at 53.
93. *Id.* at 54.
94. PRATT & GRABOWSKI, *supra* note 12, at 3-4.

on a market player's perceived risk of the company.[95] This is true even when a company's own return data is used to estimate the Beta because the cost of equity should reflect the risk the market perceives and the return demanded for that risk.[96] If the CAPM is calculated using a comparable company's Beta, adjustments should be made for the different risk levels of the two companies.[97] These adjustments can include deleveraging the Beta of a comparable company to account for that company's risk due to its amount of leverage, and then re-leveraged by the target company's Beta to include the risk related to its capital structure.[98] In addition, an adjustment due to any company-specific risk should be accounted for when estimating the cost of equity.[99]

Once a cost of equity estimation is made, it can be used to determine the company's WACC and plugged into the DCF model to estimate the value of the company.[100]

III. REFINING THE DEFINITION OF FAIR VALUE-DEALING WITH DISCOUNTS.

A. *Elements of Fair Value and a Presumptive Ban on Discounts*

The Delaware statute commands the court to determine fair value of the dissenting shares "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."[101] The "only litigable issue [in an appraisal proceeding is] the determination of the value of the petitioner's shares on the date of the merger."[102] However, the *Weinberger* decision expanded the valuation standard in appraisal cases to include "all relevant factors" which shed light on the future prospects of the corporation which would be considered by the market in assessing the value of the petitioner's shares, and in fact, required that those considerations be taken into account.[103]

Despite a potential purchaser's consideration of the minority status of a block of shares, the court in *Cavalier Oil* rejected the

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95. *Id.*
96. *Id.*; *see also id.* at 40-41, 54-55.
97. SOLOMON & SARET, *supra* note 2, at 53-54.
98. *Id.*
99. *See* PRATT & GRABOWSKI, *supra* note 12, at 40-41.
100. *See supra* note 65 and accompanying text.
101. DEL. CODE ANN. tit. 8, § 262(h) (1953).
102. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1142 (Del. 1989).
103. Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

application of a minority or marketability discount reasoning the objective of the appraisal proceeding is to "value the *corporation* itself, as distinguished from a specific fraction of its shares as they may exist in the hands of a particular shareholder."[104] The denial of applying discounts in *Cavalier Oil* is contradictory to the previous decision of *Tri-Continental Corp. v. Battye* which allowed the discounts to be applied to a shareholder's block of shares.[105] *Tri-Continental* was unique in the fact that it was a closed-end investment company, so the shareholders did not have the right to demand a proportionate share of its assets at any time.[106] The *Cavalier* court distinguished the case by recognizing the difference between applying discounts at the company level for all assets and applying them to a specific shareholder's interest.[107] It held that "where there is no objective market data available, [an] appraisal . . . is not intended to create a *pro forma* sale but [rather] to assume the shareholder was willing to maintain his investment position . . . ."[108] The court expressed concern that failing "to accord [the] shareholder [his] full proportionate [interest would impose] a penalty for lack of control . . . ."[109]

Despite the court's denial of consideration of market factors in the *Cavalier Oil* case, it was willing to entertain the petitioner's corporate opportunity claim as one of the "all relevant factors" to be considered.[110] The court agreed with the petitioner that his corporate opportunity claim should be considered in the appraisal because his claim related directly to the value of his shares.[111] In doing so, the court avoided the rule of *Cede & Co. v. Technicolor, Inc.* which required a separate derivative action to be brought apart from the appraisal proceeding.[112] It was on the specific facts in the case that the court considered the opportunity claim in the appraisal, mainly that the petitioner did not have knowledge of the misrepresentations forming the basis of his opportunity claim prior to the appraisal and a prior settlement agreement between

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104. *Cavalier*, 564 A.2d at 1144.
105. Tri-Continental Corp. v. Battye, 74 A.2d 71, 76-77 (Del. 1950).
106. *Id.*
107. *Cavalier*, 564 A.2d at 1144-45.
108. *Id.* at 1145.
109. *Id.*
110. *See id.* at 1143-44.
111. *Id.*
112. *Id.*; see, *e.g.*, Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1189 (Del. 1988) (requiring a separate action for shareholder derivative damages because derivative plaintiff loses standing to assert the claim on behalf of the corporation in subsequent appraisal proceedings).

the parties providing that derivative claims were viable for appraisal purposes.[113]

After the *Cavalier Oil* case, a shareholder must bring a derivative suit challenging the validity of the merger itself as a separated action from the appraisal; in considering "all relevant factors," the court may inquire into the effects of majority action on the value of an individual's shares in an appraisal proceeding under certain factual circumstances, but the court will not assess factors influencing the market's perception of the value of an individual block of shares.[114] The appraisal proceeding is not a proper forum to contest the validity of a fundamental transaction that a minority shareholder does not have the ability to control with his limited voting rights.[115] However, the minority's shares are valued based on their proportion of the entire enterprise value, including those portions that the shareholder lacks control over.[116]

An example of this approach can be found in *In re Radiology Associates*, in which the court ruled that the plaintiff was entitled only to his "proportionate value . . . as a continuing shareholder" at the merger date.[117] The court rejected the argument that it may, when interpreting the terms of a settlement agreement concerning a breach of fiduciary duty, and ruled that the determination of fair value should proceed without regard to damages from any breach of fiduciary duty.[118] Therefore, the plaintiff's interest should be valued concerning his current position in the ongoing company as it exists.[119] The court then denied the application of adjustments for discounts relating to a specific block of shares, although this time rejecting the plaintiff's use of a premium added to the valuation model.[120] Following the reasoning of the *Cavalier Oil* court, the plaintiff is not entitled to his proportionate value of a pro forma sale but rather is "[assumed to be] willing to maintain his invest position, however slight, had the merger not occurred."[121]

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113. *Cavalier,* 564 A.2d at 1143-44.

114. *See id.* at 1143-45.

115. *See Cede,* 542 A.2d at 1189.

116. *Cavalier,* 564 A.2d at 1145.

117. *In re* Radiology Assocs., Inc. Litig., 611 A.2d 485, 494 (Del. Ch. 1999).

118. *Id.* at 489 (reasoning that settlement was meant to compensate plaintiff for breach of duty damages and consideration of settled claim would result in double recovery).

119. *See id.*

120. *Id.* at 494.

121. *Id.*

B. *The Role of CAPM and the Implied Minority Discount.*

Following the *Radiology* decision, confusion emerged as to the proper use of the CAPM model and minority discounts.[122] Delaware law recognizes an inherent minority discount that is priced into the market for purchases of minority positions, but only in some situations.[123] A premium is applied to the market price to adjust for the discount only when using the comparable company method of valuation.[124] The inherent minority discount should not be applied when using the DCF method however and has only been done so in one anomalous case that drew criticism.[125]

In 1991, the Delaware court first denied an adjustment for an "implied minority discount" to a Discounted Cash Flow model in the case of *In re Radiology Associates.*[126] In that case, the plaintiff's valuation expert added a premium to compensate for an implicit minority discount in the open market price.[127] She based her inclusion of a premium on the assumption that the market priced in a discount to compensate for the inherent risk associated with minority shares.[128] Because the CAPM model is based on estimating market price, its results would apparently include this discount and not reflect the price a buyer would pay for the entire company.[129] To compensate for the discrepancy, she testified that a premium should be added to the final value as determined by the CAPM.[130] Presumably, a purchaser acquiring the entire 100% controlling interest would pay a premium over the market price, and the plaintiff should be entitled to his portion of that premium.[131] The Court did not reject this argument outright, but reasoned that "the appraisal process is not intended to reconstruct a pro forma sale," but rather to compensate a plaintiff as a continuing shareholder, therefore he was not entitled to the premium.[132]

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122. *See* Hammermesh & Wachter, *supra* note 7, at 17-23.

123. Agranoff v. Miller, 791 A.2d 880, 892-93 (Del Ch. 2001); *see also* Hammermesh & Wachter, *supra* note 7, at 18-23.

124. Wertheimer, *supra* note 37, at 648.

125. Wertheimer, *supra* note 37, at 651 (noting the logic requiring an upward adjustment to a market priced valuation does not apply to DCF valuations).

126. In re *Radiology*, 611 A.2d at 494.

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* (quoting Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989)).

The same valuation expert from *In re Radiology* testified again in *Hodas v. Spectrum Technology, Inc.* about the existence of the implied minority discount.[133] This time however, the result of the inclusion of the discount was contrary to her party's interest and met no opposition from the opponent.[134] Later in *Kleinwort Benson Ltd. v. Sigan,* no expert unequivocally objected to the existence of an implied minority discount in the market, and so the court ruled that the inclusion was proper based on the evidence presented in the case at hand.[135] The rule became binding by law when the Delaware Supreme Court upheld the application of the implied minority discount in *M.G. Bancorporation, Inc. v. Le Beau,* finding that the lower court's reasoning was fully supported by the record evidence.[136] The binding nature of this decision is evidenced by the *Doft & Co. v. Travelosity.com, Inc.* decision.[137] Despite the absence of testimony from either expert witness, the court held that Delaware law recognized an implied minority discount in comparable company analysis and an upward adjustment must be applied.[138] The propriety of applying the discount has since been clarified by the *Lane v. Cancer Treatment Centers for America, Inc.* decision that explained why the implied minority discount is to be applied, if at all, to comparable company methods and not to DCF models without persuasive evidence.[139] The comparable company method uses data from similar transactions involving similar companies and a premium may be applied by the buyer in that situation. However, it is not included in the CAPM, and DCF respectively, because the CAPM measures the cost of equity of the company, which reflects the ability of the corporation to raise equity capital, not sell the entire enterprise.

The court explained why it would reject adjustments to the implied minority discount without persuasive evidence citing Shannon Pratt's reasoning:

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133. Hodas v. Spectrum Tech., Inc., No. 11265, 1992 Del. Ch. LEXIS 252, at *4-5 (Del. Ch. Dec. 7, 1992).

134. *Id.*

135. Kleinwort Benson, Ltd. v. Silgan Corp., No. 11107, 1995 Del. Ch. LEXIS 75, at *8-9 (Del. Ch. June 15, 1995).

136. M.G. Bancorporation, Inc. v. Le Beau, 737 A.2d 513, 523 (Del. 1999).

137. Doft & Co. v. Travelocity.com, Inc., No. 19734, 2004 WL 1152338, at *10 (Del. Ch. May 20, 2004).

138. *See id.*

139. Lane v. Cancer Treatment Ctrs. of Am., Inc., No. 12207-NC, 2004 WL 1752847, at *31 (Del. Ch. July 30, 2004).

> Some analysts believe that the income approach always produces a publicly traded minority basis of value because the Capital Asset Pricing Model and the build-up method develop discount and capitalization rates from minority transaction data in the public markets. This is a very common and highly-flawed conclusion. *There is little or no difference in the rate of return that most investors require for investing in a public, freely tradable minority interest versus a controlling interest.*[140]

The key characteristic of Pratt's analysis is its basis on minority interests in public, freely traded companies.[141] The court went on to announce that the issue would remain open to the possibility of including adjustments for an implied minority discount stating, "[there remains an] intellectually interesting argument in support of the proposition that the DCF analysis necessarily introduces something of a minority discount."[142]

A brief look at financial theory can help to explain why the market prices for public, freely tradable securities do not include a discount for minority risk. First, the CAPM model as well as much of modern financial theory is based on the assumption that investors will hold portfolios that reflect the Security Market Line.[143] The Security Market line is constructed upon the notion that prices for securities will adjust up or down in order to properly reflect their risk/return ratio.[144] Beta measures any deviations in returns from the SML which represent the unsystematic risk that is attributable to that company.[145] Modern Portfolio theory is based on the assumption that risk-averse investors can diversify away company specific risk and hold portfolios that resemble the security market line.[146] Therefore, the market price of a publicly traded security, based on CAPM assumptions, does not include a risk premium other than that represented by Beta.[147] As the Delaware court said in *Delaware Open MRI* regarding the difference between the CAPM and the build-up method, "the build-up method typically

140. *Id.*

141. *See id.* (citing SHANNON P. PRATT, BUSINESS VALUATION DISCOUNTS AND PREMIUMS 30 (2001)).

142. *Lane*, 2004 WL 1752847, at *32 n.160.

143. *See* PRATT & GRABOWSKI, *supra* note 12, at 34-35.

144. *See id.*

145. *See id.*

146. *See id.* at 34.

147. *See* PRATT & GRABOWSKI, *supra* note 12, at 34.

incorporates heavy dollops of . . . 'company-specific risk,' the very sort of unsystematic risk that the CAPM believes is not rewarded by the capital markets and should not be considered in calculating a cost of capital."[148]

A publicly traded company's stock price may not include a risk premium for minority risk due to the liquidity of the shares available for measurement by the CAPM.[149] When faced with an unfavorable scenario due to that minority risk, the investor will liquidate his interest and invest in a comparable security.[150] The investor can then adjust his portfolio weight to maintain the total expected returns of his overall portfolio.[151] The overall effect on his portfolio is negligible.[152] Therefore, the market does not include a discount to the stock price based on minority status.[153]

C. *Deviations from the CAPM.*

However, the court in *Radiology Inc.* was correct not to completely dismiss the argument that selling the company as a whole might garner a control premium.[154] Essential to modern portfolio theory and the CAPM is the assumption that investors will be able to balance the holdings in their portfolios in order to diversify away unsystematic risk.[155] In that case of an investor seeking to buy into a controlling interest of the company, the investor would not be simply looking to add to his portfolio but would rather be seeking an active role in controlling management activities.[156] The controlling investor would be more exposed to the company's risks and unlikely able to manage those risks through diversification.[157] In order to justify the acquisition of a controlling interest and a greater exposure to the

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148. Delaware Open MRI v. Kessler, 898 A.2d 290, 338-39 (Del Ch. 2006).

149. *See* Lane v. Cancer Treatment Ctrs. of Am., Inc., No. 12207-NC, 2004 WL 1752847, at *31-32 (Del. Ch. July 30, 2004).

150. *See* PRATT & GRABOWSKI, *supra* note 12, at 34; *see also supra* note 138 and accompanying text.

151. *See* PRATT & GRABOWSKI, *supra* note 12, at 34.

152. *See* PRATT & GRABOWSKI, *supra* note 12, at 34.

153. *See* PRATT & GRABOWSKI, *supra* note 12, at 34.

154. *See* Lane v. Cancer Treatment Ctrs. for Am., Inc., No. Civ. A 12207-NC, 2004 WL 1752847, at *32 n.160 (Del. Ch. July 30, 2004) ("[W]hile there may be an intellectually interesting argument in support of the proposition that the DCF analysis necessarily introduces something of a minority discount. Cimasi failed to make that argument persuasively.").

155. *See* PRATT & GRABOWSKI, *supra* note 12, at 34; *see also supra* note 140 and accompanying text.

156. *See* Moll, *supra* note 16, at 300.

157. *Cf. id.* This is assuming the shareholder is not able to have an active role and salary in multiple companies to the point of achieving diversification.

specific company's risk, the investor must expect to be able to control management and cash flows of the company in a way that produces a greater return on investment.[158] The level of control is represented by a premium,[159] which is not included in the CAPM model.

In regards to a closely-held corporation, a majority investor is also likely to be seeking an active role in management and a higher exposure to the specific company risk.[160] In that regard, he is more like the above-mentioned investor who is purchasing a controlling block of shares at a market price that deviates from the CAPM required return.[161] Similarly, the minority investor will have a large exposure to the company's specific risks, yet he will not have the control necessary to reduce these risks.[162] In addition, because the minority shareholder relies on salary from continued employment, he is further exposed to the risk of his employment being cancelled at the discretion of the majority and may not be able to control this risk.[163] A rational minority investor will demand a higher return on his investment than the CAPM contemplates.[164] A portion of the higher return can be expressed as the company specific risk premium present in the build-up model.[165] In addition to the company specific premium, an investor will demand a discount for the minority status of the shares and for the risk that the controlling shareholders' actions may inhibit him from realizing the full amount of the expected return.[166] Because of these demands, the cost of equity for a close company is higher than what is estimated from the CAPM.[167]

Despite the possibility of a third party investor including minority or marketability discounts for shares of a close company, Delaware law does not allow a discount to be applied to

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158. SOLOMON & SARET, *supra* note 2, § 4.3 at 108-09; *see also supra* note 23 and accompanying text.

159. SOLOMON & SARET, *supra* note 2, § 4.3 at 108-09.

160. *See* Moll, *supra* note 16, at 300.

161. *See supra* note 155 and accompanying text.

162. *See supra* notes 21-23 and accompanying text.

163. *See supra* note 28 and accompanying text. This is assuming that the shareholder agreement contains no contractual agreements regarding the at-will termination of a shareholder.

164. *See* PRATT & GRABOWSKI, *supra* note 12, at 34 ("[T]he analyst would consider that security mispriced. It would be mispriced in the sense that the analyst's expected return on that security is less than it would be if the security were correctly priced assuming fully efficient capital markets.").

165. *See supra* note 86 and accompanying text.

166. *See supra* note 31 and accompanying text.

167. *See supra* note 163 and accompanying text.

a specific block of shares.[168] Only discounts applicable to the entire corporation are allowed.[169] The most common rationales for denying the discounts can fit into three categories: (1) an appraisal is not intended to be a pro forma sale; (2) the majority is purchasing the shares and therefore does not suffer from lack of control; and (3) recognizing the discounts would lead to undesirable behavior, mainly the majority using the discounts to buy out the minority's interest below fair price.[170]

IV. LITIGATION- CHOOSING WHAT FACTORS TO INCLUDE IN THE VALUATION MODEL

The court in the *Weinberger* decision to include "all relevant factors" relied on the earlier case of *Tri-Continental Corp. v. Battye*,[171] which explained which factors were pertinent to the ongoing value of the company. The court concluded:

> In determining what figure represents this true or intrinsic value, the appraiser and the courts must take into consideration all factors and elements which reasonably might enter into the fixing of value. Thus, market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts which were known or which could be ascertained as of the date of merger and which throw any light on future prospects of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholders' interest, but must be considered by the agency fixing the value.[172]

Because the only litigable issue in an appraisal is the value of the interest,[173] each party's expert may testify to a valuation that is vastly different from the other party's.[174] Therefore, the battleground turns to what factors are used by each party's expert in their respective models. Common factors that may substantially affect the value of the company are discussed below.

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168. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144-45 (Del. 1989).

169. *Id.*

170. Moll, *supra* note 16, at 319-20, 325-26, 327.

171. 74 A.2d 71, 72 (Del. 1950).

172. *Id.* at 72.

173. Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1186-1187 (Del. 1988).

174. Wertheimer, *supra* note 37, at 629-30 n.94 (noting that even when experts employ the same methods for estimating valuation there is much room for subjectivity that can dramatically affect the valuation).

A. *Date of Valuation*

Most states' dissenting shareholder statutes set the valuation date to be the date on which the shareholder voted on the action giving rise to appraisal rights.[175] The Model Business Corporations Act sets the valuation date at the time "immediately before the effectuation of the corporate action to which the shareholder objects."[176] The Model Act explains that the purpose of setting the date "immediately before the effectuation of the action" is to protect shareholders from a period when they are denied rights as a shareholder, yet have not perfected appraisal rights.[177] Delaware follows the MBCA in that it sets the date to be the "day of the merger, reflecting all relevant information regarding the company and its shares."[178] "This includes information concerning the future events not arising solely 'from the accomplishment or expectation of the merger,' which, if made public, can affect the current value of the shares . . . ."[179] By including the period up until the merger, the rights of the parties are better emulated by the resulting valuation models.[180] Business decisions leading to the merger are reflected in the fair value, while a stationary date does not reflect the status of the business as a going concern.[181]

B. *Financing of the Transaction*

As evidenced by the difference of opinions in each side's expert, a number of factors may alter the weighted average cost of capital, thereby altering the value estimation.[182] One of the questions a valuation expert must deal with is the effect the funding of the challenged corporate action has on the pro rata value of the company.[183] How the majority funded the corporate

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175. MODEL BUS. CORP. ACT § 13.01(4) (2007), comment.

176. MODEL BUS. CORP. ACT § 13.01(4) (2007).

177. MODEL BUS. CORP. ACT § 13.01(4) (2007), comment.

178. *Cede & Co.*, 542 A.2d at 1187 (citing Weinberger v. UOP, Inc., 547 A.2d 701, 713 (Del. 1983)).

179. *Id.* (citation omitted).

180. *See* Moll, *supra* note 16, at 371-72 (reasoning that a shareholder continues to have rights in participating in the company's overall worth, and the value should reflect his participation, even after the oppressive conduct).

181. See *id.*

182. Tri-Continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950); *supra* note 37 at 629-30 n. 94.

183. *See* PRATT & GRABOWSKI, *supra* note 12, at 163 (discussing a Chancery court decision in 2003 allowing the company to be valued regarding the acquirer's cost of capital because it was part of a new business plan that was implemented after the tender offer but before the squeeze out).

action can have a substantial effect on the going value of the company.[184]

The remaining entity faces a potentially serious burden if cash was used to finance the corporate action. Because cash flows are the targeted measurement reflecting the value of the company to the shareholders, financing the transaction through cash reduces the remaining value of the company.[185] The majority interest has the de facto control over the cash flows.[186] However, as a current shareholder, the minority investor is entitled to his portion of the cash flows.[187] If the award paid to the minority shareholder is a deduction of the free cash flows used in the DCF, the minority interest is essentially supplying part of the cash to finance the purchase of his own shares.[188] The company is valued as a whole before the shares are bought-out, therefore, the minority's proportion of cash used for the buy-out should not be taken out of the free cash flows used in the numerator of the DCF equation.[189] However, the use of cash to finance the overall transaction may affect the company's cost of capital going forward as the surviving entity must raise capital to replace the cash needed to operate the business. Adjustments to the denominator of the DCF model that reflect the ability of the remaining entity to raise capital may be proper before allocating the minority's portion under the "any relevant factors" standard.[190]

The company may choose to finance the transaction with debt, depending on its target capital structure.[191] More debt may result in a higher cost of debt and change the weight of the capital structure.[192] Even if the company does not take on debt for the purchase, the loss of the cash may still have an effect on the existing debt structure. By reducing available cash flows, the corporation's current ratio, measuring a company's assets to liabilities, and more importantly, its quick ratio, measuring a

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184. *See id.*

185. *See supra* note 71 and accompanying text.

186. *See* SOLOMON & SARET, *supra* note 20 at 109.

187. *See* Moll, *supra* note 16, at 371-72 (noting that an investor is entitled to participate as an owner until his status as shareholder ceases).

188. *See supra* note 71.

189. *See supra* note 176; *see also* PRATT & GRABOWSKI, *supra* note 12 at 162-63.

190. *See* Tri-Cont'l Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950); *see also* PRATT & GRABOWSKI, *supra* note 12 at 162-163.

191. *See supra* note 79.

192. *See supra* notes 79-80 and accompanying text.

company's ability to pay off its liabilities with cash, decrease after the transaction.[193]

The quick ratio is important to the lender and is often referred to as the acid test ratio because it can quickly determine the health of a loan.[194] The effect of the loss of cash on the quick ratio can cause a lender to raise the existing interest rate at which the company is able to borrow.[195] The actions of a third party lender raising interest rates might be seen as speculative, however cash forecasts and current account ratios can be reliably calculated and may fit well within the parameters of requiring a higher interest rate from the lender's perspective.[196]

Further, the cost of equity may change due to a number of reasons in addition to those just mentioned. The loss of available cash and an increase in debt would increase the risk level of the company and the market would demand a higher return for the added risk.[197] Even without a significant change in cash or cost of debt, the market may demand a higher return if it perceives the dissention proceeding as discourse in the management of the company.[198] The filing of a dissention is a public act and will likely be reflected by the market price.[199] More importantly, from the corporation's perspective, stock reflects the ability to raise cash.[200] The remaining shareholders are left with the burden of finding a willing buyer since one does not readily exist.[201] Because a market does not exist, the corporation must create a market which is a costly endeavor.[202]

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193. *See* SOLOMON & SARET, *supra* note 2 at 108-11.

194. *Id.*

195. *Cf. id.* (raising interest rates may reflect the risk that the company will not be able to fulfill the loan by liquidating assets).

196. Weinberger v. UOP, INC., 457 A.2d 701, 713 (1983) (stating that "any other facts which were known or which could be ascertained as of the date of merger and which throw any light on *future prospects* of the merged corporation are not only pertinent to an inquiry as to the value of the dissenting stockholder's interest, but *must be considered*") (quoting Tri-continental Corp. v. Battye, 66 A.2d 910, 917-918 (1949)).

197. SHANNON P. PRATT & ROGER GRABOWSKI, COST OF CAPITAL IN LITIGATION 26 (2010) (noting that risk premiums are added to compensate for high leverage levels).

198. Moll, *supra* note 16, at 334 (noting the adverse effect on the company's future business if creditors, suppliers, or other parties vital to the business become aware of discord).

199. *See* 8 Del. Code § 262(e) (West 2010).

200. SHANNON P. PRATT & ROGER GRABOWSKI, COST OF CAPITAL IN LITIGATION at 4 (2010).

201. Berreman v. West Publ'g. Co., 615 N.W.2d 362, 367 (identifying a closely-held company as one without a ready market for its stock).

202. SOLOMON & SARET, *supra* note 2, at 140.

C. *Addition of the Minority's Shares to the Corporation's Cost of Equity.*

The cost of equity represents the ability of the corporation to raise equity capital and therefore is properly calculated to reflect a hypothetical market price.[203] Minority and marketability discounts are applied to the shares of a close company for the risk that security presents.[204] The investor will only purchase the stock if the price is such that, coupled with the risk, it would offer an adequate risk/reward payoff.[205] Without the discount, the investor would demand a higher rate of return from the stock for his excess exposure to risk from the position.[206] That higher expected return should be reflected in the cost of equity.[207]

Application of minority discounts is understandably banned when used on a post-valuation basis because it can lead to a windfall for the majority.[208] Discounts are traditionally applied by reducing the amount of cash in the numerator of the DCF and discounting the remaining cash flows by the entire company's cost of capital.[209] The windfall results because the majority pays for a fraction of the cash flows that would be included in valuing the entire enterprise.[210] However, to reflect the ongoing ability of the enterprise to raise equity, risk premiums regarding minority and marketability status should be included in the cost of equity because the corporation will only be able to raise equity capital at a price that reflects those discounts.[211]

Applying discounts in the cost of equity way does not offend the rule in *Cavalier* because discounts are applied to the entire

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203. *See supra* note 93 and accompanying text.

204. *Supra* notes 30-32 and accompanying text.

205. *Supra* note 163 and accompanying text.

206. *Supra* note 163 and accompanying text.

207. *See supra* notes 201-02 and accompanying text.

208. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144-45 (ruling that discounts should not be applied only to a specific block of shares).

209. Treas. Reg. § 25.2701-3(b)(4). Regarding an interest received by gift, the value of the interest is determined after the application of a minority or similar discount. *Id.*; *see also* Treas. Reg. § 20.2031-1(b)(1)(1965) (defining fair market value for estate tax purposes as the price a willing purchaser would pay knowing all relevant factors).

210. *See supra* note 184 and accompanying text.

211. *See supra* note 93 and accompanying text. Note the difference between allocating for the cost of equity by including a discount for minority and marketability and the implicit minority discount. The implicit minority discount is rejected because it is based on the assumption that market prices for publicly traded companies do not reflect the value of the company as a whole. The price on the market is the actual price that investors acquired that security. From the close corporation's perspective, adjusting the cost of capital is appropriate to account for burdens faced by the corporation to convince the market to invest.

company.[212] In addition, the reasons behind denying the discounting of individual interests does not hold when applied to the cost of capital.[213] First, the rationale for denying individual discounts based on characterizing the buy-out as a non-sale does not apply.[214] After the purchase of the minority shares, the corporation is burdened by the lack of marketability because it will bear the cost of creating a market for the securities, and adjustments to the cost of capital reflect the ability of the company to raise equity going forward.[215] Second, denial of the minority discount based on the controlling interest purchasing the shares does not provide a sufficient reason for outlawing the adjustment.[216] Granted the lack of control does not directly affect the corporation, but the shares represent the ability to raise equity capital and will be priced at a discount due to the minority status when the company attempts to raise capital.[217] Further, the "fair value" of the shares from the controlling interests' perspective is less valuable because the majority would not pay for the privilege of exercising powers it already holds.[218] The block of shares is effectively as valuable as the majority allows it to be because it can divert cash away from the shares.[219] Third, there is not a risk of encouraging oppressive behavior by the majority since the premiums applied to the cost of equity reflect the true value of the shares to the corporation.[220] The corporation purchases the shares at the amount that the corporation will be able to sell the shares in the market and therefore does not receive a windfall.[221]

V. CHOOSING A VALUATION DATE AND DISCOUNT RATE.

The statutory determination of the valuation date can have a substantial impact on the make-up of the WACC that is used to

212. *Cavalier*, 564 A.2d at 1144-45.

213. *But see supra* note 169 and accompanying text.

214. *Id.*

215. *See* Solomon, *supra* note 2, at 140-41.

216. *But see supra* note 169 and accompanying text.

217. *Supra* note 165 and accompanying text. The controlling interest is unlikely to sell his entire controlling stake so it is assumed the shares will be sold as minority shares.

218. *See* John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions While Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 387 (1996) (explaining that an interest who has *de facto* control is not entitled to fully realize a control premium).

219. *Supra* notes 24-25 and accompanying text.

220. *But see supra* note 169 and accompanying text.

221. *See supra* note 209 and accompanying text.

determine the value of the company.[222] Under the voting date statutes, the changes in the capital structure may not be taken into account because they are unlikely to commence until after the shareholders vote on the issue.[223] Under the Model Business Corp. Act, the time immediately before the merger may cause the transaction to become complex in order to secure a favorable position for valuation purposes.[224] The majority would like to raise debt capital before the transaction in order to have it included in the DCF model, yet it would not want to have the cash included.[225] The Delaware method that calls for the valuation date on the merger date may present the same issue.[226] An argument can be made, in the case of oppressive action, that the valuation date should be set before the oppressive action took place to protect the minority shareholder's interest.[227] Even in jurisdictions where the statute sets the valuation date, the court may take into account "all relevant factors" to choose which factors to include regardless of when they occurred, but is hesitant to divert from the rule that post-merger developments are not to be considered.[228]

The appraisal proceeding seeks to compensate the dissenting shareholder for his interest at the merger date, but on an ongoing basis.[229] By not taking into account the changes in capital structure the company may undertake during the transaction, strict application of a cut-off date ignores that the majority is the party who must deal with post-acquisition results of the transaction.[230] The strict cutoff date cuts both ways because it may deny the dissenter any appreciation in value from the merger, but also protects him from any further loss to his shares.[231] In light of some cases, it appears that courts are willing to take into account the post-transaction affects to ascertain which valuation model best reflects the ongoing aspect

222. Eric I. Abraham, *Using the Equities to Set the Valuation Date in Oppressed Shareholder Actions*, N.J. LAWYER, June 2006.

223. *See id.* at 30 (describing the effect of a New Jersey statute that sets a presumptive valuation date at the date the appraisal action commenced).

224. Moll, *supra* note 16, at 373 (noting that a post-filing valuation date may be problematic in the context of pending litigation).

225. *See id.*

226. *Id.*

227. *Id.* at 371-72.

228. Wertheimer, *supra* note 37, at 692.

229. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 713.

230. Abraham, *supra* note 222, at 31.

231. *Id.*

of the business.[232] The court has allowed a post-acquisition cost of capital to be used and has considered information brought forward through discovery.[233] By taking in all relevant factors, the court is better able to determine the value of the shareholder's stake.[234]

A preference to valuation models that includes post-acquisition factors would better value the ongoing enterprise regardless of which party would benefit from such inclusion.[235] Only with the post-acquisition WACC can the valuation reflect the dissenter's rights as they existed before the corporate action.[236] The minority shareholder never had the voting power to control cash flows or to effectively change the capital structure of the original enterprise.[237] Why should he be given this right in the appraisal proceeding? The appraisal statutes were designed to protect minority shareholder's reasonable expectations in the ongoing business.[238] These expectations never included the ability to control the date at which he could sell his interest or the ability to alter the capital structure.[239] In addition, if the board were voting on purchasing outside shares, or proposing to make another investment that required capital financing, the minority interest would not be able to halt the corporate action.[240] Therefore, the value of the company should be valued with a discount rate reflective of the decisions of controlling management.[241]

If the reason for a pro-rata enterprise value per share is to prevent the majority from a windfall and discourage oppressive behavior, the use of the post-acquisition discount rate will not frustrate that goal.[242] The majority will not receive a windfall because the majority will pay for the exact value of the shares'

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232. *See supra* note 181; Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144-45; *see also* Wertheimer, *supra* note 37, at 694.

233. *See supra* note 181; *Cavalier*, 564 A.2d at 1144-45.

234. *See* Wertheimer, *supra* note 37, at 691 (citing DEL. CODE. ANN. tit. 8, § 262(h) (1991)).

235. *See* Wertheimer, *supra* note 37, at 692 (advocating that post-transaction developments that do not reflect the effects of the merger offer the best evidence of fair value at the time of the transaction).

236. *See* Moll, *supra* note 16, at 375-76 (noting that allowing the minority to avoid any post-oppression losses may seem unfair since it cannot be proved that the minority's participation would have resulted in a different outcome).

237. *Supra* note 17 and accompanying text.

238. *Supra* note 43 and accompanying text.

239. *Supra* notes 20, 23 and accompanying text.

240. *See supra* note 20 and accompanying text.

241. *See id.*

242. *See* Coffee, *supra* note 218, at 386-87.

worth to the company as an ongoing enterprise.[243] Further, changes to the capital structure based solely with an eye toward litigation may depress the value of the minority's shares, but will also affect the ability of the ongoing business to function at a healthy level.[244] On the other hand, if the pre-acquisition cost of capital is used and the transaction does not produce substantial value, the majority will essentially be paying a premium for the shares.[245] The price paid per share based on the previous discount rate may exceed the new value of the shares to the company because the entire company will be of a lesser value assuming a higher discount rate is applied to the company in the future.[246]

Valuing the company at a time before the consummation of the corporate action results frustrates the statute's purpose to foster liquidity by giving a minority shareholder incentive to hold-out.[247] It will essentially encourage a minority shareholder to claim his appraisal rights any time he is out-voted on a decision to enter into a worthwhile transaction that could increase the company's cost of capital.[248] This is unnecessary protection afforded to the minority shareholder because if the majority enters into the transaction to freeze-out the minority, a derivative suit is not barred and may even be considered within the context of an appraisal suit.[249]

In addition, using a pre-transaction date and discount rate leads to uncertainty when evaluating the prospects of a transaction. The company must take into account its current WACC and allow for the possibility of having to buy-out the minority and the effect on its WACC at the time of the transaction.[250] However, if the valuation date is set at the date of the merger, the corporation can estimate the value of the transaction based on what its cost of capital will actually be for the transaction.[251]

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243. *See supra* notes 165, 169, 214-15 and accompanying text.

244. Abraham, *supra* note 222, at 31.

245. *Cf.* Abraham, *supra* note 222, at 32 (noting the argument that awarding the minority shareholder the proportionate value of their shares will discourage potential controlling investors from taking a position unless they can capture all the returns from their efforts).

246. *See* O'NEAL & THOMPSON, *supra* note 26 and accompanying text.

247. *See supra* notes 239-41 and accompanying text.

248. *See supra* notes 239-41 and accompanying text.

249. *See* Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144-45.

250. *Cf.* Moll, *supra* note 16, at 370 (noting a prospective purchaser needs a fixed point in time to determine whether he should purchase the shares or contest liability).

251. *See id.*

Regardless of what date is prescribed by the statute, the valuation is always forward-looking to reflect the company's value as a going concern.[252] The discount rate to be used should reflect the ability to raise capital in the future.[253] The minority's interest is valued "exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation," but in order to get an accurate estimate of the value of the company on an ongoing basis, it is necessary to include the factors that affect the cost of capital stemming from the transaction.[254]

VI. CONCLUSION

In cases involving allegations of oppression, it may be proper to disallow minority and marketability discounts on a broad basis in order to prevent the oppressor from being able to purchase the minority's shares at fire-sale prices.[255] However, in doing so, the court is making a pure policy determination that the minority is entitled to his proportion of the entire value of the company prior to the oppressive acts.[256] It follows that the oppressor is forced to take on the risk associated with reissuing the shares by his devious acts.[257]

On the other hand, a pure appraisal case does not include a judicial determination of malicious acts.[258] Each party is simply exercising its respective legal rights.[259] The court should adhere faithfully to the goal of compensating the shareholder for his interest in the company as a going concern, but not to award him for his dissention.[260] The minority shareholder's reasonable expectations were that he would be afforded an interest in the continuing company, but only as a minority interest accompanied by the disadvantages that may result from that position.[261] The

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252. PRATT & GRABOWSKI, *supra* note 12, at 3-4.

253. *Id.*

254. *See* Del. Code Ann. tit. 8, § 262(h) (1991) (West); Wertheimer, *supra* note 37, at 627 n.74; *see also* Wertheimer, *supra* note 37, at 691-92 (arguing that post-transaction results should not be entirely excluded from consideration).

255. *See* Moll, *supra* note 16, at 327-28 n.127.

256. *See* Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989) (stating that majority shareholders may reap a windfall from the appraisal process by cashing out a dissenting shareholder without according full proportionate value).

257. *See id.*

258. *Id.* at 1143 (quoting *Cede and Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1189 (Del. 1988)).

259. *See id.* at 1144.

260. *See id.* (citing the "fairness concept" established in *Weinberger v. UOP* to determine the value of the shareholder's interest in the going concern).

261. *See supra* notes 230-31 and accompanying text.

minority holder never held the expectation that he would be able to cash-out his interest without facing the difficulties inherent with selling the shares.[262] Bright line rules barring the use of minority or marketability discounts for all cases should be avoided, especially in cases lacking a judicial determination of unwanted behavior.[263]

In order to include "all relevant factors" affecting the value of the company, its future prospects of raising capital for new projects and revenues is an important consideration.[264] While the "intellectually interesting argument" as to the existence of the implicit minority discount in DCF models may remain open, the premium would apply only in the event of a sale of the entire company, but an appraisal is not meant to reconstruct a sale.[265] The same non-sale reasoning that discounts are not applied to an individual block of shares holds true in denying the minority any premium accompanying the market's calculation of the company's CAPM.[266] If an appraisal is conducted with the view that the minority would continue to maintain his interest in the enterprise, the goal of the proceeding should be to assess all of the factors, including capital requirements, of the company going forward.[267] Awarding the dissenter based on a snap-shot in time disproportionately awards the minority for burdens that are borne by the continuing interests.[268] The continuing interest is stuck with the costs of the minority shareholder for a decision that the minority shareholder did not have the legal rights to effectively determine.[269] Awarding the dissenter for the fair value of his shares without applying any discounts awards him a value greater than the pro-rata fair value of his interest to the remaining business.[270]

The controlling interest should be able to carry out its chosen business decision at its proportionate cost of that

262. *See* Berreman v. West Publ'g Co., 615 N.W.2d 362, 368 (Minn. Ct. App. 2000) (noting that lack of a public market, combined with several tactics used by majority shareholders can hold the minority shareholder's investments hostage).

263. *See* Wertheimer, *supra* note 37, at 634 n.115.

264. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (citing Del. Code Ann. tit. 8, § 262(h) (1991) (West)) (taking into account all relevant factors).

265. Hammermesh & Wachter, *supra* note 7, at 24 (citing *Lane v. Cancer Treatment Ctrs. Of Am., Inc.*, No. 12207, 2004 Del. Ch. LEXIS 108, at *29-30 (July 30, 2004)).

266. *See Cavalier*, 564 A.2d at 1145.

267. *See Weinberger*, 457 A.2d at 713 (taking into account all relevant factors).

268. *See generally id.* (noting that elements of future value, including the nature of the enterprise, which are known or susceptible or proof as of the date of the merger should be considered).

269. *Supra* notes 231-33 and accompanying text.

270. *See* Wertheimer, *supra* note 37, at 643 n.140.

decision.[271] The minority should only be compensated for the fair value of his interest, not necessarily the value of his interest in the company as it is managed as he envisions.[272]

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271. *See* Wertheimer, *supra* note 37, at 619.
272. *See* Wertheimer, *supra* note 37, at 619.