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A REAPPRAISAL OF FAIR SHARES IN CONTROLLED MERGERS

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With the decision of the Seventh Circuit in April of 1977 and the subsequent denial of certiorari by the Supreme Court, the final curtain appears to have been brought down on *Mills v. Electric Auto-Lite Co.*¹ It is the sort of case that Charles Dickens (or perhaps a less perceptive social critic) would have cherished:² seven years and three reported decisions were required to find that the plaintiffs had a cause of action,³ and then another seven years and two reported decisions were necessary to determine that the plaintiffs had suffered no damages and were not entitled to any other relief.⁴ The final Seventh Circuit decision, however, raises a number of further questions, primarily concerning the basic authority on which the decision is premised: an article written in 1974 by Professors Victor

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¹ 552 F.2d 1239 (7th Cir.), *cert. denied*, 98 S. Ct. 398 (1977).

² "Battledore and Shuttlecock's a wery good game, when you a'n't the shuttlecock and two lawyers the battledores, in which case it gets too excitin' to be pleasant." C. DICKENS, *PICKWICK PAPERS*, Ch. 20. Further, the fourteen year duration of the case and the resultant attorneys' fees that must have been generated bring to mind Oliver Wendell Holmes Sr.'s poetic remark that "Knowledge may starve while Law/grows fat." *THE POETICAL WORKS OF OLIVER WENDELL HOLMES* 118, 120 (Cambridge ed. 1975).

³ *Mills v. Electric Auto-Lite Co.*, 281 F. Supp. 826 (N.D. Ill. 1967), *rev'd*, 403 F.2d 429 (7th Cir. 1968), *vacated and remanded*, 396 U.S. 375 (1970).

⁴ 552 F.2d 1239 (7th Cir.), *cert. denied*, 98 S. Ct. 398 (1977). The district court's decision on the computation of the damages is unreported. The district court had decided earlier that it would be impractical to rescind the merger. See *Mills v. Electric Auto-Lite Co.*, [1971-72 Transfer Binder] *FED. SEC. L. REP.* (CCH) ¶ 93, 354 (N.D. Ill. Jan. 10, 1972).

Brudney and Marvin Chirelstein⁵ that dealt with the evaluation of fairness of terms in controlled merger situations.⁶ The Brudney & Chirelstein article contains much useful analysis and is without doubt a significant and provocative contribution to the literature in an area that simply does not admit of any completely satisfactory answers, but there is substantial reason to doubt whether the analysis which it proposes is grounded in sound theory. In addition, it is clear from the Seventh Circuit decision in *Mills* that the court did not fully understand the concepts set forth in the Brudney & Chirelstein article; to some extent, that incapacity on the court's part may have been due to an incomplete articulation of some basic ideas of the article.

The adoption of the Brudney & Chirelstein analysis by the Seventh Circuit makes it important to focus attention on the flaws in that approach as well as on the errant application of the analysis by the Seventh Circuit, particularly during a period in which it appears that the courts will increasingly be drawn into fairness evaluations.⁷ Moreover, the recent proposal of the Securities and Exchange Commission⁸ to require fairness in controlled mergers pursuant to its rulemaking power under section 13⁹ of the Securities

⁵ Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974).

⁶ Controlled mergers, as that term is used in this Article, occur when the acquiring corporation, prior to the merger, exercises such significant control over the acquired corporation that the transaction cannot reasonably be viewed as negotiated at arms' length. See *id.* 298.

⁷ See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *McNally v. Vickers Energy Corp.*, 427 F. Supp. 1211 (N.D. Ill. 1977); *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977); *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977); *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976). Cf. *People v. Concord Fabrics, Inc.*, 83 Misc. 2d 120, 371 N.Y.S.2d 550 (Sup. Ct.), *aff'd mem.*, 50 App. Div. 2d 787, 377 N.Y.S.2d 84 (1975) (injunction granted by trial court to state attorney general to halt defendant from "going private" in order to protect investors from falling prey to "self-interested majority").

⁸ Proposed Rule-Going Private Transactions By Public Companies or Their Affiliates, 42 Fed. Reg. 60,090, 60,101 (1977).

⁹ *But cf.* *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (holding that allegations of unfairness do not state a claim under § 10 of the Securities Exchange Act of 1934 and rule 10b-5 thereunder). While the SEC may have greater authority under § 13(e) of the Act than under § 10, and while *Santa Fe* did not involve any specific rule promulgated under § 10 to address controlled mergers but was rather a private action based on the general anti-fraud provisions, it is far from clear that the proposed rule is within the rulemaking authority of the SEC. Indeed, the entire disclosure orientation of the Act, as well as some of the specific language of § 13(e)(1) itself, strongly suggest that the rulemaking authority is limited to rules concerning what must be disclosed, rather than rules governing substantive fairness. Section 13(e)(1) provides that "the Commission . . . may adopt [rules] . . . to define acts and practices which are fraudulent . . . Such rules . . . may require such issuer to provide holders of equity securities . . . with such information . . . as the Commission deems necessary or appropriate . . . or . . . material."

Exchange Act of 1934¹⁰ is demonstrative of the importance of the present inquiry. That proposed rule, which would permit the SEC to become involved for the first time in a substantive fairness analysis of securities transactions by corporations, specifically requires that in controlled mergers and similar absorption transactions, the "transaction [must be] fair to unaffiliated securityholders."¹¹ This Article is intended first to explain the underlying theory of the Brudney & Chirelstein article and to clarify aspects of the theory that seem to have been misunderstood by the Seventh Circuit. Second, the specific facts of the *Mills* case will be examined, because the case provides a useful focal point for an appraisal of the question of fairness in controlled mergers involving exchanges of stock. Third, some questions will be raised concerning the underlying assumptions of the Brudney & Chirelstein analysis, in order to emphasize its limitations. Finally, the problems of applying the Brudney & Chirelstein approach to controlled mergers that do not involve exchanges of stock will be discussed.¹²

I. THE BRUDNEY & CHIRELSTEIN ANALYSIS

Before criticizing the Brudney & Chirelstein analysis, it is appropriate to review the analysis itself. Further, the apparent confusion of the *Mills* court in applying the Brudney & Chirelstein approach suggests the utility of elucidating some of the implications

¹⁰ 15 U.S.C. § 78m (1975).

¹¹ Proposed Rule-Going Private Transactions By Public Companies or Their Affiliates, 42 Fed. Reg. 60,090, 60,101 (1977).

¹² Although the primary focus of this Article is on the fiduciary concept advanced by Brudney & Chirelstein as the basis for their fairness analysis, *see* text accompanying notes 20 & 47-53 *infra*, their article included a survey of traditional judicial approaches to the fairness issue and of minority shareholders' ability to obtain an equitable distribution. In that context Brudney & Chirelstein evaluated in some depth the ratification rights of minority shareholders, the efficacy of disclosure mechanisms, *see* Brudney & Chirelstein, *supra* note 5, at 299-304, and the extent of protection provided by appraisal rights, *id.* 304-07. It may be that their rejection of those alternatives will provide useful background for legislatures that consider the need for statutory revision, even though it is suggested in this Article that their own solution to the problem of fairness is not satisfactory. Brudney & Chirelstein also examined in some depth the question of mergers following tender offers and the purchase of control for a premium. *Id.* 330-44. None of those issues is fully addressed in this Article for the simple reason that they have all been subjected to substantial scrutiny in the literature. *See, e.g.,* ABA National Institute, *Corporate Takeovers—The Unfriendly Tender Offer and the Minority Stockholder Freezeout*, 32 BUS. LAW. 1297 (Special Issue 1977); Buxbaum, *The Dissenter's Appraisal Remedy*, 23 U.C.L.A. L. REV. 1229 (1976); Hazen, *Transfers of Corporate Control and Duties of Controlling Shareholders—Common Law, Tender Offers, Investment Companies—and a Proposal for Reform*, 125 U. PA. L. REV. 1023 (1977); Hetherington, *Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility*, 21 STAN. L. REV. 248 (1969); Manning, BOOK REVIEW, 67 YALE L.J. 1477 (1958).

of their analysis as applied to controlled mergers in which the minority shareholders of the subsidiary receive stock of the parent, particularly since an important implication of their analysis—and one central to the *Mills* decision—was rather cursory in nature, and was contained in one footnote¹³ and a sentence in the middle of a conclusory paragraph.¹⁴ Consequently, one cannot place all of the blame on the Seventh Circuit for failing to be cognizant of that implication, which is not necessarily clear intuitively. This section of the present analysis is intended, therefore, solely to clarify certain aspects of the Brudney & Chirelstein analysis; it is not intended to contradict that analysis.

The significant point made in the Brudney & Chirelstein article is that the traditional *post factum* measure of fairness, which is described as the “give-get” formula, is inadequate when applied to certain mergers. The traditional mode of analysis has been merely to compare the market value of the minority shareholders’ interest in the controlled corporation prior to the transaction with the value of the consideration received by them.¹⁵ Brudney & Chirelstein, however, argue that mergers frequently result in additional benefits to the acquiring corporation that are not reflected in the prior market value of the acquired entity and that the minority shareholders are entitled to participate in those benefits. For example, the merger may make available any number of operating efficiencies, economies of scale, or other benefits that will make the whole of the combined entity worth more than the sum of the pre-existing parts. Moreover, the management of the controlling entity is most apt to know of the availability of those benefits and of when the disparity between market value and “real” value is greatest. That knowledge should create additional reason to be dissatisfied with a procedure for valuation that gives the minority shareholders no more than the pre-merger market value of their interests in the subsidiary. The authors then assert that the review of fairness should not be limited to the question whether the minority shareholders received equivalent value for their interest—the “give-get”

¹³ Brudney & Chirelstein, *supra* note 5, at 310-11 n.36. The key statement was that “sharing in the gains occurs if *both* enterprises are valued on a premerger basis and the parent’s stock, so valued, is the currency in which the subsidiary’s public stockholders are paid.” *Id.* (emphasis in original).

¹⁴ *Id.* 323. The key statement here was that the Brudney & Chirelstein fairness analysis “is satisfied by an exchange of shares based on the premerger [market] value of each entity.” *Id.* See text accompanying notes 27-29, *infra*.

¹⁵ *Id.* 310-12 & n.37. See, e.g., *Gerstle v. Gamble Skogmo, Inc.*, 332 F. Supp. 644 (E.D.N.Y. 1971), *aff’d*, 478 F.2d 1281 (2d Cir. 1973); *Bastian v. Bourns Inc.*, 256 A.2d 680 (Del. Ch. 1969), *aff’d per curiam*, 278 A.2d 467 (Del. 1970).

formula—but should include an analysis of whether the additional benefits resulting from the merger were fairly allocated between the parent and the minority shareholders of the subsidiary. That is, Brudney & Chirelstein challenge the courts to recognize that there is an additional benefit to be recognized in merger transactions, and they assert that the courts are simply not going far enough if they examine only the corpus of what is surrendered by the minority shareholders.¹⁶

In examining how properly to allocate the merger benefits, the authors suggest two alternatives: a straw man, which they properly reject, and their own solution. The straw man alternative springs from a sense that the additional benefit from the merger, which the Seventh Circuit in *Mills* refers to as the synergistic effect of the merger,¹⁷ might be divided between parent and subsidiary on the basis of their relative bargaining power, under the theory that parties bargaining at arms' length might have arrived at some negotiated agreement.¹⁸ Rejecting that concept as without any firm footing,¹⁹ Brudney & Chirelstein suggest instead that the courts draw from what should, in their view, be the duty of a fiduciary managing trust funds of different sizes but comparable investment goals. They assert that such a fiduciary should allocate any savings or investment opportunity in proportion to the size of the funds, thereby ensuring proportionate sharing in the benefit by equalizing the return on investment for each of the funds.²⁰ For comparable reasons, they argue for a sharing of the merger benefits in proportion to the size, as measured by market value, of the entities that existed prior to the merger.

The authors set forth a hypothetical that is instructive in understanding their analysis. They assume that the following facts prevail:

	<i>Price/ Earnings Multiple</i>	<i>Earnings Per Share</i>	<i>Out- standing Shares</i>	<i>Market Price</i>	<i>Total Market Value of Public Shares</i>
Parent (P)	10	\$12	1,000,000	\$120	\$120,000,000
Subsidiary (S)	10	\$.50	2,000,400*	\$5	\$ 5,000,000*

* 1,000,000 shares are held by the public, the remainder by P; P's share (50.01%) of S's earnings is a part of P's earnings in the hypothetical.

¹⁶ Brudney & Chirelstein, *supra* note 5, at 313-14, 321-23.

¹⁷ 552 F.2d at 1248.

¹⁸ See Brudney & Chirelstein, *supra* note 5, at 315-16.

¹⁹ *Id.* 316-18.

²⁰ *Id.* 318-22.

Brudney & Chirelstein further assume that when *S* is merged into *P* the synergistic effect is such that the post-merger *P* has a market value of \$135 million, which they assume will be the total market value of *P* regardless of how many shares of *P* are issued to the minority shareholders of *S*; that is, however many shares of *P* may be outstanding after the merger, the price per share of *P* will adjust to yield a total market value of \$135 million.²¹

This hypothetical yields three possible conclusions in evaluating whether the minority shareholders of *S* received "fair" compensation in the transaction. First, under the "give-get" test, the transaction will be fair if the minority shareholders receive a value equal to the \$5 million worth of *S* shares surrendered. If shares of *P* are issued, the "give-get" test is satisfied by the issuance to the minority of 38,462 *P* shares, each of which will have a market value of \$130.²² Under the negotiation test, the \$10 million increment in value resulting from the merger would most likely be split evenly between *P* and *S*.²³ Because *P* itself owns approximately one-half of *S*, *P* shareholders would receive \$5 million of the increment directly and \$2.5 million indirectly. The minority shareholders of *S* would be entitled to the remaining \$2.5 million of merger benefit plus the \$5 million of value they surrendered, for a total of \$7.5

²¹ See *id.* 313.

²² The determination of the number of shares and price follows from the solution of simultaneous equations. If *x* is the number of shares of *P* to be received by the *S* shareholders, and *p* is the post-merger price per share of *P* shares, the "give-get" approach requires as a minimum that $xp = \$5,000,000$. Furthermore, since all post-merger shares must have the same price, and the *P* shareholders will continue to hold 1,000,000 shares, and the total market value of the new enterprise is assumed to be constant at \$135 million, it follows that

$$(x + 1,000,000)p = \$135,000,000$$

Solving the equations simultaneously:

$$\left(\frac{\$5,000,000}{p} + 1,000,000 \right) p = \$135,000,000$$

$$\$5,000,000 + 1,000,000p = \$135,000,000$$

$$1,000,000p = \$130,000,000$$

$$p = \$130$$

so that

$$x = 38,462.$$

²³ Although Brudney & Chirelstein argue in principle that the allocation under the negotiation test depends on the relative bargaining power of the parties, see Brudney & Chirelstein, *supra* note 5, at 315-16, they conclude that in fact the synergy will probably be divided equally. That conclusion springs from their assertion that a weighing of relative bargaining power involves an evaluation of "indeterminate variables"; as a result, the even split is a likely outcome because it has "an appearance of neutrality and evenhandedness." *Id.* 316.

million. If shares of P are issued in the merger, the minority shareholders would receive 58,823 shares of P having a value of \$127.50 per share.²⁴

If the Brudney & Chirelstein solution is accepted, however, the synergy should be allocated in proportion to the total market values of the entities before the merger. Specifically, reducing the authors' approach to a formula, the "fair" amount of compensation to minority shareholders is equal to:

$$\text{Mkt}_s + \left(\frac{\text{Mkt}_s}{\text{Mkt}_s + \text{Mkt}_p} \right) \text{MB} \text{ [Formula B-1]}$$

where

Mkt_s = Total market value of the minority ownership of S

Mkt_p = Total market value of P

MB = Additional benefit from the merger.

The minority shareholders should therefore receive value equal to the value of S stock surrendered plus a proportionate share, determined by reference to market values, of the additional benefits expected from the merger.²⁵ Such a proportionate allocation of the merger benefit would, according to Brudney & Chirelstein, conform to the fiduciary obligation of a trustee managing trusts of different sizes. In the hypothetical above, the "fair" compensation to the minority shareholders of S under this theory is:

$$\begin{aligned} & \$5,000,000 + \left(\frac{\$5,000,000}{\$5,000,000 + \$120,000,000} \right) \$10,000,000 \\ = & \$5,000,000 + \left(\frac{5}{125} \right) (10,000,000) \\ = & \$5,400,000 \end{aligned}$$

²⁴ See note 22 *supra*. In this case:

$$\begin{aligned} xp &= \$7,500,000 \\ (x + 1,000,000)p &= \$135,000,000 \\ \left(\frac{\$7,500,000}{p} + 1,000,000 \right) p &= \$135,000,000 \\ p &= \frac{\$135,000,000 - \$7,500,000}{1,000,000} \\ p &= \$127.50 \end{aligned}$$

so that

$$x = 58,823$$

²⁵ Brudney & Chirelstein, *supra* note 5, at 321. The division of the merger benefit into a \$400,000 portion to the minority shareholders of S and a \$9,600,000 portion to the shareholders of P yields an equal 8 per cent return on the respective investments of \$5 million and \$120 million.

If the compensation to the minority shareholders is all in the form of *P*'s stock, it then follows that the merger terms are fair only when the minority shareholders of *S* receive 41,667 shares of *P*, the price of which will be \$129.60 per share.²⁶ Under these circumstances, the minority shareholders receive a total value of \$5.4 million, which is their original value of \$5 million in *S* stock plus 5/125 of the \$10 million merger benefit.

But it is only in a footnote ten pages before and in the middle of a paragraph two pages after this analysis that the authors make the observation, which follows directly from the foregoing formula, that in the case of a stock merger an exchange of shares in the ratio of the pre-merger market values of the companies necessarily satisfies the theory.²⁷ Therefore, the notion of a proportionate sharing in the merger benefit, although conceptually helpful, is surplusage in the formula when applied to a stock merger. If the number of shares of *P* issued to the minority shareholders is in the same proportion to the number of shares of *S* formerly held by them as the pre-merger price of a share of *S* is to the price of a share of *P*, the participants will necessarily retain their proportionate shares in the synergy resulting from the merger. The analysis of relative market values of *S* and *P* answers the following question: "If *S* has a given total public market value, how many shares of *S* must exist in order for each share to have the same price as one share of *P*?" Because the merger benefit will be reflected in the post-merger price of *P*, a proportionate sharing of benefits in the stock merger case will be ensured by putting pre-merger shares of *S* on the same footing as those of *P*. That follows from the critical point made by Brudney & Chirelstein, which is that the minority shareholders should have the same portion of the post-merger combined entity that they had of the premerger entities, and portions are determined as a percentage of total market value. Expressing this concept in a formula,

²⁶ See note 22 *supra*. In this case:

$$\begin{aligned} xp &= \$5,400,000 \\ (x + 1,000,000)p &= \$135,000,000 \\ \left(\frac{\$5,400,000}{p} + 1,000,000 \right) p &= \$135,000,000 \\ p &= \frac{\$135,000,000 - \$5,400,000}{1,000,000} \\ p &= \$129.60 \end{aligned}$$

so that

$$x = 41,667$$

²⁷ Brudney & Chirelstein, *supra* note 5, at 310-11 n.36, 323.

the total number of shares of P that should be issued to the minority shareholders of S is:

$$Sh_{ps} = \frac{(MP_s \times Sh_s)}{MP_p} \quad [\text{Formula B-2}]$$

Sh_{ps} is the number of P shares issued in exchange for S shares;

MP_s is the pre-merger market price of one S share;

Sh_s is the total number of S shares outstanding in the public's hands; and

MP_p is the pre-merger market price of one P share.²⁸

The number of shares issuable in exchange for each pre-merger share of S is therefore in proportion to the pre-merger market prices of S and P stock:

$$\text{Fair Exchange Ratio} = \frac{Sh_{ps}}{Sh_s} = \frac{MP_s}{MP_p} \quad [\text{Formula B-3}]$$

It is important to note one additional aspect of the article that raises problems: not all, and perhaps not even most, controlled mergers involve the issuance of stock. In considering that factor, Brudney & Chirelstein merely note in passing that their approach is to be followed in "cash-outs" or similar transactions, with the merger

²⁸ For those who prefer to see the algebra step by step, to simplify notation let:

a = pre-merger price of P per share

b = number of P shares outstanding prior to merger

c = pre-merger price of S per share

d = number of S shares held by public prior to merger

x = post-merger number of P shares

y = post-merger price per P share

Formula B-1 can therefore be expressed as

$$cd + \left(\frac{cd}{cd + ab} \right) (xy - (ab + cd))$$

since total market value (Mkt_s and Mkt_p) is equal to the number of shares times the price of each and MB is defined as the market value of the combined entity minus the sum of the market values of the separate entities (after eliminating the value of P 's holdings in S , which are included in P 's market value).

Moreover, formula B-1 was posited to establish the compensation that is to be received by S 's minority shareholders, which is necessarily equal to the number of shares they receive of P times y since, after the merger, all P shares must have the same price. If z is that number of shares, then

$$z + b = x$$

because the P shareholders will not receive any additional shares. (If this last fact were not true, the number yielded by the formula developed here for z would have to be multiplied by the number of P shares held by P shareholders after the merger divided by the number previously held by those persons.) The total num-

benefit possibly to be paid even subsequent to the transaction.²⁹ As will be shown, that suggestion entails immense difficulties that the authors do not attempt to resolve.

ber of shares to be issued to the public S shareholders must then be formula B-1 ÷ y, so that

$$z = \frac{cd + \left(\frac{cd}{cd + ab} \right) (xy - ab - cd)}{y}$$

$$zy = cd + \frac{cdxy - cd(ab + cd)}{cd + ab} = cd + \frac{cdxy}{cd + ab} - cd$$

$$z = \frac{cdx}{cd + ab}.$$

Substituting $z + b$ for x , then

$$z = \frac{cd(z + b)}{cd + ab}$$

$$cdz + abz = cdz + cdb$$

$$abz = cdb$$

$$z = \frac{cd}{a}$$

which is formula B-2 expressed in the notation of this footnote. Formula B-3 may then be derived by dividing both sides of the equation by d , the total number of S shares held by the public:

$$\frac{z}{d} = \text{shares of parent to be issued per subsidiary share} = \frac{c}{a}$$

²⁹ Brudney & Chirelstein, *supra* note 5, at 323. It may provide some insight to express formula B-1 in terms of market price/earnings multiples. When so viewed, that formula provides that the minority shareholders of the subsidiary are entitled to the market multiple of their "old" earnings plus a proportionate part, based on pre-merger market prices, of the amount by which the market multiple applicable to the post-merger entity multiplied by its earnings exceeds the sum of the earnings of the pre-merger entities multiplied by the market price/earnings multiples applicable to each. Viewed in that manner, the amount of the merger benefit will depend upon both the earnings of the post-merger entity and the price/earnings multiple it commands. The Brudney & Chirelstein analysis is designed to give each participant in the merger a market-proportionate share in this benefit, but since the benefit *itself* is determined by the characteristics of the participants, such as the price/earnings multiples they command, it is not altogether apparent that the sharing formula is equitably based. Assume, as is often likely to be true, particularly if the subsidiary is considerably smaller than the parent, that the post-merger entity carries a multiple equal to that of the pre-merger parent. If that multiple is higher than that of the subsidiary, by what logic should the subsidiary's former shareholders share in this benefit that resulted solely from a characteristic of the parent? If the subsidiary's multiple were higher, why should the participatory right of its former shareholders in an increased income stream be reduced by the lower multiple of the parent? The first element of formula B-1 creates in the subsidiary's shareholders an entitlement to the market multiple of their former corporation's earnings; in equity, should not a comparable right relate

II. BRUDNEY & CHIRELSTEIN IN OPERATION:

Mills v. Electric Auto-Lite

The most recent *Mills* decision is important to the present inquiry in two respects. First, as the culmination of fourteen years of litigation involving five reported decisions—including one by the Supreme Court—it is likely to receive significant attention. The Seventh Circuit's decision, in the final round of the case, to embrace fully the Brudney & Chirelstein analysis therefore requires some comment, particularly in light of the confusion inherent in the decision. In addition, as a case presenting rather squarely the type of situation which is under discussion here, it provides a useful focal point for the analysis.

Mills involved a merger of Electric Auto-Lite Company ("Auto-Lite") into Mergenthaler Linotype Company ("Mergenthaler"), followed by the change of Mergenthaler's name to Eltra Corporation ("Eltra").³⁰ Mergenthaler had begun to purchase common stock of Auto-Lite in 1957 and had acquired 54.2 percent of that stock by 1962, thereby achieving operating control of Auto-Lite.³¹ The merger of Auto-Lite and Mergenthaler occurred in 1963. The merger proxy statement, however, although stating that the Auto-Lite board of directors had approved the merger, failed to disclose that the board was already under the control of Mergenthaler.³² The district court found this omission to be material, and, on the first appeal, the Seventh Circuit agreed with that holding; the defendants would, however, have been permitted by the court of

to their share of the post-merger corporation's earnings? Under such an approach, the fair share of such persons would be:

$$\text{Mkt}_s + \frac{\text{Mkt}_s}{\text{Mkt}_s + \text{Mkt}_p} (Y_m) (\text{pem}_s)$$

where all terms have the definitions of formula B-1, and

Y_m = the estimated annual increase in income of the post-merger entity attributable to the merger and

pem_s = the price/earnings multiple of S prior to the merger.

That formula is, of course, much more difficult to apply than formula B-1, particularly since it cannot usefully be reduced further, but it at least recognizes an intangible asset (price/earnings multiple) of the pre-merger entities. Under this formula, the minority shareholders would receive not a share of the increment in value of the post-merger enterprise, but a share of the post-merger incremental income multiplied by the acquired entity's historical multiplier. Benefits or detriments attributable to a reevaluation of the merged entity's multiplier by the market become the risk of the parent. See text accompanying note 81, *infra*.

³⁰ *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1240 (7th Cir.), *cert. denied* 98 S. Ct. 398 (1977).

³¹ *Id.*

³² *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 378 (1970).

appeals to show "by a preponderance of probabilities that the merger would have received a sufficient vote even if the proxy statement had not been misleading" ³³ The Supreme Court reversed the Seventh Circuit on the issue of causation, holding that under the proxy rules of the Securities Exchange Act of 1934 it was necessary to show only that the omission "was of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." ³⁴ On remand both the district court and the Seventh Circuit viewed the only question before them to be whether, in fact, the terms of the merger were fair to the minority shareholders of Auto-Lite.³⁵

³³ *Mills v. Electric Auto-Lite Co.*, 403 F.2d 429, 436 (7th Cir. 1968), *rev'd*, 396 U.S. 375 (1970).

³⁴ 396 U.S. at 384. The Supreme Court decision went on to say:

[A] shareholder has made a sufficient showing of causal relationship between the violation and the injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction.

Id. 385.

³⁵ The history of the *Mills* case may be seen to suggest a troublesome problem quite apart from the use of the Brudney & Chirelstein analysis. After seven years the Supreme Court confirmed that the material omission in a proxy statement, which was a violation of section 14 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78n (1970), gave rise to a cause of action. After another seven years the Seventh Circuit determined that there were no damages. There is at least, then, the suggestion of what the law abhors: a wrong without a remedy. Fortunately, three elements make the finding of the wrong significant and give real meaning to that finding, notwithstanding the ultimate conclusion of *Mills*. First, the Supreme Court's decision in *Mills* put another arrow in the aggrieved investor's quiver, a practice that the Court has abstained from conspicuously in more recent years. See *Piper v. Chris-Craft Indus., Inc.*, 97 S. Ct. 926 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). In addition, the SEC is able, in appropriate cases, to obtain relief of an injunctive nature when omissions of the *Mills* type are found. *Cf.*, e.g., *Henwood v. SEC*, 298 F.2d 641 (9th Cir. 1962); *SEC v. Okin*, 137 F.2d 862 (2d Cir. 1943); *SEC v. May*, 134 F. Supp. 247 (S.D.N.Y. 1955), *aff'd*, 229 F.2d 123 (2d Cir. 1956).

Second, even though rescission of the merger was deemed inappropriate in *Mills*, that holding was partially due to the seven-year period that was consumed in determining the existence of a section 14 violation. *Mills v. Electric Auto-Lite Co.*, [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,354 (N.D. Ill. Jan., 10, 1972). See also *Yamamoto v. Omiya*, 564 F.2d 1319 (9th Cir. 1977); *Swanson v. American Consumer Indus., Inc.*, 475 F.2d 516, 519 (7th Cir. 1973). In future cases the determination that a section 14 violation exists will presumably be made more easily, and rescission may become a viable alternative. For the plaintiff who acts quickly enough, a compelled resolicitation of proxies may well be available as a remedy. E.g., *Central Foundry Co. v. Gondelman*, 166 F. Supp. 429 (S.D.N.Y. 1958). It is, however, likely that the resolicitation remedy will not be viewed as sufficient by plaintiffs who bring actions under section 14, since control of the proxy machinery is effectively equivalent to control of the vote; therefore, resolicitation would probably again generate an approval of the merger. See *Hetherington*, *supra* note 12 at 252-55; *Manning*, *supra* note 12 at 1483 n.17.

Finally, and perhaps most important, there is an inherent confusion between the nature of the wrong and the nature of the remedy in cases like *Mills*. The

The facts necessary to apply a Brudney & Chirelstein analysis to the *Mills* case were reasonably clear as set forth in the Seventh Circuit opinion. Mergenthaler had 2,698,822 common shares outstanding prior to the merger, which shares traded at an average price of \$24.875 over the six months prior to the merger. Of the 1,159,265 Auto-Lite common shares outstanding immediately prior to the merger, 532,550 shares were held by the public and they traded at an average market price of \$52.25 in the six months before the merger. Under the terms of the merger, one Mergenthaler share became one common share of Eltra; each share of Auto-Lite became 1.88 shares of preferred stock of Eltra, convertible into Eltra common at the rate of one common share per preferred share in the first two years of the merger and at declining rates thereafter over the next three years, after which the conversion option expired. During a period of one month following the merger, Eltra preferred traded at an average price of \$31.06 and Eltra common traded at an average price of \$25.25. Determining equivalence by reference to market values, each preferred share of Eltra was equivalent to approximately 1.23 common shares ($\$31.06$ market price of Eltra preferred \div $\$25.25$ market price of Eltra common). Consequently, the merger terms could be considered as 2.31 equivalent common shares of Eltra being issued for each share of Auto-Lite (1.88 preferred Eltra shares \times 1.23 equivalence factor between preferred and common).³⁶

As a preliminary matter, the Seventh Circuit examined the data and concluded "that when market value is available and reliable, other factors should not be utilized in determining whether the

wrong claimed is not unfairness, but rather nondisclosure. After the fact, however, the nondisclosure wrong cannot be meaningfully remedied. The unfairness claim may be seen as a hybrid private right of action that is developing under section 14. The recent cases make clear that there is no federal cause of action (under section 10 of the Securities Exchange Act of 1934 and rule 10b-5) for the unfairness per se of merger terms. See, e.g., *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977). But cf. Proposed Rule—Going Private By Public Companies or Their Affiliates, 42 Fed. Reg. 60,090 (1977) and Proposed Rule—Regulation of Issuer Tender Offers, 42 Fed. Reg. 63,066 (1977) (proposing under section 13 to identify and require fairness in "going private" mergers). Conversely there is no true remedy for nondisclosure. But under the Supreme Court's decision in *Mills*, the unfairness remedy will become available if the private plaintiff can establish the nondisclosure wrong. Admittedly, the potential remedy is not related to the wrong, but *Mills* creates one remedy for the combination of nondisclosure and unfairness, where none other would be possible in the federal courts. Cf. *Kaye v. Pantone*, [current] CCH Sec. Reg. Rptr. ¶ 96,336 (S.D.N.Y. Feb. 22, 1978) (discussing the same problem in the rule 10b-5 context).

³⁶ *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1241-43, 1248-49 (7th Cir.), cert. denied, 98 S. Ct. 398 (1977).

terms of a merger were fair.”³⁷ Although that conclusion is subject to some doubt for reasons that will be examined subsequently, it is certainly a prerequisite to an acceptance of the Brudney & Chirelstein approach, since that approach is grounded in the acceptance of relative pre-merger market values.³⁸ It should therefore have been relatively easy for the Seventh Circuit to apply the Brudney & Chirelstein approach: Using formula B-3 above, the merger would be deemed fair to the Auto-Lite minority shareholders if the exchange ratio of Eltra common shares for Auto-Lite shares was at least

$$\frac{MP_s}{MP_p} = \frac{\$52.25}{\$24.875} = 2.1$$
³⁹

Since the actual exchange ratio of 2.31 was well in excess of the “fair” ratio, the terms of the merger should have been approved on that basis. Remarkably, however, the Seventh Circuit, although fully endorsing the Brudney & Chirelstein analysis, rejected that clear and simple computation:

The simplest method . . . would be to compare the price ratio, in this case 2.1, to the effective exchange ratio . . . 2.31. Under this framework the merger would be fair . . .

This method of calculation, however, assumes that the new corporation . . . is worth exactly as much as the sum of . . . its two component parts . . . before the merger. As Professors Brudney and Chirelstein have cogently pointed out, this assumption is usually false . . .⁴⁰

The Seventh Circuit did not appreciate the simplicity of the Brudney & Chirelstein analysis in the stock merger situation, because the court then reverted to the more complicated, but fully equivalent, B-1 formulation. Thus, the court concluded that the merger was fair since the Auto-Lite shareholders had received value of \$32,095,594, which exceeded the dollar value of their Auto-Lite holdings (\$27,825,737) plus a proportionate part (\$27,825,737/\$94,958,934) of the amount by which the total post-merger value of Eltra (\$99,240,849) exceeded the combined pre-merger values of

³⁷ *Id.* 1247.

³⁸ The Seventh Circuit properly observed that post-merger earnings were not a basis upon which to determine the relative values of Mergenthaler and Auto-Lite, since there was substantial commingling of assets and managerial talent; in addition, Auto-Lite’s expenses on a divisional basis were probably understated. *Id.* 1243-44.

³⁹ *See id.* 1247.

⁴⁰ *Id.* 1248.

Auto-Lite and Mergenthaler (\$94,958,934).⁴¹ For some reason that defies explanation, the court in several instances mixed wrong computations of share amounts with right computations of dollar amounts, but was finally drawn to the conclusion that comported with the Brudney & Chirelstein analysis.⁴²

If the court were guilty only of a failure to recognize the equivalence of the B-1 and B-3 formulae, it would be both unfair and unseemly to give the matter excessive attention. However, there is no real authority in this area other than the Brudney & Chirelstein article, which can easily but unintentionally mislead. Furthermore, the rejection of the 2.1 exchange ratio suggests a misconception of the supposed error in the "give-get" approach that the Brudney & Chirelstein analysis was seeking to correct. As long as the ratio of pre-merger prices is used, there will be a proportionate allocation of the merger benefit.⁴³ The "give-get" approach as characterized by Brudney & Chirelstein would have been satisfied if the Auto-Lite shareholders had received 1,051,530 common shares of

⁴¹ *Id.* 1248-49. Indeed, the court subsequently initiated a discussion which, if completed, would have demonstrated the fallacy of the quoted portion of the opinion. The court observed that the calculation under formula B-1 would yield a fair value to Auto-Lite shareholders of \$29,080,338 or, using the actual value of Eltra common stock, 1,151,696.5 equivalent shares of Eltra common at \$25.25 per share. *Id.* 1249. The court then properly observed:

[T]he price of Eltra common depended in part on the exchange ratio actually used . . . [I]f we assume . . . an effective exchange ratio of 2.16 to 1 [1,151,696.5 equivalent shares of Eltra common ÷ 532,550 shares of Auto-Lite surrendered by minority shareholders], there would have been the equivalent of . . . 3,849,130 Eltra common shares outstanding. Since the total post-merger value of Eltra was \$99,240,849 the price of one share of Eltra common would rise to . . . \$25.78. However, the figures in the text give a good approximation

Id. 1249 n.17. If the *Mills* court had completed that analysis, it would have noted that at a price of \$25.78, the 1,151,696.5 equivalent shares of Eltra common would have a value of \$29,690,735, or \$610,397 more than the amount the court had properly determined to be fair. If the court had then adjusted its calculation of the number of Eltra common shares to be delivered to the Auto-Lite minority in view of the \$25.78 price, it would have found that the exchange ratio moved downward, the price per share moved upward and another adjustment was necessary. The limit would be approached at a price of \$25.997, and the resultant issuance to the Auto-Lite minority of 1,118,622.50 common equivalent shares of Eltra, would yield the 2.1 exchange ratio initially rejected as a mere "price ratio." *See id.* 1248. Maintaining constant the total enterprise value is, of course, necessary to the Brudney & Chirelstein analysis since it is the total post-merger value of the enterprise that determines the benefit springing from the merger. A simpler approach to the same question would have been to recognize that Auto-Lite minority shareholders were entitled to \$29,080,338, the total enterprise value was \$99,240,849, leaving \$70,160,511 to the stockholders of Mergenthaler. Since the latter group had 2,698,822 shares, the correct price for the post-merger enterprise should be \$25.997; therefore, 1,118,603 shares of Eltra at \$25.997/share should have been distributed to the Auto-Lite shareholders. Minor inconsistencies are due to rounding.

⁴² *Id.* 1249.

⁴³ *See* text accompanying notes 27-28 *supra*.

Eltra with a value of \$26.46 per share.⁴⁴ This would result in a "fair" exchange ratio under the "give-get" formula of 1.975, which is substantially less than the 2.1 exchange ratio rejected by the *Mills* court as the unfair "give-get" figure. More simply, the total value actually received by the Auto-Lite shareholders, determined by post-merger market values, exceeded the \$27,825,737 surrendered, and therefore a "give-get" analysis would need go no further. Thus, the court misinterpreted the evil it was trying to avoid; this realization is a ground for consternation. At the very least, the confusion of the Seventh Circuit in applying the Brudney & Chirelstein analysis suggests the need for a clearer explanation of that theory. In fact, a re-examination of the basic principles of the analysis is called for.

III. THE BRUDNEY & CHIRELSTEIN ANALYSIS RE-ANALYZED

The primary value of the Brudney & Chirelstein approach is the conceptual framework in which they seek a resolution of the fairness question. Rather than accepting the "give-get" formulation, which ignores participation in the full benefits of the merger, or searching for the elusive bargain that parties at arms' length would have reached, Brudney & Chirelstein suggest, quite reasonably, that the courts are faced with a question of conflicting fiduciary obligations.⁴⁵ The directors of the parent corporation have fiduciary obligations to two groups of shareholders and an asset—the benefit to be derived from the merger—that must be divided between those groups in some acceptably fair manner. As noted above, the Brudney & Chirelstein solution is to analogize the situation to a fiduciary managing two trusts who must allocate a potential saving, or an investment opportunity, between them. It is erroneous, however, to believe that this analytical framework simplifies the problem of deciding what "fairness" requires; in fact, it introduces substantial additional complexities. Although the traditional "give-get" formulation requires only an appraisal of the pre-merger value of the subsidiary and a comparison with the consideration received by the minority shareholders,⁴⁶ the solution suggested by Brudney & Chirelstein requires that three difficult issues be faced.

⁴⁴ The 1,051,530 shares of Eltra common stock, multiplied by the price of \$26.46, yields approximately (due to rounding) the \$27,825,737 actually surrendered by the Auto-Lite minority.

⁴⁵ See Brudney & Chirelstein, *supra* note 5, at 319-22.

⁴⁶ "[T]he stockholder of a merged corporation is entitled to receive directly securities substantially equal in value to those he held before the merger" *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 303, 93 A.2d 107, 112 (Sup. Ct. 1952). See *Cole v. National Cash Credit Ass'n*, 18 Del. Ch. 47, 156 A. 183 (Ch. 1931).

First, the fiduciary duty of one who must allocate a benefit between two trusts needs to be defined. Second, assuming with the authors that the fiduciary duty requires a weighted allocation of the benefit between the trusts, valuations of the subsidiary and the parent must be undertaken so that the corpus of the supposed trusts being managed can be compared on some rational basis. Third, if the analytic framework is to be at all useful to the corporate planner, a valuation of the benefit to be allocated is also required.

A. *The Nature of the Fiduciary Duty*

The conflict faced by the parent's directors may usefully be viewed (as Brudney & Chirelstein suggest) as equivalent to that faced by a trustee managing two separate trust funds with similar investment objectives, when the trustee has an opportunity to reduce expenses, and the savings must be allocated between the beneficiaries. But while the notion that the benefit should be allocated in proportion to the size of the funds is logical, it is not the "only sensible view of the trustee's obligation,"⁴⁷ and there is no clear statement of law to that effect, as the Brudney & Chirelstein article itself makes clear.⁴⁸

Let us suppose that two investment funds are managed by a single adviser. Fund *A* has \$100,000 and fund *B* has \$50,000 in assets. Let us further suppose that the administrative cost of managing fund *A* alone is \$1,100 and fund *B* alone is \$700, but that together they can be managed at a cost of \$1,200. The Brudney & Chirelstein approach suggests that the \$600 saving resulting from joint management should be allocated in proportion to the size of the funds; that is, \$400 to fund *A*, leaving it with a charge of \$700, and \$200 to fund *B*, leaving it with a charge of \$500. But by what logical compulsion is that answer "fairer" than allocating the remaining charge, rather than the savings, on a proportional basis, leaving fund *A* with an \$800 charge and fund *B* with a \$400 charge, or retaining the prior ratio of charges, thereby charging \$733.33 to fund *A* and \$466.67 to fund *B*? Further, if fund *A* has been a historical client, and fund *B* is willing to let the adviser manage its

⁴⁷ See Brudney & Chirelstein, *supra* note 5, at 319.

⁴⁸ The best empirical support that can be mustered for the Brudney & Chirelstein view is the practice of certain investment advisers to allocate investment opportunities in proportion to the sizes of the various accounts managed by them. Brudney & Chirelstein, *supra* note 5, at 320-21 n.37. The authors themselves admit that this is a "far from exclusive practice." *Id.* In addition, they report that "the Securities and Exchange Commission has indicated that a wide variety of allocation practices are used" by investment advisers. *Id.* See notes 49-53 *infra* & accompanying text.

funds for a charge of not more than \$150, should the adviser be under some fiduciary constraint to refuse the account even though accepting it would save fund *A* \$50? If fund *A* has an exclusive contract for the adviser's services, but is willing to let fund *B* share in them provided that fund *B* pays at least \$650 of the \$1,200, cannot the adviser make that provision? If this is a world of perfect competition, equivalent advisorial talents would not be available for less than \$700 to fund *B*, absent some ability to share expenses with another fund. Allocating the savings proportionately would lead to identical percentage "returns" from the savings, but allocating the post-savings cost proportionately would equalize total investment returns (assuming equal investment success with each fund) and other arguments can be made for each of the suggestions above. It should be apparent that the duty of the adviser as a fiduciary is unclear: any of the suggested methods of allocating the administrative saving may reasonably be viewed as "fair."⁴⁹ Although a court might properly label as "unfair" any allocation that would result in fund *B*'s paying more than \$700 or in fund *A*'s paying more than \$1,100, it is impossible to pinpoint any one "fair" basis for allocating the charge within those extremes.⁵⁰

Nor is it clear empirically that fiduciaries view themselves as having such a duty of proportionality in administering two managed accounts. Although that practice is followed by some investment advisory organizations, they are in a minority.⁵¹ The practice of

⁴⁹ In many real world cases, the precise considerations discussed here are not really pertinent questions, because the trustee/advisory fee is a percentage and the fiduciary bears most expenses of the type that could give rise to a pooled savings; therefore, any such savings simply increase the fiduciary's effective fee. See 2 SEC, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES AND EXCHANGE COMMISSION 207, 454-56, 458-59, 476-79 H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971). If economies lead to reduced percentage fees, the Brudney & Chirelstein sharing formula may as a consequence be achieved, but that is an effect rather than a cause.

⁵⁰ It is possible that an economic model can be constructed to yield economically efficient answers to the allocation problem, since the issue may be comparable to the peak load pricing problem, although there are some significant differences. See Boiteaux, *La Tarification des demandes en pointe*, 58 REVUE GÉNÉRALE DE L'ÉLECTRICITÉ 321 (1949); Lorne, *Natural Gas Pipelines, Peak Load Pricing and the Federal Power Commission*, 1972 DUKE L.J. 85; Steiner, *Peak Loads and Efficient Pricing*, Q.J. ECON. 585 (1957). However, the nature of the assumptions that must be made concerning relative strengths of demand to generate reasonably specific implications for behavior are likely to render those implications useless to the present analysis. Furthermore, it is not at all clear that the economically efficient approach is equivalent to the fiduciary duty.

⁵¹ See 2 SEC, INSTITUTIONAL INVESTOR STUDY REPORT OF THE SECURITIES & EXCHANGE COMMISSION 348-49 H.R. Doc. No. 92-64, 92d Cong., 1st Sess. (1971). Of 106 investment advisers responding, 34 had no allocation policy, 27 prorated orders on the basis of purchase requests by clients or portfolio managers within the

pooling small bank trust funds⁵² achieves proportionality of return, but it is the result of pooling for practical reasons, rather than the cause for the pooling; indeed, if separate trust funds are pooled, the subsequent charges will typically be in proportion to the size of the funds and there will be no proportionate allocation of the saving as such. Moreover, if the Brudney & Chirelstein view of the fiduciary duty were accepted, there would appear to be an impropriety in a fiduciary's managing two separate funds with similar objectives in anything but a pooled fashion; yet the extent to which funds are in fact separately administered in highly regulated industries compels the conclusion that the law does not view this practice as improper.⁵³

Thus, not only is there no clear law to the effect of requiring proportional sharing of a savings resulting from joint administration of two funds, there is no logic to compel the development of such a body of law. It is somewhat disingenuous to draw upon the law applicable to fiduciaries to determine the obligations of the parent's directors, and then to posit with neither substantial precedent nor compelling basis in theory, the law that is being borrowed. Moreover, even if the fiduciary duty as defined by Brudney & Chirelstein were accepted, its application to the controlled merger context is at best dubious. It is not at all clear that the value of a corporation can be quantified as easily as the corpus of a trust, and there may not exist "savings" in a merger to which shareholders of both the parent and the subsidiary have some equivalent claim of right. Those questions are examined in the sections that follow.

B. *The Nature and Source of the Benefit to be Allocated*

It is one thing to propose a clean, simple model of fairness that is analogous to a trustee who obtains a saving for two managed trusts and allocates this saving on a basis that plausibly satisfies a sense of propriety concerning the sharing formula. It is, however, quite another matter to apply that model to controlled merger cases, because in those situations the benefit to be allocated is not a simple saving but rather a post-merger market value for the new enterprise that is different from the combined pre-merger market values of the

advisory organization, 10 rotated accounts to give long-term equality and 24 did not identify an allocation basis. Some organizations do allocate on the basis of size of the fund. *Id.* 348-55, 782.

⁵² See *id.* 444-50.

⁵³ Of course, the prevalence of the practice is not a completely satisfactory indication as to what the law is or should be. But in a field of the law that has been subjected to so much scrutiny, over so long a period of time, it seems unlikely that any obvious duty has been overlooked.

pre-existing enterprises. Notions of how the benefit should be allocated may well depend upon the source from which the benefit springs. This section therefore examines in greater detail the source of merger benefits and the impact of such considerations on ideas of how a fiduciary should allocate the benefit or on notions of what parties at arms' length would have negotiated for.

1. The Sources of Synergy

The concept of synergy is, quite simply, that the whole may be greater than the sum of its parts. If, for example, a parent corporation has superb management and its subsidiary has inept management which has not yet been removed by the parent for public-relations or other reasons, a management synergy may be envisioned from a merger which releases the parent from constraints on the dismissal of the subsidiary's management. Managed by the parent, the income and therefore the value of the subsidiary may well be increased. Another type of synergy may arise when a parent and subsidiary are in complementary types of business, so that their complete union may make possible economies of scale, elimination of duplicative facilities, increases in production experience and efficiency, tax benefits, or other sorts of operating synergies.⁵⁴ Under a completely different analysis of value, but one no less significant to shareholders, a form of synergy may arise if a parent sells at eight times earnings and its subsidiary at five times earnings, and the market continues to apply the parent's price/earnings multiple to the combined entity.⁵⁵ Under those circumstances, unless the income of the post-merger entity is less than the total income of the pre-merger entities, the market value of the combined entity will exceed the sum of the prior market values due to what might be called "market synergy." The concept of a benefit arising from a merger thus embraces a number of different possibilities. In any given case, it is likely that some elements or all of the foregoing, and quite possibly others, will interact in a manner that defies accurate projection.

2. The Right to Participate in Synergy

Accepting for the moment the proposition that mergers inevitably result in synergies, notions regarding the method of allocating a fair share of those synergies should be affected by their sources.

⁵⁴ See F. SCHERER, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* 72-122 (1970).

⁵⁵ See notes 79-80 *infra* & accompanying text.

It is no less true that the ability of an independent management to negotiate for a share of the synergy would be affected by similar considerations.⁵⁶ Intriguingly, however, it is reasonable to postulate that the factors affecting judgments with respect to what is fair in the Brudney & Chirelstein sense may have quite a different impact from those that would affect arms' length negotiations.

In cases where management synergy exists as described above, it is doubtful that the inept management of the subsidiary, if able to negotiate on an independent basis, would press hard the suggestion that the company would be worth more with someone else managing it. From the subsidiary shareholders' viewpoint, however, the dictates of fairness are ambiguous. On the one hand, these shareholders could argue that they should receive a share of the synergy because it is their company whose income will be increased in the merger, through the elimination of duplicative management services from the subsidiary. On the other hand, however, the superior management of the parent is an asset of the parent's shareholders for which they have paid in the market, and the subsidiary's shareholders have no particular entitlement to participate in it.

In the case of operating synergy, notions of fairness and the result under arms' length bargaining may coincide when the allocation of the synergy is considered. The fairness analysis might well suggest that both entities are contributing to and should therefore participate in the merger benefit, although there is no particular reason to suppose that the actual contributions to the synergy will always coincide with the allocation of the synergy resulting from the weight given to relative market valuations of the entities.⁵⁷ In all probability the operating synergy would also be apparent to negotiators who are bargaining at arms' length on behalf of the parent and subsidiary, and would affect the bargain they strike. In cases of pure market synergy, no sense of fairness dictates that the subsidiary's shareholders should benefit from the higher price/earnings multiple of the parent. Yet it is almost certainly true that in an arms' length negotiation, the existence of the disparate multipliers and the parties' expectation that the subsidiary will be worth more under the parent's umbrella than it is alone will lead to a higher negotiated price.⁵⁸

It is not, then, quite so simple as it might appear to allocate the benefits of a merger between parent and subsidiary. An exam-

⁵⁶ See Brudney & Chirelstein, *supra* note 5, at 314-16.

⁵⁷ Cf. Brudney & Chirelstein, *supra* note 5, at 316 (allocation of merger benefit under arm's-length bargaining likely to be evenly split).

⁵⁸ See notes 79-80 *infra* & accompanying text.

ination of two different cases with identical pre- and post-merger market values might well lead to different conclusions concerning participatory rights in any synergy, depending on the source of the synergy and the adoption of the fairness or the arms' length bargaining analysis. To return to the prior discussion of the fiduciary with two trust funds, the case of management synergy may be analogized to the situation in which fund *A* has a prior and exclusive claim to the fiduciary's talents. The claim of the minority shareholders of the subsidiary to a proportionate share in the benefits to be derived from those talents then becomes questionable. The case of operating synergy may be comparable to some administrative saving that results from the joint management of the two funds. Consequently an allocation of the synergy is appropriate, although the ratio of market values of the two enterprises, even if accepted as equivalent to the size of the two funds, is no more compelling as a basis for allocating the synergy than the ratio of sales, which is equivalent to activity of the funds, the ratio of expenses, which is equivalent to independent charges assessed against the funds, or a number of other ostensibly reasonable ratios. The case of market synergy presents no basis for a claim by the minority shareholders of the subsidiary to a participatory right in the synergy. If any analogy is to be drawn to the case of the fiduciary with two trust funds, market synergy seems more like an additional contribution by the settlor of trust fund *A* than anything else, and a claim to a share, asserted by the beneficiaries of fund *B*, is hardly colorable.

3. Negative Synergy

It is also important to recognize that synergy may be negative and that in such a case the Brudney & Chirelstein formula, if accepted, would properly yield a fair consideration which was less than that which would result from the "give-get" approach. In the case of stock mergers, it is clear from the Brudney & Chirelstein formulae that the relationship of the market value of the parent's shares received by the subsidiary's minority shareholders to the market value of the pre-merger shares of the subsidiary depends in part upon the post-merger price of the parent's stock. Unfortunately, the Brudney & Chirelstein critique of the "give-get" approach entails the risk that the pre-merger value of the minority shareholders' interest will be viewed as a minimum. The adoption of that view is, however, both unfair and unwise. It is unfair because if the subsidiary's minority shareholders are to be given part of any benefit that would otherwise accrue to the parent's share-

holders, they should also share the risk that the anticipated benefits will not materialize.⁵⁹ It is unwise because the Brudney & Chirelstein formula, to the extent that it is useful, provides a framework for corporate planning by the parent that is destroyed if its application in the first instance is to depend on the market's evaluation of post-merger developments, which cannot be anticipated in pre-merger planning.

*C. The "Corpus" of the "Trust" Being Managed:
The Utility of Market Value*

Finally, the application of the fiduciary concept to a factual setting of the sort found in *Mills* is fraught with practical obstacles. The adherence to market values in *Mills*, raises at the first level the question of which time periods should be considered in calculating average market value. In *Mills*, the "fair" exchange ratio, under a correct application of the Brudney & Chirelstein analysis, was 2.1005025, so that 1,118,623 shares of Eltra common stock should have been issued to Auto-Lite's minority shareholders. But if the periods chosen for averaging market prices had yielded pre-merger average prices of \$54.75 for Auto-Lite instead of \$52.25, and \$23.25 for Mergenthaler instead of \$24.875, the precise ratio would have jumped to 2.355, requiring 1,254,155 shares of Eltra common stock.⁶⁰ Assuming that the total market value of Eltra would remain constant, the difference between those figures would result in a shifting of approximately \$2,410,000 of the synergy to the Auto-Lite minority shareholders from that dictated by the 2.1 ratio.⁶¹ Moreover, at the actual exchange ratio of 2.31, the merger of Auto-Lite and Mergenthaler would apparently have been adjudicated unfair by the

⁵⁹ See F. SCHERER, *supra* note 54, at 74-78.

⁶⁰ In fact, Auto-Lite's high and low prices in 1963, before the merger, were 61% and 49% respectively; Mergenthaler's high was 28% and the low was 22%. See Wall St. J., June 26, 1963, at 26, cols. 2 & 4. In 1962 the high-low for Auto-Lite was 63%-46%; for Mergenthaler, the high-low was 33%-19%. See Wall St. J., Aug. 7, 1962, at 24, cols. 2 & 4. These figures are suggestive of the different results that could be reached in determining ratios of market value, if different time periods are selected.

⁶¹ Assuming the constant total market value of \$99,242,340 the two different exchange ratios would yield the following:

	<i>2.1 ratio</i>	<i>2.355 ratio</i>
Eltra common shares to Mergenthaler holders	2,698,822	2,698,822
Eltra common equivalent shares to Auto-Lite holders	1,118,355	1,254,155
Total shares	3,817,177	3,952,977
Price per share	\$25.999	\$25.106
Value received by Auto-Lite holders	\$29,075,980	\$31,486,465

Mills court, if the averaging periods actually used had yielded the hypothesized market values.⁶²

This hypothetical result emphasizes that the use of the Brudney & Chirelstein formula in a rigid fashion is erroneous. Although the formula may yield a precise answer, the information on which such an answer is based is quite imprecise. Indeed, if a blind sense of precision is adhered to, as the *Mills* court did by using the Brudney & Chirelstein formula as a litmus test for fairness, it should follow that unless the corporate planners of a parent use the same measuring data and period as the court which subsequently examines the fairness of the merger terms, either the subsidiary's or the parent's shareholders will have a cause of action.⁶³ In the *Mills* case, to say that the exchange ratio of 2.31 was fair to the Auto-Lite minority shareholders because it was greater than the precise ratio of 2.1 required by the Brudney & Chirelstein formula is *ipso facto* to say that it was *unfair* to the Mergenthaler shareholders. If the Brudney & Chirelstein analysis is accepted as yielding one precise answer, any variation from that answer compels a conclusion of unfairness to the shareholders of either the parent or the subsidiary.

A far preferable approach to the question of fairness would be to view the Brudney & Chirelstein formula as an analytic framework and not as a litmus test. If the actual exchange ratio is within some reasonable range suggested by using a number of potential average market prices, it should be accepted as fair. In *Mills*, if the ratio of Auto-Lite's market price to Mergenthaler's were 2.3 over the year preceding the public announcement of the proposed merger, 2.0 over the six months preceding it and 2.4 over the six weeks preceding it, any exchange ratio between 2.0 and 2.4 should be

⁶² Cf. *Mills v. Electric Auto-Lite Co.*, 552 F.2d 1239, 1249 (7th Cir.), cert. denied, 98 S. Ct. 398 (1977) (finding that the actual exchange ratio of 2.31 exceeded the "fair" exchange ratio of 2.16).

⁶³ The cases would probably suggest a different conclusion, since the subsidiary's shareholders can claim a conflict of interest whereas public shareholders of the parent could claim only that too high a price was paid—a claim which, absent management shareholdings in the subsidiary, would likely not pass the business judgment barrier. See generally *Shlensky v. Wrigley*, 95 Ill. App. 2d 173, 237 N.E.2d 776 (1968); *Bishop, Sitting Ducks and Decoy Ducks: New Trends in Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968). However, there is little rational basis of general application upon which to argue that a parent's management will necessarily feel a greater loyalty to the parent's shareholders than to the subsidiary's—the basis for a conflict of interest claim; nor is there a basis to argue that they owe more of a duty to its subsidiary's shareholders than to the parent's own shareholders. See generally *Singer v. Creole Petroleum Corp.*, 297 A.2d 440, 442 (Del. Ch. 1972), modified on other grounds, 311 A.2d 859 (Del. 1973); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 722 (Del. 1971); *Getty Oil Co. v. Skelly Oil Co.*, 267 A.2d 883, 888 (Del. 1970); *Case v. New York Central R.R.*, 15 N.Y.2d 150, 204 N.E.2d 643 (1965).

accepted as within the reasonable range. The actual periods used to generate such a range in any given case would depend on the facts of the case. But it is important that the precise answer of the Brudney & Chirelstein formula not be accepted too readily. There is no general basis for preferring a six-month to a three-month market price average. For similar reasons, it must be recognized that no single security has a market price that is determined in a vacuum. The difficulty of establishing the extent to which a stock's decline was related to disclosure violations rather than general market trends has been demonstrated in other securities cases.⁶⁴ If there is reason to believe that some generalized trend affected a security price without regard to the specific quality of the particular issue, that factor might properly be given recognition in controlled merger situations as well.

But a far more profound problem than that of selecting periods of time is suggested by the *Mills* court's determination that no other factors are to be considered in evaluating the fairness of merger terms when "market value is available and reliable." Although a fundamental acceptance of market values and an adherence to the views espoused by the random walk/efficient market theorists⁶⁵ is essential to an acceptance of the Brudney & Chirelstein approach, the market is bound to reflect factors that destroy its ability to serve as a reliable measure of value for evaluating the fairness of the terms in controlled mergers. In such situations, the very existence of control in the hands of the parent corporation will undoubtedly skew the market's evaluation of the intrinsic value of the minority shareholders' interests, thereby disrupting the general congruence between market value and "true" value.⁶⁶ The knowledge that another entity controls the subsidiary will at least cause others who might desire to obtain control to withdraw from the market, reducing current demand for the stock and diminishing the interest of other potential buyers of the subsidiary's securities.⁶⁷ Furthermore, no matter how far the courts or the legislatures might move toward establishing an expectation of fairness in controlled mergers, it is

⁶⁴ See, e.g., *Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 & n.22 (2d Cir. 1978); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 586-88 (E.D.N.Y. 1971).

⁶⁵ See, e.g., B. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (Coll. Ed. Rev. 1975).

⁶⁶ See, e.g., *Perlman v. Feldmann*, 154 F. Supp. 436 (D. Conn. 1957).

⁶⁷ See Metz, *Morton-Norwich and Takeover Problems*, N.Y. Times, Feb. 17, 1978 at D2, cols. 3-4. Cf. *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976) (disclosure that tender offer might result in inactive market and/or deregistration for remaining shares of target company not a basis for liability under Delaware law).

likely that the market will react to a fear that the controlling shareholder will use its control to the disadvantage of the subsidiary or to time a merger so as to take advantage of short-term market factors. In short, the parent's ability to do the very things that prompted in part the Brudney & Chirelstein fairness analysis may make market prices in controlled mergers unreliable.

Thus, there is substantial doubt about whether the market price of a partially-owned subsidiary can ever be truly reliable in the sense of reflecting the value that the subsidiary would have, shorn of the parent's domination. Yet it is clear that such a consideration was not thought by the Seventh Circuit in *Mills* to lead to an unreliable market, even though Auto-Lite had been controlled by Mergenthaler for a number of years prior to the merger.⁶⁸ Rather, the decision suggests that misleading or incomplete disclosures of a market-relevant type are the only factors that might lead a market to be unreliable.⁶⁹

It may be that a merger following a tender offer, where the controlled subsidiary had a recent and active market for its stock, would provide an environment in which the Brudney & Chirelstein analysis could reasonably be applied.⁷⁰ Even in that context, how-

⁶⁸ See 552 F.2d at 1245-47. In the specific facts of *Mills*, it might be argued that this consideration is of less significance since Mergenthaler itself was a controlled subsidiary, and its shares would be subject to the same downward pressure on price. However, there is no particular reason to assume that the market's reaction to the minority status of the public shares was proportionate as between the two corporations.

⁶⁹ It may not be inconsistent with the *Mills* opinion to suggest that a "low-demand" market would be unreliable, see *Lynch v. Vickers Energy Corp.*, 351 A.2d 570 (Del. Ch. 1976), unlike a market depressed by the ownership of a controlling block of stock by another party.

⁷⁰ Brudney & Chirelstein themselves, however, would reject the application of their analysis to the tender offer situation on the grounds of potential unfairness to nontendering shareholders, except when the merger is not viewed by the parent as a part of the tender process. Brudney & Chirelstein, *supra* note 5, at 330-40. In the latter context, however, there is likely to be a time differential that would destroy the reliability of the market. To a substantial degree, the authors' notions of fairness in the case of a merger shortly after the acquisition of control by tender or by private purchase are affected by the long-standing view of some commentators that control is a corporate asset, and that no one group of stockholders is entitled to be paid an additional sum for it. See, e.g., Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 85 HARV. L. REV. 505 (1965); Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Jennings, *Trading in Corporate Control*, 44 CAL. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725 (1956). While the topic has drawn the attention of several commentators, and captured the attention of some, see, e.g., Bayne, *Noninvestment Value of Control Stock*, 45 IND. L.J. 317 (1970); Bayne, *Investment Value of Control Stock*, 54 MINN. L. REV. 1265 (1970); Bayne, *The Sale-of-Control Premium: The Definition*, 53 MINN. L. REV. 485 (1969); Bayne, *The Sale-of-Control Premium: The Disposition*, 57 CAL. L. REV. 615 (1969); Bayne, *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEX. L. REV. 215 (1969); Bayne, *A Legitimate Transfer of Control: The Weyenberg Shoe-*

ever, it is not unreasonable to suggest that the subsidiary was perceived as a likely merger target by the market, thereby resulting in a higher market price for the subsidiary than its "true" value.⁷¹ As a consequence, there is a risk in that context that the market would be unreliably high, and the "fair" price dictated by the Brudney & Chirelstein approach would be unfair to the parent corporation's shareholders.

Finally, there remains a lingering doubt that market valuations are the proper approximation of the corpus of the trust that Brudney & Chirelstein assert is being managed by the parent. Perhaps the most troublesome case is that of the closed-end investment company. Such entities, which typically hold a liquid portfolio of securities, traditionally sell in the market at a discount from the per-share value of their securities portfolio.⁷² How then would the

Florsheim Case Study, 18 STAN. L. REV. 438 (1966); Bayne, *The Definition of Corporate Control*, 9 ST. LOUIS U. L.J. 445 (1965); Bayne, *The Sale of Corporate Control*, 33 FORDHAM L. REV. 583 (1965); Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22 (1963), the courts have largely rejected such an approach except where "special facts" have been found, justifying the conclusion that the transfer of control worked a particular hardship on minority shareholders in violation of the fiduciary duty owed them, as in *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); and *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955), *cert. denied*, 349 U.S. 952 (1955). See *McDaniel v. Painter*, 418 F.2d 545, 548 (10th Cir. 1969). One California District Court of Appeal decision, *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969) appears to come close to adopting the theory of control as a corporate asset, but that aspect of the decision is of questionable authority at best in view of the clear refusal of the California Supreme Court to adopt such a general view in its subsequent decision in *Jones*, 1 Cal. 3d at 117, 460 P.2d at 478, 81 Cal. Rptr. at 606. Thus, the concluding comments of Professor Leech in one of the first articles to deal with the topic thoroughly remain valid: "Thus far, the courts have been unwilling to require every seller of control to account for his profit; control as such has not yet attained the status of a 'corporate asset.'" Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV. 725, 837 (1956).

⁷¹ For example, when Bayer Corp. announced that it was mounting a tender offer for Miles Laboratories, the price of Miles stock jumped approximately 18 points in six weeks. *Compare* N.Y. Times, Sept. 27, 1977, at 53, col. 3 (Miles selling at 29½ when Bayer tender of at least \$40 a share announced) *with* Wall St. J., Nov. 11, 1977, at 34, col. 5 (Miles selling at 46%). Similarly, the tender battle between Eaton Corp. and Kennecott Co. over Carborundum Corp. caused Carborundum's price to rise 33 points in seven weeks. *Compare* Wall St. J., Nov. 1, 1977, at 46, col. 4 (Carborundum closing at 33%) *with id.* Dec. 22, 1977, at 24, col. 2 (Carborundum closing at 66%). Empirical data does not appear to be available as to the extent to which those, or other corporations, were perceived as potential take-over targets, or as to the impact of such perceptions on pre-announcement prices.

⁷² See, e.g., SEC, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH 44 H.R. REP. NO. 2337, 89th Cong., 2d Sess. (1966) indicating that on June 30, 1966 nine of the ten largest diversified closed-end investment companies in the United States sold at discounts from net assets per share ranging from 5.6 per cent to 27.8 per cent. See generally Boudreaux, *Discounts and Premiums on Closed-End Mutual Funds: A Study in Valuation*, 28 J. FINANCE 515 (1973); Mendelson, *Closed-End Fund Discounts Revisited*, 2 FINANCIAL REV. — (forthcoming, 1978).

Brudney & Chirelstein analysis apply to a merger of two closed-end investment companies selling at disproportionate discounts from their book value? The fiduciary theory on which the analysis is based suggests that the merger should be at a price which is in proportion to the value size of the portfolios; the formula which they derive would compel a merger price based on relative market prices of the shares.⁷³ Although closed-end investment companies are certainly different from the ordinary, operating corporation, the clear difference between the trust corpus sense out of which the theory sprang and the market value context in which the formula developed raises the question whether the market measurement is the right one for asserting the fiduciary duty. In the specific context of closed-end investment companies, the view of the SEC, with the recent approval of the Supreme Court, is that net asset value, not market value, is the appropriate benchmark for valuation purposes.⁷⁴ And although one might posit an exception to the general theory for the peculiar case of closed-end funds, there is nothing in the theory that justifies such an exception. More properly, if the fiduciary duty is accepted, the question of valuing the corpus of the trust should remain.

Thus, even in the relatively simple context of the stock merger, when the Brudney & Chirelstein analysis reduces to the convenience of formula B-3, that analysis may be seen to suffer from severe deficiencies. The fiduciary notion on which it is based, while providing a useful framework, does not yield any compelling conclusion as to how a fiduciary should behave. Similarly, it is far from clear that the benefits available in a merger can properly be considered the equivalent of a saving, or an investment opportunity, to which the supposed trust beneficiaries have equal claims. And finally, there are three distinct and quite severe impediments in the transition from the general fiduciary theory to its practical application. First, the approach suggests a precision that is simply not realistic in these matters. Second, it is likely that market prices are seldom reliable indicators of the fair value of a controlled subsidiary, since the market value reflects the entity *qua* subsidiary, not the

⁷³ Given, for example, fund A with net asset value of \$100 per share and market value of \$90 per share, which controls fund B with net asset value of \$50 per share and market value of \$40 per share, the fiduciary theory, according to Brudney & Chirelstein, would dictate a 2:1 exchange ratio, but the sharing formula would dictate a 2.25:1 ratio, even though the latter is in theory derived directly from the former.

⁷⁴ See *E. I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46 (1977). See generally Note, *Fairness and Net Asset Valuation in Mergers Under the Investment Company Act*: *Collins v. SEC*, 76 COLUM. L. REV. 1332 (1976).

entity by itself. Third, it is not at all clear that the market's measurement of value of the enterprise is the measurement that should be used for determining the corpus of the trust that the directors are to be viewed as managing. When the theory is examined in the more complex context of non-stock mergers, in which the subsidiary's minority shareholders no longer have an ongoing equity interest in the combined entity, it becomes considerably less useful, as the section following will demonstrate.

IV. THE BRUDNEY & CHIRELSTEIN ANALYSIS AS APPLIED TO NON-STOCK MERGERS

Many, if not most, controlled mergers do not take the form of stock transactions, but rather involve the issuance of cash or debt securities in exchange for the minority shareholders' interest in the subsidiary. In stock transaction mergers, at least it can be said that the Brudney & Chirelstein analysis suggests an approach which, although not compelling as the single fair approach, is possibly one fair approach that provides some guidance to corporate planners. In the non-stock transaction, those qualities evaporate. The Brudney & Chirelstein article does not address the substantial practical difficulties that are involved in allocating possible synergies in non-stock mergers; the article casually suggests the possibility of some post-merger distribution of cash.⁷⁵ That suggestion is not sufficient to dispel the problems of applying the Brudney & Chirelstein analysis to non-stock transactions.

It is possible, in the stock transaction, that one will naturally be led to accept the fairness of a merger whose terms are based on the comparative market values of the merging entities. Although the process by which the Brudney & Chirelstein analysis arrives at that conclusion is dubious, the analysis is an inherently satisfying one, perhaps because it would be a logical starting point for actual arms' length negotiations,⁷⁶ or perhaps because relative market

⁷⁵ Brudney & Chirelstein, *supra* note 5, at 323.

⁷⁶ Interestingly, but not surprisingly, the business literature suggests that the Brudney & Chirelstein formula as applied to stock transactions might yield a lower price than that for which reasonable parties would negotiate at arms' length. "[I]t will be very difficult to make the acquisition without offering a premium over the stock market price." Keidan, *How to Establish a Price Range in ACQUISITION AND MERGER NEGOTIATING STRATEGY* 105, 114 (M. Strage ed. 1971). See also D. BEAN, *FINANCIAL STRATEGY IN THE ACQUISITION DECISION* 90, 91 (1975). Indeed, one might question how frequently it will be that the managers of one corporation would surrender their managerial positions in a merger in which they receive no more than the present market value of their own stock in the form of shares of the acquiring corporation, for that is clearly what formula B-3 provides. Perhaps the answer is that they will do so only when they are convinced that there will be substantial positive synergy, quite likely of the market synergy type.

values provide a viscerally satisfying sense of equivalent value, if the minority shareholders of the subsidiary are to be folded into the shareholder family of the parent. In the non-stock merger, where cash or equivalent debt is to be distributed, formula B-1 does not reduce to formula B-3.⁷⁷ Therefore, if the Brudney & Chirelstein approach is to be followed, there must be an explicit recognition of the merger benefit and payment for it. As the following discussion will show, the Brudney & Chirelstein approach loses whatever attraction it might otherwise have in the context of non-stock mergers.

Consider the following example: *P* owns 75% of the stock of *S*. Pertinent information concerning the earnings and market value of *P* and *S* is as follows:

	<i>Annual Net Income</i>	<i>Shares Outstanding</i> *	<i>Recent Average Market Price</i>	<i>Market Value</i> *
<i>P</i>	\$12,000,000	2,000,000	\$48	\$96,000,000
<i>S</i>	\$ 1,500,000	2,000,000	\$15	\$30,000,000

* Including 1,500,000 *S* shares owned by *P*. The public market value of *S* is therefore \$7.5 million.

If the two companies were merged through an exchange of stock, *S*'s minority shareholders would be entitled to a fair exchange ratio of .3125 (which equals \$15 divided by \$48), or 156,250 *P* shares, under the Brudney & Chirelstein analysis. Thus, the minority shareholders of *S* would have approximately a 7.2 per cent interest in the combined entity.⁷⁸ If the market price of *P* remains at or above \$48 per share following the merger, the minority shareholders' interest in *P* will have a value the same as or greater than their interest in *S* prior to the merger.

Assume further that the post-merger enterprise will have annual income of \$12,875,000; that represents an increase of \$500,000 over the combined pre-merger incomes, since all but \$375,000 of *S*'s pre-merger income was already included in *P*'s income. However, if *P*'s directors evaluate this situation and expect the market to continue to value *P* at a price/earnings multiple of 8 after the merger,

⁷⁷ Essentially, formula B-1 does not reduce to formula B-3, *see* note 13 *supra*, in non-stock mergers because the value of the consideration to be given to the subsidiary's minority shareholders cannot be expressed in relation to the parent's stock.

⁷⁸ The 7.2 per cent figure is achieved by dividing the 156,250 *P* shares that would be issued by the 2,156,250 total *P* shares outstanding. The same result may be reached through the more complicated formula B-1.

they may decide against a stock merger. If *P*'s price/earnings multiple of 8 is not affected by the absorption of *S* with its price/earnings multiple of 20, the price of a post-merger share of *P* will drop to \$47.77, and the combined market value of the entities will drop from \$103.5 million to \$103 million.⁷⁹ Thus, both *P* shareholders and *S* shareholders will have less, in a market sense, than they had prior to the merger even though the merger generated a 4.2% increase in *P*'s total net income. In such a situation, without knowing whether the additional \$500,000 of income is the result of management synergy or operating synergy, the Brudney & Chirelstein analysis yields more than one solution, and none of those solutions appears to be more compelling than any other.

Brudney & Chirelstein themselves would probably conclude that the minority shareholders of *S* are entitled to \$7,789,854.80. That figure is determined by formula B-1, viewing the merger benefit in this case as \$4,000,000, which represents the market's recognition of the \$500,000 of additional annual income to *P* multiplied by *P*'s price/earnings multiple of 8. Thus, *S*'s minority shareholders would be entitled to their pre-merger value of \$7.5 million plus their proportionate part ($\$7,500,000 \div (\$7,500,000 + \$96,000,000)$) of the benefit, or \$7,789,854.80. It would not be unreasonable, however, for *P* to argue that *S*'s minority shareholders should participate not in what did happen in a cash payment context, but in what would have happened in a stock merger transaction. *P*'s directors, having been prescient enough to divine the adverse market consequences of a stock merger, might argue that in a stock merger the *S* shareholders would have received 156,250 *P* shares with a market value of \$47.77 per share, or a total of \$7,463,768, under the Brudney & Chirelstein fairness analysis. Under that theory, a payment of \$7,463,768 for the minority interest in *S* should therefore be deemed fair. Admittedly, the total figure is slightly less than the pre-merger market value of \$7,500,000 held by *S*'s shareholders, but the decrease is the result of the negative synergy that would have been produced by the market. Of course, after a cash merger *P*'s shareholders would in fact see *P*'s stock move from \$48 per share to \$51.50 per share,⁸⁰ but that is the result of the pre-

⁷⁹ The calculation follows from the assumptions that the merged enterprise will earn \$12,875,000 and will have a price/earnings multiple of 8. Since the total market value would then be \$103 million and 156,250 shares would be issued to the former *S* shareholders by following formula B-3, each post-merger share of *P* would have a market value of $\$103,000,000 \div 2,156,250 = \47.77 .

⁸⁰ Since the market multiple is assumed to stay at 8, thereby yielding a total market value of \$103 million for *P* after the merger, the price of *P* will be \$51.50 per share if there are only 2 million shares outstanding after the transaction.

science of their directors in avoiding the negative market synergism of the stock merger. After all, if the *S* shareholders tried to get a piece of the pie, it would not be there.

Alternatively, *S*'s minority shareholders might reasonably reject as unfair a payment for their stock that is as high as \$7,789,854.80. It could be argued on their behalf that if their claim for \$7,500,000 is recognized as a starting point in a Brudney & Chirelstein analysis, *P* is paying 20 times the historical earnings of *S*. Why then should their fair share of the additional annual earnings of \$500,000 that resulted from the merger be capitalized at *P*'s multiple of 8 rather than *S*'s multiple of 20?⁸¹ Under this argument, the minority holders of *S* would be entitled to their initial \$7,500,000 plus the product of their 7.2 per cent share of the additional income times their capitalization rate of 20, which yields a total payment of \$8.22 million. Even though such an approach would lead to *P*'s paying out more than the total \$4,000,000 market benefit if *S* constituted more than 40 per cent of the combined market values of *S* and *P*, the shareholders of *S* could argue that this result is the price of buying out companies with a higher multiple than one's own.

Thus, on the same basic assumptions, different notions of what is meant by "merger benefit" and of how that benefit is quantified as a present value lead to "fair" payments differing by more than 10 per cent before considering the reasons for the additional income, the impact of making adjustments to market price that might be appropriate, or the effect of selecting different periods to measure market prices. Moreover, the three possibilities suggested above all used capitalization rates that were suggested by price/earnings multiples, where the price is based on market value.⁸² But in quantifying the merger benefit as a present value, any number of other discount rates might be suggested for capitalizing the \$500,000 income benefit attributable to the merger. The selection of an

Although this sort of analysis may suggest rather remarkably that the market cares not one whit about how much is paid for the minority interest, it is perhaps fairer to indicate that the assumptions stated concerning the post-merger income of *P* necessarily included lesser assumptions as to the loss of other income opportunities or the incurring of interest expenses connected with the acquisition.

⁸¹ See note 29 *supra*.

⁸² Actually, price/earnings multiples that look to historical, or even immediately estimated, earnings provide a poor substitute for capitalization ratios that should look to a future stream of earnings. A high price/earnings multiple may suggest not so much a low percentage discount rate for capitalization as an expectation of substantial increases in future earnings. *But see* *Gibbons v. Schenley Indus., Inc.*, 339 A.2d 460 (Del. Ch. 1975); *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216 (Del. 1975). However, the present analysis seemed complicated enough without delving extensively into such matters.

appropriate discount rate is as important and difficult as any other calculation in this quest for fairness.⁸³

Even if the Brudney & Chirelstein analysis did lead to one "fair" solution, however, it would be misapplied here, because it is fundamental that the stock market does not merely yield varying rewards; it yields rewards in some proportion to risks taken.⁸⁴ An element of fairness inherent in the application of the Brudney & Chirelstein analysis to the stock merger case may be that it gives the minority shareholders a proportionate interest in the benefits and risks of the merger. If the synergism as viewed by the market is negative, the minority shareholders will participate in that, too.⁸⁵ If the Brudney & Chirelstein analysis were equally applied to cash mergers, the minority shareholders would bear no risk. Whether the share of the synergy is paid contemporaneously with the merger—in which case the frailty of estimates provides additional basis for dissatisfaction—or after the merger, there is little chance that the minority shareholders of *S* will be persuaded or compelled to reimburse *P* proportionately if the combined enterprise income does not increase to the extent expected, or even declines.⁸⁶ When the *S* shareholders are removed from the risk of stock ownership by a cash merger, their entitlement to a participation in potential future rewards becomes extremely doubtful.

V. CONCLUSION

It is with some regret that this Article is written. At least in stock mergers, the Brudney & Chirelstein approach yielded an ascertainable, satisfying and simple solution. But the fiduciary duty posited by Brudney & Chirelstein has no grounding in actual law or theory. Their notion of a right to share in merger benefit is insufficiently considered and their reliance on market prices is questionable. In the context of non-stock mergers the advantages of certainty and simplicity are lost, and the intrinsic appeal of the analysis disappears. Thus, the value of the Brudney & Chirelstein approach may lie more in what it has provoked than in the solution it proposed—but the value of provocation is not inconsiderable. The

⁸³ See, e.g., Blum & Katz, *Depreciation and Enterprise Valuation*, 32 U. CHI. L. REV. 236 (1965).

⁸⁴ See, e.g., Malkiel, *supra* note 65, at 176-82, 190-93.

⁸⁵ Under the "give-get" approach to a stock merger the minority shareholders also participate in market risks, since what they receive should properly be measured as of the date of receipt.

⁸⁶ In theory, *S*'s shareholders could be paid by a note with a provision for offset if post-merger earnings failed to equal combined pre-merger earnings. Much is possible in theory.

conclusion of this Article is obviously that we cannot easily avoid the old, traditional approaches—the examination and weighing of historical and appraised book value and market value, the calculation of the present value of anticipated earnings, and the like⁸⁷—in the quest for valuation. But that does not render the conceptual framework suggested by Brudney & Chirelstein valueless, for the analysis of fairness may often be aided by recognition of the fact that the directors of the parent have a conflict in their fiduciary duties to both the minority shareholders of the subsidiary and the public shareholders of the parent. In that framework, it becomes clear, *inter alia*, that to give the minority shareholders of the subsidiary more is not necessarily to make the merger fairer; for both groups of public shareholders are entitled to the elusive fairness. While a reasonable case might sometimes be made that the parent created the conflicting allegiance (such as when an interest in a wholly-owned subsidiary was sold publicly) and should therefore suffer the consequences of its existence, the validity of that argument will depend upon the history of the particular case, and the argument will often be unavailable. In many cases the conflicting allegiances will have arisen in a manner such that the parent—and its public shareholders—can in no way be charged with fault for having allowed the situation to develop.

Having challenged the simple approach of the Brudney & Chirelstein analysis, it is perhaps incumbent upon the author to provide some guidance to the courts. Three suggestions may be useful. First, recognition must be given to the rights of all parties; there is, after all, no free lunch. Second, notwithstanding that the search should be for total fairness, the imprecision inherent in such an analysis must be accepted: fairness must be viewed as some acceptable range, not as a precise amount. And finally, whatever standards may evolve, they must be based upon information available prior to the merger. For while it may be useful to help courts in post-merger analyses, it is far more beneficial to help corporate planners in establishing a fair price in the first instance.

⁸⁷ See generally, B. GRAHAM, D. DODD & S. COTTE, SECURITY ANALYSIS 405-79 (4th ed. 1962). The SEC's proposed rule to regulate fairness in controlled mergers, see text accompanying notes 8-11 *supra*, seems implicitly to reject the Brudney & Chirelstein approach, since fairness of price is to be evaluated "in light of such factors as, for example, current market prices, historical market prices, net book value, going-concern value, liquidation value, previous purchases . . . and any report, opinion or appraisal . . ." 42 Fed. Reg. 60, 101 (1977). However, those factors are only to be considered, and the rule is, at this stage, merely a proposal. If such a proposal is adopted, it would appear likely that questions of fairness to come before the courts will increase, and greater stress will therefore be placed upon the methodology of evaluating that rather abstract concept.