1993

The Fair Value of Minority Stock in Closely Held Corporations

Zenichi Shishido

The Fair Value of Minority Stock in Closely Held Corporations

Cover Page Footnote

THE FAIR VALUE OF MINORITY STOCK IN CLOSELY HELD CORPORATIONS

ZENICHI SHISHIDO [*]

In this Article, Professor Shishido examines the various methods—those used by the courts as well as those suggested by law and economics scholars—for determining the fair value of minority stock in closely held corporations. In Professor Shishido's view, the courts' method of weighing—the so-called Delaware block method—fails to arrive at the true value of the minority's shares and often undervalues their worth. Professor Shishido also argues that law and economics scholars fail to differentiate between closely held corporations and publicly held corporations, thus failing to include the effect of corporate law on the fair value of closely held corporate stock.

Professor Shishido proposes that fair value is a matter of both normative and positive analyses. After examining the conflicts of interest between the majority and minority shareholders of closely held corporations, Professor Shishido concludes that fair value equals best-use value defined as the higher of the cash flow discounted value and the asset value. Professor Shishido asserts that the best-use value grants majority shareholders due entrepreneurial rewards while preventing an undervaluation of minority shareholders' investment.

INTRODUCTION

ALTHOUGH stock valuation plays a critical role in adjudicating disputes involving closely held corporations, courts and scholars use inconsistent methods of calculating the fair value of the minority stocks in these corporations. Recognizing that no "precise" value inheres for minority shares, most judicial attempts at valuation represent rough estimates based on overly simplistic assumptions. This phenomenon is best exemplified by the so-called Delaware block approach.[1] Using this method, judges, unable to choose between one of three approaches, use all three and average the result.[2] Law and economics scholars, particularly Judge Frank Easterbrook and Professor Daniel Fischel, have contributed significantly to this area of corporate law,[3] yet they too

1. Delaware courts have equated fair value with the weighted average of earnings value, asset value, and market value.

2. *See In re* General Realty & Utilities Corp., 52 A.2d 6, 14-15 (Del. Ch. 1947); Tri-Continental Corp. v. Battye, 66 A.2d 910, 917-18 (Del. Ch. 1949), *rev'd*, 74 A.2d 71 (Del. Supr. 1950); Bell v. Kirby Lumber Corp., 413 A.2d 137, 150-51 (Del. 1980); *In re* Valuation of Common Stock of Libby, McNeill & Libby, 406 A.2d 54, 60 (Me. 1979); *In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1003 (Me. 1989). *But see* Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983).

3. Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law (1991) [hereinafter Easterbrook & Fischel, *Economic Structure*]; Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 271

oversimplify stock valuation analysis with respect to the calculation of fair value of minority stock in closely held corporations.

Two concepts, "hypothetical market value" and "fair value," play central roles in this Article. "Hypothetical market value" is what a reasonable buyer would pay for stock. Establishing this value is a matter of positive, as opposed to normative, analysis. I observe that the reasonable buyer, when faced with alternative measures of value such as asset value or cash flow discounted value, will pay the higher of the two figures. Therefore, the Delaware block weighing method is erroneous, at least as it relates to the hypothetical market value.[4] Often the hypothetical market value will be different for majority and minority stock. This difference is called the "controlling premium" and results from the various conflicts of interest between majority and minority shareholders.[5]

The "fair value," which is the final goal of this Article's analysis, is a judicial judgment of how much the buyer *should* pay for the minority stock in the case of a buyout or appraisal. Thus, fair value is a matter of normative analysis. The fair value must result from a correction of the inequalities that arise from the conflicts of interest between majority and minority shareholders, and cannot be reached without an examination of these conflicts at a positive level.

In many court decisions involving fair value, whether for buyouts or appraisals, positive and normative analyses are seemingly confused, or at least not distinguished.[6] At this early point, I believe it is necessary to outline the particularly notable attempt by Easterbrook and Fischel to avoid any normative analysis for obtaining fair value. Essentially, they define the fair value as the hypothetical market value.[7] My position is that both positive and normative analyses are necessary to determine fair value.

Instead of using normative analysis, Easterbrook and Fischel substitute a contractarian analysis of "what the party would have wanted" to arrive at the fair value.[8] Easterbrook and Fischel seem to suggest that the fair value of minority stock is, even from a normative perspective, the same as its hypothetical market value—that is, what the party would have wanted.[9] They argue, therefore, that the controlling premium should not be distributed to the value of the minority stock because such

---

(1986) [hereinafter Easterbrook & Fischel, *Close Corporations*]; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698 (1982) [hereinafter Easterbrook & Fischel, *Control*]. I will analogize their stock valuation arguments on publicly held corporations to arguments on closely held corporations because they themselves insist that there is no theoretical difference between publicly held corporations and closely held corporations. *See* Easterbrook & Fischel, *Economic Structure*, *supra* at 228-232.

4. *See infra* text accompanying note 82.
5. *See infra* text accompanying notes 105-17.
6. *See infra* notes 23 & 28.
7. *See infra* part III.
8. *See* Easterbrook & Fischel, *Economic Structure*, *supra* note 3, at 245.
9. *See id.* at 123-25.

a distribution would decrease *ex ante* efficiency.[10]

"What the party would have wanted," however, is not necessarily the hypothetical market value. Rather, in closely held corporations, when the parties fail to specify a valuation scheme for minority stock, the valuation will be governed by the corporate law of the state of incorporation as a sort of off-the-rack contract.[11] "What the parties would have wanted," thus, embodies, by implication, existing corporate law, including such normative considerations of fairness as are incorporated in the concept of fiduciary duty. One of Easterbrook and Fischel's errors is disregarding that legal rules shape the price of closed corporation stock.

Easterbrook and Fischel make another error in arguing that publicly held corporations and closely held corporations are similar for stock valuation purposes. Although they state that "[i]lliquidity is not the problem,"[12] it is a serious problem. Different liquidity of majority stock and minority stock in closely held corporations will create different transaction costs, which will create conflicts of interest among shareholders about dividend policy.[13] The risk of squeeze-out, which makes the controlling premium in closely held corporations different from that in publicly held corporations, is a result of the conflicts of interest over dividend policy. These conflicts concentrate on the "hidden cash flow," which consists of retained earings, hidden retained earnings, and hidden dividends.[14]

As a matter of normative analysis, judicial intervention in closely held corporations should treat the hidden cash flow portion of the controlling premium differently from the entrepreneurial rewards portion.[15] Any other treatment will make minority shareholders in closely held corporations worse off and permit majority shareholders to keep a windfall and encourage them to squeeze out minorities.[16]

This Article concludes that the fair value should be the cash flow discounted value, which is the result of allowing the majority shareholder to keep the entrepreneurial rewards and giving all shareholders a share of hidden cash flow.[17] In the case where the asset value is higher than the cash flow discounted value, there is no reason to discount the higher asset value by the lower cash flow discounted value.[18] This conclusion arises from adjusting the level of controlling premium in closely held corporations to that in publicly held corporations. This conclusion does not sacrifice *ex ante* efficiency.

The Article proceeds in four parts. Part I starts by distinguishing the

---

10. *See id.* at 117-19.
11. *See infra* text accompanying notes 156-64.
12. Easterbrook & Fischel, *Economic Structure, supra* note 2, at 230.
13. *See infra* text accompanying notes 94-97.
14. *See infra* text accompanying notes 106-12.
15. *See infra* notes 204-10 and accompanying text.
16. *See infra* text accompanying note 199.
17. *See infra* text accompanying notes 204-10.
18. *See infra* text accompanying notes 211-16.

two important concepts in this Article: hypothetical market value and fair value. Part I then provides the necessary context for identifying the various approaches to valuation. Part II formulates the invisible market value of minority stock and majority stock by hypothesizing a reasonable buyer. This value may also be termed the hypothetical market value. Part II then makes clear that a reasonable buyer will not pay a weighted value but rather will pay a best-use value, which is the greater of cash flow discounted value and asset value. This section particularly highlights the difference between the controlling premium of the closely held corporation and that of the publicly held corporation. Part III develops a framework for gauging the intent of shareholders in cases where no contract provides for stock valuation. As a counter-argument to Easterbrook and Fischel, this Article posits that the hypothetical market value of the minority stock is *not* what the shareholders intended as a fair value, and that considerations of fairness cannot be avoided by using the magic word "bargain." Part IV suggests a general approach to calculating fair value. By balancing the conflicting interests of majority and minority shareholders in closely held corporations, Part IV identifies the portion of the controlling premium that should be apportioned to the minority. This Article concludes that the fair value of minority stock is its best-use value.

I. STOCK VALUATION

In order to arrive at a proper method of evaluating minority stock in closely held corporations, we must first address four issues. First, we must distinguish between hypothetical market value and fair value. Second, we must examine the methods that the courts have developed to arrive at fair value. Third, we must examine the contractarian approaches suggested by the law and economics scholars. Finally, we must examine a major failure of some law and economics professors—that is, the failure to distinguish between closely held corporations and publicly held corporations.

A. *Hypothetical Market Value and Fair Value*

All state statutes include appraisal remedies that allow minority shareholders the opportunity to sell their stock back to the corporation in the cases of mergers and other fundamental changes of corporate structure.[19] Some statutes also provide minority shareholders the opportunity to sell their stock to the majority shareholders in case of squeeze-out, as a buyout remedy.[20] In both statutory remedies, properly evaluating the

---

19. *See, e.g.*, Revised Model Business Corp. Act §§ 13.01-13.03, 13.20-13.28, 13.30-13.31 (1985); Del. Gen. Corp. Law § 262 (1992); *see also* Joel Seligman, *Reappraising the Appraisal Remedy*, 52 Geo. Wash. L. Rev. 829, 831-36 (1984).
20. *See* Cal. Corp. Code §§ 1800(b), 2000 (1990); Ill. Corp. Law Ann. ch. 805, para. 12.55 (Smith-Hurd 1993); Me. Rev. Stat. Ann. tit. 13A, § 1123 (1981); Md. Corps. & Ass'ns Code Ann. § 4-603 (1985); Mich. Comp. Laws Ann. § 450.1489(1)(e) (1990);

minority stock is the primary legal issue. Most statutes provide that courts should calculate the "fair value" in appraisal and buyout cases, but include very few standards of how fair value is determined.[21] This Part of the Article endeavors to outline the components of a fair value.

Hypothetical market value and fair value are not and should not be considered equals. Given the current state of the law, the hypothetical market value is what a reasonable buyer would pay for stock.[22] The fair value, on the other hand, is a judicial judgment of how much the buyer— either the corporation or the majority shareholder—should pay for the minority stock in cases of buyouts and appraisals. Although it is possible to argue that the fair value of the minority stock should be equal to its hypothetical market value,[23] such an argument is unconvincing. Hypothetical market value is, by definition, the price at which the minority shareholder can find a willing buyer. If the law merely defines the fair value for minority stock as the hypothetical market value, minority shareholders will have no use for judicial intervention.[24]

While the hypothetical market value and the fair value are distinct concepts, they are also related. In particular, once courts adopt a notion of fair value, that notion will be reflected at least partially—if not completely—in hypothetical market value. In other words, what a reasonable buyer will pay will take into account what the courts have determined to be fair value. The hypothetical market value is influenced not only by the state of the company, but also by the state of the law. Legal rules shape the price. While the hypothetical market value will likely differ from the fair value, the former serves as a useful starting point for exploring the interests of majority and minority shareholders.

Fair value is a slippery concept. There may be many different fair

---

Minn. Stat. Ann. § 302A.751(2) (1985 & Supp. 1993); N.J. Stat. Ann. § 12A:12-7 (1978); N.Y. Bus. Corp. Law §§ 1104, 1104-a, 1118 (McKinney 1986 & Supp. 1993); N.C. Gen. Stat. §§ 55-14-30, 55-14-31 (1991); S.C. Code Ann. § 33-14-310(d)(4) (Law. Co-op 1990); W. Va. Code § 31-1-134 (1988); Model Stat. Close Corp. §§ 40, 42, 43 (Supp. 1992); Revised Model Business Corp. Act § 14.30 (1985); Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 Notre Dame L. Rev. 425, 440, 462 (1990); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 Wash. U. L.Q. 193, 206 (1988).

21. On appraisal, see Revised Model Business Corp. Act §§ 13.01(3), 13.02, 13.30(a) (1985); Del. Gen. Corp. Law § 262 (1992). On buyout, see Model Stat. Close Corp. Supp. § 42(a) & (b)(1) (Supp. 1992); Cal. Corps. Code § 2000 (1990).

22. *See* Vought v. Republic-Franklin Ins. Co., 192 N.E.2d 332, 333 (Ohio 1962).

23. *See* McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 244 (N.M. Ct. App. 1986) (in a buyout case, the court allowed a minority discount of 25% because "when the shares sought to be sold are non-controlling shares, there is a limited market which depresses the value of the stock"); Perlman v. Permonite Mfg. Co., 568 F. Supp. 222, 231 (N.D. Ind. 1983) (in an appraisal case, the court allowed a minority discount of 15%, marketability discount of 15% and another 5% discount for lack of diversity because "the exclusive duty of this Court . . . is to find the fair market value . . . . [t]he Court should not simply find the plaintiffs' pro rata share of the asset value . . . ."), *aff'd*, 734 F.2d 1283 (7th Cir. 1984).

24. *See* Murdock, *supra* note 20, at 480.

values, depending upon the purpose for which one computes that value.[25] For example, judicial valuations in tax cases may employ different notions of fairness than valuations in buyout cases.[26] Similarly, fair values will differ depending on the theory producing the values. That is, one must distinguish between positive analysis and normative analysis. Positive analysis considers the conflicts of interest among shareholders, and the hypothetical market values of the minority stock and the majority stock. Normative analysis considers economic fairness among shareholders as a separate basis for determining fair value of the minority stock.

Unfortunately, both the hypothetical market value and the fair value are not easily or readily measurable. Moreover, it is misleading to seek an "objectively correct" valuation. Rather, one must consider which value is the most persuasive fair value based on positive analysis of hypothetical market value.

B. *Case Law Approaches to Stock Valuation*

Though many may consider stock valuation to be merely a technical business calculation best left to accountants and investment bankers, the valuation of stock in buyouts and appraisals is an important legal matter. While the details accompanying these calculations are business matters, the main framework of stock valuation must be created by lawyers. The fair value is necessarily a judicial conclusion reached by balancing the conflicting interests among shareholders.[27]

There are essentially three calculations that factor into a determination of a given stock's value: (1) Cash Flow Discounted Value *(CFDV)*;[28] (2) Asset Value *(AV)*;[29] and (3) Market Value *(MV)*.[30] Most attempts at

---

25. *See* Harry J. Haynsworth IV, *Valuation of Business Interests*, 33 Mercer L. Rev. 457, 459, 489 (1982).

26. Many cases on statutory buyout confuse the fair value in the buyout context with fair value in the tax context. *See* McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232 (N.M. Ct. App. 1986). *But see*, Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170, 175-76 (Cal. Ct. App. 1979).

27. The "fair value" has no implications of justice, but simply means the value which courts determine in cases of buyouts and appraisals.

28. Cash flow discounted value assigns a current dollar value to a company's current and future benefits. *See* David Cohen, Comment, *Valuation in the Context of Share Appraisal*, 34 Emory L.J. 117, 128 (1985). Cash flow discounted value treats a company as a future cash flow breeding machine and ignores the company's assets. Earnings value, which has been used by Delaware courts, does not fully reflect the going-concern value of a company because it ignores future prospects for the company. *See infra* note 32.

29. Asset value may be used in two ways: as a liquidation value and as a going-concern value. Going-concern value, however, should be the same as cash flow discounted value. *See* Cohen, *supra* note 28, at 135-38. In this Article, the liquidation value is used to define asset value. In other words, the focus is on the market value of the company's assets without consideration of its current business. *See* Tri-Continental Corp. v. Battye, 74 A.2d 71, 75 (Del. 1950). The asset value is only significant when it is greater than the cash flow discounted value.

30. If there were a perfect capital market, the market value of the stock would be the

valuation use one or a combination of these figures. Because closely held stock has no market value,[31] the problem in a closely held corporation is narrowed to deriving a value based on cash flow discounted value and asset value.

A common judicial approach to stock valuation, the Delaware block method, approaches valuation as a compromise and combines the figures described above. The block method uses a weighted average of the basic calculations—for example, sixty percent from earnings value[32] and forty percent from asset value. The weight assigned to either value is flexible depending on the circumstances of the corporation.

Recently, the Maine Supreme Judicial Court, in *In re Valuation of Common Stock of McLoon Oil Co.*,[33] employed the Delaware block approach in constructing an appraisal remedy.[34] In *McLoon*, the court took a weighted value as the hypothetical market value of the corporation.[35] Declining to calculate any share price discount for the minority, the court took the proportional share of the hypothetical market value of the corporation as the fair value of the minority stock.[36]

Though the Delaware Supreme Court has rejected this method,[37] many other jurisdictions still use it.[38] Why is the weighted method so

---

same as the highest of either its cash flow discounted value, which is the same as its going-concern value, or its liquidation value. *See* Cohen, *supra* note 28, at 145. In fact, the actual market value is affected by many factors other than the future cash flow. Delaware courts have been reluctant to rely solely on the market value of the stock even when it is traded on a stock exchange. *See id.* at 146.

31. Even when there is no market price for the stock, courts have attempted to find a constructive market value in order to apply the Delaware block method. *See* Bell v. Kirby Lumber Corp., 413 A.2d 137, 147 (Del. 1980); *In re* Delaware Racing Ass'n, 213 A.2d 203, 212 (Del. 1965). The attempt to create such a constructed market value, is however, unnecessary. *See* Cohen, *supra* note 28, at 150.

32. In their weighing method, Delaware courts have used earnings value instead of cash flow discounted value. *See, e.g., Bell,* 413 A.2d at 138-44 (using earnings value). The major differences between earnings value and cash flow discounted value are twofold: (1) earnings value considers historical average earnings instead of future earnings; and (2) earnings value uses the accounting earnings figure instead of real net cash inflows which equals the sum of the cash inflows minus the cash outflows. *See Cohen, supra* note 28, at 141. *See generally* George J. Benston, *Accounting Numbers and Values,* 27 Antitrust Bull. 161 (1982) (questioning the appropriateness of accounting methods for legal purposes).

33. 565 A.2d 997 (Me. 1989).

34. *See id.* at 1002.

35. *See id.*

36. *See id.*

37. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703-04 (Del. 1983) (it is still commonly referred to as the Delaware block method because it was first developed in Delaware).

38. *See McLoon,* 565 A.2d at 1003; *see also* Walter S. Cheesman Realty Co. v. Moore, 770 P.2d 1308, 1311-12 (Colo. Ct. App. 1988) (considering market value, investment value, and net asset value weighted according to the facts of each case); Richardson v. Palmer Broadcasting Co., 353 N.W.2d 374, 378 (Iowa 1984) ("courts should view these three approaches to valuation as relevant factors rather than essential components"); Columbia Management Co. v. Wyss, 765 P.2d 207 (Or. Ct. App. 1988) (thorough analysis of various methods of valuation), *review denied,* 771 P.2d 1021 (Or. 1989); Blasingame v.

popular? First, the Delaware block method is flexible and simple. Courts make seemingly equitable solutions by using their wide discretionary power in weighing. Second, it is a good way to effect an apparent middle ground. When the asset value is higher than the earnings value, for example, the minority insist the higher is more accurate and thus more fair, while the majority adamantly insist that the lower earnings value is the fair value. Understandably, courts try to find a point between the two values as a compromise. Third, the weighing method persists as a form of reliance: corporate participants shape transactions and bargain with rules of law in mind. Similarly, the market integrates case law, so the hypothetical market value would reflect this valuation approach.

The Delaware block method is unreasonable, however, as a calculation of the hypothetical market value. Although Delaware courts may have believed that they could "take into consideration all factors and elements" by using the Delaware block method,[39] the method is equivalent to putting everything into a melting pot. By definition, the Delaware block method creates a weighted value: the lower of asset value or earnings value deflates the higher in a compromised result. The reasonable buyer, however, would buy up to at least the higher of the two figures— the best-use value to the particular buyer. While the Delaware block approach may embody virtues of judicial economy, it fails to provide either an accurate hypothetical market value or a defensible fair value.[40]

C. *Contractarian Approach to Stock Valuation*

The law and economics theory proceeds from the bedrock principle that markets, unlike courts, are competent arbiters of value. The less courts are involved, the more likely it is that parties' expectations of *ex ante* efficiency will be accomplished. *Ex post* fairness criteria are based on the general contractarian theory that the law should provide for results mirroring "what the parties would have agreed to," but this approach should be used only "[i]f a court is unavoidably entwined in a dispute."[41]

The contractarian theories reflect a genuine understanding that much of our corporate legal structure is enabling.[42] That is, parties in a close corporation are free to contract around the mandatory rules in order to personalize corporate governance and dispute resolution. Default rules, or gap-fillers, are invoked when parties fail to so plan.[43] Easterbrook and

American Materials, Inc., 654 S.W.2d 659, 667 (Tenn. 1983) (court explicitly adopts Delaware block method of stock valuation).

41. *See* Tri-continental Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950).

40. *See generally* Elmer J. Schaefer, *The Fallacy of Weighting Asset Value and Earnings Value in the Appraisal of Corporate Stock*, 55 S. Cal. L. Rev. 1031 (1982).

41. *See* Easterbrook & Fischel, *Economic Structure*, supra note 3, at 245.

42. *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 Colum. L. Rev. 1618 (1989).

43. Fiduciary duties are an example of these gap-fillers. *See generally* Ian Ayres &

Fischel take a stern view of the gap-filling role of legal rules.[44] They argue that when parties fail to provide available gap-fillers, the law should presume that the failure was intentional.[45] For instance, if parties fail to account for dissolution procedures and minority parties seek to dissolve the venture, a court must initially decide whether dissolution is justified.[46] Easterbrook and Fischel consider the liberal approach to involuntary dissolutions as an invitation for exploitation by minority shareholders.[47] They note that minority shareholders have other remedies, including damages for breach of fiduciary duty and the appointment of a custodian or provisional director.[48] Moreover the parties could have bargained for more protection.[49]

After determining that dissolution is justified, the court must then value shareholder claims. Majority shareholders seek to capture the full value of their majority status, including a premium in a change of control context. Alternative approaches attempt to divide the control premium between the majority and minority shareholders—creating a so-called sharing requirement. Easterbrook and Fischel argue that all parties, including minority shareholders, prefer gap-fillers that allow majority owners to retain their entire premium. Easterbrook and Fischel argue that value-increasing transactions, like corporate control transactions, would be deterred by a requirement of sharing the controlling premium, so a sharing principle leads to a reduction in the total wealth of shareholders.[50] They conclude that the pre-transaction value standard is best for investors.[51] Further, Easterbrook and Fischel's trust of the market mechanism does not diminish even in the closely held corporation setting. Although they recognize the problems of illiquidity of closely held stocks, they still do not admit that "shareholders in closely held corporations face unique risks of oppression . . . . [b]ecause the world contains so many different investment vehicles."[52]

Easterbrook and Fischel do not clearly articulate what they consider to represent a fair value. But they would likely argue that, for minority shares in cases of appraisal remedies and buyouts, the fair value should equal the hypothetical market value—the amount a reasonable buyer would pay for the minority stock. This approach, intended to minimize judicial intervention, should approximate what the party would have wanted. Easterbrook and Fischel note that "*ex post* inequality . . . , like

---

Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989).
   44. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 238.
   45. *See id.*
   46. *See* Murdock, *supra* note 20, at 452-61.
   47. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 242.
   48. *See id.* at 241.
   49. *See id.*
   50. *See id.* at 118.
   51. *See id.* at 152.
   52. *See id.* at 231.

the *ex post* inequality in a lottery, is not 'unfair' if, *ex ante*, all investors have an equal chance to win and can eliminate risk through diversification."[53] The lottery analogy is unconvincing. Closely held corporations are often ventures made up of families and fueled by individuals' or families' entire fortunes. Thus, both the possibility of diversification and the points of comparison to decisions made in a market are reduced.

As a general matter, Easterbrook and Fischel correctly favor market forces over judicial intervention. In certain circumstances, however, such as the dispute resolution of problems involving closely held corporations, judicial intervention is needed to fill gaps. Similarly, *ex ante* efficiency in the aggregate is vitally important. Specific disputes, however, cannot be fairly or legitimately resolved by considering only *ex ante* efficiency.

Although Easterbrook and Fischel may argue that practical differences between publicly held corporations and closely held corporations theoretically do not matter and that "illiquidity is not the problem,"[54] those differences do matter, both practically and theoretically. Illiquidity is a major problem. The controlling premium of the publicly held corporation and that of the closely held corporation differ substantially depending on the degree of illiquidity.[55] Further, a contractarian approach must account for the vagaries of close corporations. "What the parties would have wanted" when they fail to contractually specify a buyout price is not necessarily the same as the hypothetical market value of the minority stock.

A specific example, one that shall serve as a paradigm throughout this Article, best illustrates the different results that obtain depending on the valuation method employed. Five computer engineers spin off from a big computer company. Each invests twenty percent of the capital in the new venture. All the shareholders become directors and work for the company on a full-time basis. The company enjoys great success and rapid growth. Several years later, however, a personal dispute divides the board three-to-two. The two shareholders in the minority are subsequently removed as directors and officers. Moreover, they receive only nominal dividends even though the company continues to enjoy healthy profits, most of which are distributed among the majority as salaries. The certificate of incorporation and the bylaws contain no divorce clauses and no buyout contracts exist. The two minority shareholders sue for involuntary dissolution because of the oppression by the majority. The court grants the motion and the majority chooses to buy out the minority.

In such a case it is not unreasonable for the minority shareholders to demand their share of the enterprise. At the stage of initiating the busi-

---

53. *See id.* at 123.
54. *See id.* at 230.
55. *See infra* text accompanying notes 94-97.

ness, they invested on the same basis as the current majority shareholders and the hypothetical market value of their stocks must have been the same. Now, however, the hypothetical market value of the two shareholders' stock is much less than that of the other three shareholders' stock. This reduction in value primarily results because the new minority has no strong mechanism for protection. It is unfair to force the minority shareholders in such a case to bear all of the disadvantage resulting from a closely held corporation's lack of balancing mechanisms.

In the case at hand, what is the fair value a court should allow? Suppose the cash flow discounted value per share is $1,000, the hypothetical market value per minority share is $50 (calculated based on the historical dividend value), and the asset value per share is $200. The weighted method, if its components were computed as in *McLoon*—sixty percent from the cash flow discounted value and forty percent from the asset value—yields a value of $680 per share. Easterbrook and Fischel would likely be satisfied with the hypothetical market value of $50. A valuation based on the best-use of the shares to a buyer, in this case the cash flow discounted value, would be $1,000.[56]

This hypothetical situation demonstrates the differences among Easterbrook and Fischel's analysis, the Delaware block method, and my arguments in arriving at the fair value of minority shares in closely held corporations. If valued according to either Easterbrook and Fischel or the Delware block method, minority shares are undervalued.

D. *Closely Held Corporations Compared to Publicly Held Corporations*

Theoretically, comparisons between closely held corporations and publicly held corporations are too speculative at best. There are many varieties of corporations, either closely held or publicly held, with different asset values, different numbers of shareholders, different liquidity of stock, and so on.[57] The differences are not absolute but continuous.

---

56. As another example, suppose that in a single shareholder company, the founder-CEO died intestate. His wife and two sons inherit all shares of the company based on the inheritance law. The wife receives one half of the stock and the sons each receive one quarter of the stock. The mother lets the first son succeed to the business and he can now control three quarters of the voting rights. The second son is deemed to be a minority shareholder from the beginning.

If the first son, now CEO, gives his brother a position as an officer and pays him a handsome salary or a reasonable amount of dividends, there is no problem. The conflicts occur if the second son obtains nothing from his stock ownership, particularly if the liquidation value of the company is much higher than the cash flow discounted value. We could also apply this analysis in the case of a holding company, which is created specifically for managing the family assets.

It would be unfair to allow the first son, the controlling shareholder, to buy out the stock of the second son, the minority shareholder, at the hypothetical market value of the minority stock. If the court were to deflate the higher asset value by the lower cash flow discounted value, because the first son will run the corporation, or because the corporation is a going concern, it would change the principle of equal inheritance as applied to corporate law.

57. Professor O'Kelley categorizes closely held firms into three types: the archetypi-

Squeeze-outs, for example, can occur even in publicly held corpora-
tions.[58] To make this discussion more precise, therefore, I will focus on
two criteria that separate public corporations from closely held corpora-
tions: concentration among shareholders and liquidity of stock. The risk
of squeeze-out depends on both concentration and liquidity,[59] and the
controlling premium differs accordingly.[60]

In terms of the diversification (concentration) criteria, there are two
extremes. The first extreme is where there is no conflict of interest at all
among shareholders and every shareholder is a member of the majority.
The second extreme is where shareholders are fully divided between the
majority and the minority, with severe conflicts of interest about divi-
dend distribution policy. Between the two extremes, there are many
levels of concentration.[61] In terms of the liquidity criteria, consider a
corporation trading its shares on a perfectly efficient stock market, where
shareholders can sell their stock without transaction costs, and retained
earnings are perfectly reflected in the stock price.[62] Although no actual
corporation trades in a perfect market, a corporation listed on the New
York Stock Exchange is closer to the perfect model than a non-listed
family corporation.

One of Easterbrook and Fischel's major criticisms of conventional
close corporation theory is that the distinction between public and pri-
vate ownership does not constitute a fundamental difference.[63] Theoreti-
cally, one might try to use the same formulae and same equations for
both closely held corporations and publicly held corporations. Practi-
cally, however, it is still useful to discuss the two categories separately.
The differences between a Fortune 500 company with thousands or mil-
lions of small shareholders trading in a liquid market, and a family cor-
poration with one majority shareholder and a few minority shareholders,
are indeed fundamental. Because the standards of liquidity and concen-
tration—and therefore the contents of the controlling premium—are sub-
stantially different,[64] the nature of judicial intervention should differ as
well.[65]

Economic fairness among shareholders in closely held corporations is
much harder to obtain than in publicly held corporations. This difficulty
exists because there is no strong external monitoring mechanism for fair-

cal close corporation, the partnership corporation and the sole-proprietorship corpora-
tion. *See* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A
Transaction Cost Analysis*, 87 Nw. U. L. Rev. 216 (1992).
    58. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 230-31.
    59. *See infra* text accompanying notes 93-97.
    60. *See infra* text accompanying notes 105-17.
    61. For example, shareholders may be divided into different groups without a stable
majority.
    62. *See* Merton H. Miller & Franco Modigliani, *Dividend Policy, Growth and the Val-
uation of Shares*, 34 J. Bus. 243 (1962).
    63. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 231.
    64. *See infra* text accompanying notes 93-97.
    65. *See infra* text accompanying notes 191-216.

ness in the closely held corporation.[66] Even a dissatisfied shareholder cannot sell out her stock in the public market. Moreover, her bargaining power to negotiate with majority shareholders regarding the payment of reasonable dividends or the purchase price of her stock is usually very weak.[67] It is, of course, arguable what economic fairness is.[68]

Corporate control is valuable in both publicly held corporations and closely held corporations. The corporate control of the closely held corporation, however, has much greater value than control of the publicly held corporation. In other words, in the closely held corporation, the difference between the hypothetical market value of majority stock and that of minority stock is greater than in the publicly held corporation.[69] This difference in value can also be termed the "controlling premium." Therefore, shareholders of closely held corporations often engage in severe struggles for control. Without judicial intervention, minority shareholders would easily be squeezed out by the majority. The problem of squeeze-outs is recognized by legislators and courts as inequitable. The legislators and courts have determined that some protection of minority shareholders is necessary.[70] The most important question in finding the fair value of the minority stock of a closely held corporation is: how much of the controlling premium should the majority share with the minority?[71]

All the major problems affecting closely held corporations are relevant to stock valuation.[72] In closely held corporations, these problems may be solved by contracts among shareholders in which they specify how to liquidate their investment. They may agree, for example, that in case of retirement or death of one party, the other party must buy out the stock

---

66. There are four basic problems when it comes to ordering the internal relationships among close corporation shareholders: (1) economic unfairness to minority shareholders; (2) struggles for control; (3) protection of minority shareholders; and (4) contractual modifications of the corporation law. *See* Zenichi Shishido, *Problems of the Closely Held Corporation: A Comparative Study of the Japanese and American Systems and a Critique of the Japanese Tentative Draft on Close Corporations*, 38 Am. J. Comp. L. 337, 340 (1990).

67. Note, however, that the existence of a buyout remedy changes the bargaining position of the minority shareholder. *See* Murdock, *supra* note 20, at 429.

68. *See id.* at 361.

69. *See infra* text accompanying notes 105-17.

70. *See generally* F. Hodge O'Neal & Robert B. Thompson, O'Neal's Oppression of Minority Shareholders §§ 7:01-7:43 (2d ed. 1985).

71. *See infra* text accompanying notes 204-16.

72. These issues include: What are the conflicts of interest between the majority and the minority? How shall we balance such conflicting interests? What is economic fairness? How shall we balance corporate control and economic fairness? How far shall we protect minority shareholders by judicial intervention? Is it a windfall for the minority if the court evaluates minority stock above the hypothetical market value? What was the bargain among the shareholders? To what extent should the courts enforce the bargain? We must take all these problems into consideration to determine what is the fair value of the minority stock in the closely held corporation.

owned by the retired or dead party.[73] If the contract contains a formula
to calculate the buyout price, judicial valuation would usually be unnec-
essary—we know the fair value and the intent of the parties.[74]

Professors O'Neal and Thompson observe that relatively few closely
held corporations adopt such contractual devices.[75] Parties do not use
these contractual devices because of the great cost of negotiating and exe-
cuting these agreements.[76] Moreover the parties recognize that these de-
vices are either incomplete or incompetent to solve their problems.[77]
There is also no real incentive to bargain for these provisions.[78] Even
with the currently popular provision for appraisal when a party either
dies or retires,[79] this Article's argument regarding the relationship be-
tween the hypothetical market value and the fair value is useful. With-
out understanding this relationship, the parties cannot instruct the
appraisers on how to calculate the fair value.

II. POSITIVE ANALYSIS OF CONFLICTS OF INTEREST BETWEEN
MAJORITY AND MINORITY SHAREHOLDERS

A positive analysis of the conflicts of interests between majority and
minority shareholders requires a series of inquiries. The first sets forth a
reasonable buyer hypothesis. The second establishes the method for ar-
riving at the hypothetical value of minority stock. This analysis encom-
passes dividend value, the risk of squeeze-out discount, and the
dissatisfied minority premium. The third inquiry establishes the method
for arriving at the hypothetical market value of majority stock. This
analysis examines the reasons why an individual would pay a higher
price for majority stock, and addresses the controlling premium and its
components.

A. *A "Reasonable Buyer" Hypothesis*

No visible market value exists for closely held stock. In order to define
the hypothetical market value of majority and minority stock, one begins
by hypothesizing the existence of a reasonable buyer and taking the cur-
rent state of the law as a given. The amount a reasonable buyer would
pay for stock is its hypothetical market value.

The hypothetical market value assumes that a reasonable buyer would
not pay the weighted average value, but would pay the *full value*, that is,

---

73. *See* Shannon Pratt, Valuing Small Businesses and Professional Practices 381
(1986).
74. *But see infra* notes 140-43 and accompanying text.
75. *See* F. Hodge O'Neal & Robert B. Thompson, O'Neal's Closely Held Corpora-
tions § 1.18 (3d ed. 1990).
76. *See* O'Kelley, *supra* note 57, at 243.
77. *See infra* text accompanying notes 141-51.
78. *See infra* text accompanying notes 141-51.
79. For example, shareholder agreements may contain the following language: "each
party shall appoint one arbitrator . . . the arbitrators so appointed will select a third
arbitrator." Pratt, *supra* note 73, at 383.

the best-use value. To illustrate, consider the various values adhering in a 1964 E-type Jaguar. As a classic car, it may be worth $10,000, but as a working vehicle, it may be worth only $1,000. Employing a weighted value, such as the Delaware block method uses, the car would then be valued at $5,500. The car owner, however, would have little patience with an offer of $5,500. So long as people continue investing in classic cars, the (hypothetical) market value of the Jaguar will be $10,000 because there always will be some buyers who would be willing to pay up to $10,000. Thus, as a fair value, a weighted average value is worth considering, but as a hypothetical market value, it is clearly erroneous and misleading.

Similarly, a weighing method is an unreasonable approach to stock valuation. The hypothetical market value is determined by considering how much a reasonable buyer will pay. So the question may be rephrased as: Would a reasonable buyer pay the weighted value? In fact, she will not pay a weighted value, but rather, will pay a best-use value. For example, if the cash flow discounted value is higher than the asset value,[80] the reasonable buyer will pay up to the cash flow discounted value. Thus, if she makes a bid at a price equal to the weighted average of the cash flow discounted value and the asset value, which deflates the higher cash flow discounted value by the lower asset value, some other buyer will bid at the higher cash flow discounted value. The reasonable buyer in this case will consider the corporation as a cash flow breeding machine and will not care about the liquidation value of its operating assets. The value of its non-operating assets can be added to the cash flow discounted value, but the asset value will never be used for deflating the cash flow discounted value. The reverse is also true. If the asset value is higher than the cash flow discounted value, the reasonable buyer will pay up to the asset value and will ignore the lower cash flow discounted value. *In re Valuation of Common Stock of McLoon*[81] took the weighing method as "the best available valuation method[ ];"[82] however, that analysis is flawed.

One must distinguish between calculating the hypothetical market value in theory and calculating it in practice. In theory, one may have perfect information about the future. In practice, however, information is far from perfect, so the question of how feasibly to estimate the cash flow discounted value becomes relevant. Feasibility may be derived reasonably from using the so-called two-step cash flow discounted value. For example, in the case of the higher cash flow discounted value, theoretically one should take the cash flow discounted value as the value of the corporation. It is impossible, however, to predict the future cash flow forever. Therefore, the two-step cash flow discounted value analysis considers the cash flow discounted value only for a reasonably predictable

---

80. *See supra* note 29.
81. 565 A.2d 997 (Me. 1989).
82. *Id.* at 1002, 1004.

future—for example, five years—and adds the present value of assets at the end of the period.[83] Note that the two-step cash flow discounted value is not an average of the current value factors.

B. *Hypothetical Market Value of the Minority Stock*

In order for courts to compute the hypothetical market value of minority stock, three critical elements must be analyzed. These elements are the dividend value, the risk of squeeze-out discount, and the dissatisfied minority premium.

1. Dividend Value

How much would a reasonable buyer pay for minority stock? In either closely held or publicly held corporations, and for either minority or majority shareholders, the only expected return from holding stock is the receipt of dividends and the liquidation value in case of dissolution of the corporation. For this reason, the reasonable buyer would pay the dividend value (DV) at time T, which is the present discounted value of the expected flow of all future dividends. This value is obtained by discounting the prospective dividends by the interest rate (r) taking into account the default risk (d) of the corporation.

$$\text{Hypothetical Market Value}_T = \sum_{s=t-T+1}^{\infty} \frac{\text{Div}_s}{(1+r+d)^s}$$

Accurately calculating this dividend value, however, is no simple task. Corporations of similar profitability may adopt quite different dividend policies. For instance, suppose that Corporation X pays eighty percent of its earnings to shareholders as dividends while retaining twenty percent of the earnings. Corporation Z, on the other hand, pays only twenty percent of its earnings as dividends and retains eighty percent. If the hypothetical market value equals the dividend value, the hypothetical market value of the stock of X is much higher than Z. It is strange, however, to consider that the retained earnings of the latter will not be part of the calculated hypothetical market value. Moreover, while a dividend record may prove a reasonable predictor of future dividends, the historical record does not always assure future payment. Theoretically, hypothetical market value must be based on the expected dividend value.

According to the theorem advanced by Professors Modigliani and Miller,[84] dividend policy does not affect stock value in a perfect capital market.[85] The rationale underlying this theorem is that, sooner or later,

---

83. *See, e.g.*, Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. Supp. 1989) (expert testimony relying on the two-step cash flow discounted value analysis).

84. *See* Miller & Modigliani, *supra* note 62, at 243.

85. The perfectly efficient capital market is not burdened by taxes or transaction costs. *See* Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 362 (3d ed. 1988).

retained earnings will be paid out as dividends. Therefore, in such a perfect world, the dividend value, which is the same as the hypothetical market value of either the minority stock or the majority stock, equals the cash flow discounted value.

> Hypothetical Market Value
> = Dividend Value
> = Cash Flow Discounted Value

Thus, we can assume that the hypothetical market value of the minority stock in a publicly held corporation equals the cash flow discounted value—even though the real market value is affected by various market imperfections.[86] Conversely, in cases of mergers and acquisitions, the reasonable buyer of the majority stock may pay more than the cash flow discounted value.[87] There are two elements that explain the willingness of a reasonable buyer of the majority stock to pay more than merely the dividend value: the potential synergistic effects[88] and the expectation of enhancing the company's value.[89] I call these two value-adding elements the Entrepreneurial Rewards.[90] These rewards should be added to cash flow discounted value as the hypothetical market value of the majority stock.[91] In corporations within a well developed capital market, then,

> Hypothetical Market Value of the Minority Stock
> = Cash Flow Discounted Value;
>
> and
>
> Hypothetical Market Value of the Majority Stock
> = Cash Flow Discounted Value
> + Entrepreneurial Rewards.

In other words, these entrepreneurial rewards represent the controlling

---

86. I assume that the risk of squeeze out, *see infra* note 93, is negligible because the stock market is highly liquid.

87. In actual stock market takeovers, the average premium over the market price before the bid is reported to be about 50%. *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 Stan. L. Rev. 597, 601 (1989); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 Yale L.J. 1235, 1259 (1990).

88. If the buyer has another company which is engaged in a business related to that of the issuer, he might expect some synergistic effects to result from the combination of the two companies. *See* Black, *supra* note 87, at 608, 610.

89. The buyer might consider the current management poor, and have plans to improve the company's performance. *See* Easterbrook & Fischel, *Control, supra* note 3, at 705; Black, *supra* note 87, at 609.

90. There may be other explanations of takeover premiums such as "bidder overpayment" or "price pressure" by large stock transactions. On bidder overpayment see Black, *supra* note 87, at 599; John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offers Role in Corporate Governance*, 84 Colum. L.Rev. 1145, 1243-44 (1984). On price pressure see Stout, *supra* note 87, at 1235.

91. In this stage, I do not address the legal systems that try to distribute synergy to all shareholders. *See* William D. Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 Harv. L. Rev. 505 (1965); Richard W. Jennings, *Trading in Corporate Control*, 44 Calif. L. Rev. 1 (1956).

premium of majority stock.[92]

2. Risk of Squeeze-Out Discount

The reasonable buyer of minority stock in a closely held corporation will consider factors other than the cash flow discounted value. The risk of being squeezed out by the majority must factor into a valuation of minority stock. The majority shareholders can easily restrict the payment of dividends, offering no assurance that the minority shareholders will ever enjoy potential returns made possible by retained earnings. Assuming that the few statutory checks do not prevent such behavior, the majority shareholders can enjoy the retained earnings by themselves after the minority sells out. In other words, the world of the closely held corporation is the world of the imperfect capital market, and as a result, the Miller and Modigliani theory will not work for the closely held corporation.[93] Therefore, the cash flow discounted value must be reduced by the risk of squeeze-out.

The particular risk of squeeze-out depends primarily upon the degree of concentration among the shareholders. When ownership is more concentrated, there is a higher risk of squeeze-out. For example, in a corporation with sixty percent majority and forty percent minority and without any chance of changing majority position, the majority has a strong incentive to squeeze out the minority. Such squeeze-outs are commonly undertaken and rarely monitored. In a corporation with three shareholders owning thirty-three percent each, on the other hand, the risk of squeeze-out is diminished. In this case, it is not clear who might obtain majority status, and the equal footing should provide the monitoring mechanisms that facilitate a steady flow of dividends. Still, a reasonable buyer of a thirty-three percent stake would consider the possibility that the other two shareholders might combine to squeeze her out in the future. However, the risk of squeeze-out is lowest in corporations with many shareholders and distinct separation of ownership and management.

The risk of squeeze-out varies with a stock's liquidity. Easterbrook and Fischel state: "Consider the extreme case in which a majority shareholder appropriates 100 percent of the firm's income. Even if a minority stockholder had an unrestricted ability to sell his shares, nobody would buy. Illiquidity is not the problem."[94] In response to Easterbrook and

---

92. In a perfectly efficient capital market, there should be no controlling premium because all information is revealed. Investor demands for particular stock should be perfectly elastic (the demand curve is horizontal); therefore, even majority shareholders are willing to sell all their stock to any offer above the current market price. *See* Stout, *supra* note 87, at 1239.

93. Even in publicly held corporations, there are risks of squeeze-out because of imperfect markets. Deviation from the perfectly competitive market is, however, much larger in closely held corporations than in publicly held corporations; thus, the risk of squeeze-out is correspondingly larger in closely held corporations.

94. Easterbrook & Fischel, *Economic Structure, supra* note 3, at 230.

Fischel, consider a more specific example. Suppose the Corporations P and C ("P-Corp" and "C-Corp") have identical cash flow discounted values and asset values. They also exhibit an identical concentration among shareholders: a majority shareholder with fifty-one percent equity and thousands of small shareholders. Suppose further that both companies have highly concentrated ownership amenable to squeeze-out. The only difference is that P-Corp is listed on a stock exchange, but C-Corp is not. If the majority shareholders of P-Corp and C-Corp tried to appropriate the firms' income through self dealing, they would likely fail to gather 100 percent of the income. Rather, the difference between the two corporations will appear in their dividend policies.

Suppose, in both corporations, the majorities restrict dividends and retain earnings for squeeze-out purposes. If P-Corp has a very liquid market for its minority stock and the minority shareholders can sell their stock with low transaction costs, the restrictive dividend policy poses little threat to the minority. Moreover, conflicts of interest should be averted because the retained earnings should be reflected in the market price of the minority stock.[95]

Conversely, if C-Corp has no liquid market for its minority stock and the minority shareholders cannot sell their stock absent substantial transaction costs, a restrictive dividend policy is a major threat to minority shareholders.[96] Presumably, the majority shareholder does not face the same barrier of high transaction cost, particularly not on a per-share basis. Different transaction costs for the majority stock and for the minority stock create a conflict of interest in dividend policy—giving the majority an incentive to squeeze out the minority. Therefore, different transaction costs, resulting in large part from different levels of liquidity, lead to different risks of squeeze-out.[97] Note that judicial interventions, though imperfect, are available to the minority shareholders of both C-Corp. and P-Corp.

3. Dissatisfied Minority Premium

Although dividends are critical to the valuation of hypothetical market value, that value would not be zero even if the majority shareholder paid no dividends despite high profits. This is so because a minority shareholder might have some bargaining weapons. A dissatisfied minority shareholder could continually bring lawsuits against the majority shareholders or the corporation itself, alleging oppressive conduct or minor

---

95. We could say that perfect liquidity means no risk of squeeze-out.

96. Since most shareholders are not drawing salaries from C-Corp., they rely on dividends as a source of income from their investment.

97. We can also say that the actual dividend value of the minority stock is: *Cash Flow Discounted Value — Risk of Squeeze-Out*. Although this should be the expected dividend value, the reasonable buyer of the minority stock would first look at the dividend flow for prior years. When calculating the expected dividend value, they have little choice but to rely on the historical dividend pattern. Thus, in reality, the actual dividend value of the minority stock would approach the historical dividend value.

procedural defects in shareholder meetings or the like.[98] This is a serious annoyance and might create an incentive for the majority shareholder to buy out the minority, with or without judicial intervention.[99] Even without these nuisance suits, the mere existence of a potential dissatisfied minority could deflate the value of the majority stock because of potential suits. These bargaining weapons can be used by the minority when negotiating the price terms of the buyout. I call this bargaining weapon the "dissatisfied minority premium."

To sum up, the hypothetical market value of minority stock in a closely held corporation can be calculated by subtracting the "risk of squeeze- out" from the dividend value, and adding the "dissatisfied minority premium." This can be expressed as follows:

> Hypothetical Market Value of Minority Stock
> = Dividend Value (Cash Flow Discounted Value)
> − Risk of Squeeze-Out[100]
> + Dissatisfied Minority Premium

C. *Hypothetical Market Value of the Majority Stock*

In order for courts to compute the hypothetical market value of majority stock, four critical elements must be analyzed. These elements are the reasons an individual would pay a higher price for majority shares, the controlling premium, retained earnings, and excessive asset value.

1. Reasons for Paying a Higher Price

The reasonable buyer probably would pay more for the majority stock than for the minority stock. In other words, the hypothetical market value of the majority stock will normally be higher than that of the minority stock. This is true for both closely held and publicly held corporations, although the deviation between the two values seems to be much larger in the former than in the latter. I call the deviation between the hypothetical market value of the majority stock and that of the minority stock the "controlling premium."[101] Why is there a controlling premium? Of what does a controlling premium consist? To answer these

---

98. O'Neal & Thompson categorize legal remedies for minority shareholders against squeeze-outs into remedies based on fiduciary duties, remedies based on dissolutions, and other remedies based on securities laws, discovery, etc. *See* O'Neal & Thompson, *supra* note 70, at §§ 7:01-:43.

99. The minority shareholder himself, however, must also bear some cost of litigation.

100. Mathematically, the risk of squeeze-out should be one of the multipliers of the dividend value. We will, however, denote it as above for convenience. Although this discount can be called "minority discount," it should not be considered in arriving at the fair value. *See infra* text accompanying notes 205-10.

101. *See infra* note 105. *See generally*, Ronald J. Gilson, The Law and Finance of Corporate Acquisitions 255-498 (1986); Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. Chi. L. Rev. 1465, 1486 (1992).

questions, we will start by calculating the hypothetical market value of the majority stock.

The majority shareholders also can obtain economic benefit through dividends. Therefore the hypothetical market value of the majority stock should also be based on the dividend value, which can theoretically be considered the same as the cash flow discounted value. Majority stock differs from minority stock, however, because there is no need to discount the cash flow discounted value by the risk of squeeze-out. The majority shareholders decide the dividend policy by themselves. In other words, the actual dividend value of the majority stock can be considered the same as the cash flow discounted value, or even larger than this, because of the reverse of the risk of squeeze-out. That is, if the majority squeezes out the minority, the majority will receive what the minority loses. In other words, just as the minority endures a risk of squeeze-out, the majority values a risk of squeeze-out. However, the value per majority share of squeezing-out the minority share is equal to the ratio of minority shares to majority shares (*min/maj*) multiplied by the risk of squeeze-out per minority share.

The reasonable buyer of the majority stock of the closely held corporation, like the buyer of a publicly held corporation, also pays for entrepreneurial rewards, which consist of the synergistic effect[102] and the expectation of enhancing the company's value.[103] In closely held corporations, particularly small corporations, one should include within the entrepreneurial rewards that part of the reasonable salary which is in excess of outside opportunities. This is necessary because frequently the excess is one of the most important reasons for buying a corporation. To be precise, the amount which should be considered as part of the entrepreneurial rewards is the legally admissible salary as a reasonable amount minus the opportunity cost to the particular person who takes the position.

Another difference between majority and minority shareholders is that, just as the minority benefits from the dissatisfied minority premium, the majority must take into account a dissatisfied minority discount. This discount must be taken into account because the existence of the dissatisfied minority shareholders itself may deflate the hypothetical market value of the majority stock.[104] So, the equation for determining the

---

102. *See supra* note 88.

103. *See supra* note 89.

104. The amount of the dissatisfied minority premium in the hypothetical market value of the minority stock will not usually be the same as the amount of the dissatisfied minority discount in the hypothetical market value of the majority stock. They are closely related, however. The minority will choose a level of litigation ("*L*") in order to maximize its award while keeping minority costs down. That is, the dissatisfied minority premium ("*DMP*") will (roughly) be arrived at by choosing an *L* to satisfy:

$$DMP = \underset{L}{\text{Max}} \ \text{Expected} \ [A \ (L) - C_{min} \ (L)]$$

hypothetical market value of majority shares in a closely held corporation is:

> Hypothetical Market Value of Majority Stock
> = Dividend Value (Cash Flow Discounted Value)
> + (min/maj)(Risk of Squeeze-Out)
> + Entrepreneurial Rewards
> − Dissatisfied Minority Discount

2. Controlling Premium

The sources of the hypothetical market value of minority and majority stocks are now clear. I have already defined the controlling premium as the difference between the hypothetical market value of the majority stock and that of the minority stock, or the additional amount which the reasonable buyer would pay to purchase the majority stock rather than the minority stock.[105] One can then find what the controlling premium is by simple mathematics expressed as follows:

> Controlling Premium in the Closely Held Corporation
> = Hypothetical Market Value of Majority Stock
> − Hypothetical Market Value of Minority Stock
> = $(1 + min/maj)$(Risk of Squeeze-Out)
> + Entrepreneurial Rewards
> − (Dissatisfied Minority Discount + Dissatisfied Minority Premium)

Now consider that in the cases of buyout or appraisal the dissatisfied minority shareholders will leave. In those cases, neither the dissatisfied minority discount nor the dissatisfied minority premium will be included in the controlling premium. Therefore, the controlling premium in the closely held corporation consists of the risk of squeeze-out and entrepreneurial rewards.

---

where $A(L)$ is the expected award to the minority from amount L of litigation, and $C_{min}(L)$ is the cost to the minority of instigating amount L of litigation. Similarly, the majority discount *(DMD)* is computed by taking L as given from above:

$$DMD = \text{Expected } [A\ (L) + C_{maj}\ (L)]$$

where $C_{maj}(L)$ is the cost to the majority of defending amount L of litigation.

   Note that these calculations are only rough bounds because the minority and majority will have room for bargaining between their premium and discount.

   105. Note, however, that the courts developed a different approach to the controlling premium. Our definition of controlling premium is the difference between the hypothetical market value of the majority stock and that of the minority stock. On the other hand, in both buyout and appraisal cases, the courts consider hypothetical market value of the corporation per share first, then consider minority discount. *See, e.g., In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1003 (Me. 1989); McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 243 (N.M. Ct. App. 1986). The controlling premium in our definition can be divided into two parts in case law: (1) controlling premium, which is the difference between hypothetical market value of the majority stock and that of the corporation per share; and (2) minority discount, which is the difference between hypothetical market value of the corporation per share and that of the minority stock, although these terms are not clearly defined in the case law.

Controlling Premium in the Closely Held Corporation
= (1 + *min/maj*)(Risk of Squeeze-Out)
+ Entrepreneurial Rewards

The controlling premium may be scrutinized further. There are six elements that explain the willingness of a reasonable buyer to pay more than merely the dividend value: (1) the salary that comes with a position as director or officer; (2) the potential synergistic effects; (3) the expectation of enhancing the company's value; (4) the effect of retained earnings; (5) the effect of hidden retained earnings;[106] and (6) the effect of hidden dividends.[107] These elements can be further broken down into three groups as follows:

a. Entrepreneurial Rewards
    ⊙ Reasonable Salary
    • Synergistic Effects
    ⊙ Expectation of Enhancing the Company's Value
b. Hidden Cash Flow
    • Retained Earnings
    ⊙ Hidden Retained Earnings
    ○ Hidden Dividends
c. Excessive Assets.[108]

a. *Retained Earnings*

Whether retained earnings may properly be included in the controlling premium deserves consideration. One might convincingly argue that no shareholder, majority or minority, benefits from retained earnings unless they are issued as dividends. According to this argument, retained earnings should not be included in the controlling premium.[109] The majority shareholder cannot (as a shareholder) access the retained earnings absent an issuance of dividends. In this context, the retained earnings are not realized but they do affect the stock value. In other words, we are trying to capture the cash flow of the corporation. It is the buyer, the new majority shareholder, who has the power to determine how much the corporation pays as dividends and how much it reserves as earnings.

Additionally, one must distinguish positive arguments from normative arguments. In a world without conflicts of interest between controlling shareholders and minority shareholders regarding dividend policy, the controlling shareholders would set a dividend policy that is optimal for all shareholders. In such a utopian world, the hypothetical market value of both the controlling and minority shares should equal the optimal div-

---

106. The hidden retained earnings result usually from excessive depreciation.

107. To provide some examples, dividends might be "hidden" in unreasonably high salaries, the sale of the company's products to majority shareholders below market value, or loans made to majority shareholders at unreasonably low interest rates.

108. Excessive assets only become significant in cases where the asset value is greater than the cash flow discounted value.

109. *See* Murdock, *supra* note 20, at 433 & n.61.

idend value, which is the cash flow discounted value. In fact, however, conflicts of interests are unavoidable. Lack of liquidity of stock in closely held corporations, combined with the division of shareholders into different groups, create conflicts of interests among shareholders and increase the risk of squeeze-outs.[110] This also creates a quasi-self-dealing situation in dividend or liquidation decisions by the board of a closely held corporation.[111] Thus, the business judgment argument does not work here.[112]

The dilemma about dividend policy springs from a fundamental conflict of interest in the close corporation. If the majority shareholder compels the corporation to pay dividends now, those disbursements must be shared with the minority shareholders. If, however, the corporation does not pay dividends until the minority is squeezed out, the majority can monopolize the gain from the retained earnings. Thus, the minority shareholder realizes less value from current retained earnings than the majority shareholder does. Therefore, it seems reasonable to conclude that a buyer of minority stock would not pay much for the retained earnings, whereas the buyer of majority stock would. For this reason, one must conclude that as a positive matter in calculating the hypothetical market value in the real world retained earnings should be included in the controlling premium.

b. *Excessive Asset Value*

So far the discussion has been premised on the idea that the cash flow discounted value is higher than the asset value, which is the same as the liquidation value,[113] but it is entirely possible that the asset value will be higher than the cash flow discounted value.[114] Economically, a corporation whose asset value is higher than its cash flow discounted value should be dissolved. In the real world, though, many corporations with higher asset values are preserved. Some reasons for continuing are: the majority shareholders may love their business (or its perks); the majority shareholders may not like to fire employees (including themselves); or the majority shareholders may be waiting for the minority shareholders

---

110. *See supra* text accompanying notes 94-97.

111. It is well recognized that majority shareholders have fiduciary duty to minority shareholders. *See* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 472 (Cal. App. 1969) (en banc); Donahue v. Rodd Electrotype Co., 307 N.E.2d 8 (Mass. App. Ct. 1974), *rev'd*, 328 N.E.2d 505, 515 (Mass. 1975); William L. Cary & Melvin A. Eisenberg, Cases And Materials on Corporations 431-44 (6th ed. 1988); Murdock, *supra* note 20, at 433.

112. On the business judgment argument of majority shareholders, see Sinclair Oil Corporation v. Levien, 280 A.2d 717, 720 (Del. 1971).

113. *See supra* note 29. The asset value side of the business is significant only when the liquidation value is higher than the cash flow discounted value, which is the same as its going concern value.

114. *See* Bell v. Kirby Lumber Corp., 413 A.2d 137, 147-48 (Del. 1980). *See also* Kenneth R. Hiller, Note, *Rolling Down the Curtain on "Roll-Ups": The Case for Federal Legislation to Protect Limited Partners*, 90 Mich. L. Rev. 155, 163-64 (1991) (evaluation techniques for share value in the context of real estate limited partnerships (RELPS)).

to sell their stock. In fact many corporations exist with asset values higher than the cash flow discounted values. This is so particularly among the appraisal and buyout cases.[115]

In the case of higher asset value, the hypothetical market value of the majority stock should be based not on the cash flow discounted value but on the asset value. The adjustment of the hypothetical market value is necessary because the reasonable buyer would pay up to the asset value and ignore the cash flow discounted value. One then needs to add the risk of squeeze-out and the entrepreneurial rewards, and subtract the dissatisfied minority discount, just as in the case of higher cash flow discounted value. This can be expressed as follows:

> Hypothetical Market Value of the Majority Stock
> = Asset Value
> + (min/maj)(Risk of Squeeze-Out)
> + Entrepreneurial Rewards
> − Dissatisfied Minority Discount

Costs associated with selling the assets and terminating the business must also be deducted to arrive at the asset value. Otherwise, one would overvalue the corporation and the majority stock. The mathematical expression is as follows:

> Asset Value
> = Liquidation Value
> − Costs (*e.g.*, retirement; compensation; capital gains tax;[116] etc.)

Particularly in cases where the asset value is higher than the cash flow discounted value, there is a temptation for courts to take a weighted average of asset value and cash flow discounted value. It is, however, easy to understand that the weighted average is not correct as the hypothetical market value of the corporation and its majority stock. Selling all the stock, in other words, selling a company as a whole, is simply a means of selling the corporate assets. This is particularly true in cases where the sale was made for tax reasons. In such a case, therefore, there is no reason to deflate higher asset values by lower cash flow discounted values.

The equation for the hypothetical market value of the minority stock remains the same as that in the higher cash flow discounted value case because the minority shareholder has no hope of sharing the excessive asset value with the majority. The minority shareholder can only expect dividends. This can be expressed as follows:

---

115. This is true in both Japan and the United States. *See* Shishido, *supra* note 66, at 366-67; Note, *Valuation of Dissenters' Stock Under Appraisal Statute*, 79 Harv. L. Rev. 1453, 1469 (1966).

116. This capital gain tax is not what the majority shareholder has to pay for selling her stock, but what the corporation has to pay for selling its assets.

Hypothetical Market Value of the Minority Stock
= Cash Flow Discounted Value
− Risk of Squeeze-Out
+ Dissatisfied Minority Discount

Note, also, that because the business and the non-operating assets might be sold separately, the value of those non-operating assets should be included in the cash flow discounted value, even where the cash flow discounted value is higher than the asset value.[117]

III. CONTRACTARIAN ANALYSIS AND STOCK VALUATION

In Part II, I obtained the hypothetical market value of the minority stock and that of the majority stock. I now consider what is the fair value of the minority stock. However, a consideration of contract principles is necessary before presenting the normative analysis of what the fair value should be. If there is a contract among shareholders on price determination of stock, that price will be enforced by the courts as the bargain the parties made. Even when there is no contract on stock valuation, contractarians would suggest that courts find and enforce the price which the parties would have wanted,[118] presuming it to be the hypothetical market value.[119] Though I made clear that the fair value is a different concept from the hypothetical market value,[120] it is possible to consider that the fair value should equal the hypothetical market value as a normative matter. The reasoning is that the present situation is exactly what the shareholders intended *ex ante*.[121] This Part of the Article explores the analytical tools that might allow courts to discern what the bargain among the shareholders was.

A. *The "Invisible Hand" Approach—Judicial Non-intervention*

Certain law and economics scholars may raise objections to the conclusion that the fair value is higher than the hypothetical market value. In other words, they object when courts make the majority shareholders (or the corporation) pay more than the hypothetical market value for minority shares. As a corollary to their general principle of reliance on market mechanisms, these scholars advocate allowing shareholders to determine their own rights by entering into contracts with the corporation. They insist that the minority shareholders of closely held corporations are no more exploited than minority holders in publicly held corporations since minority holders in close corporations could have bargained with the majority shareholders from the outset.[122]

---

117. *See* Schaefer, *supra* note 40, at 1031.
118. *See* Easterbrook & Fischel, *Close Corporations, supra* note 3, at 293, 298.
119. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 123-25; Easterbrook & Fischel, *Control, supra* note 3, at 726.
120. *See supra* text accompanying notes 19-26.
121. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 241.
122. *See* Easterbrook & Fischel, *Close Corporations, supra* note 3, at 273.

These scholars believe that a court should not intervene, even where there is no contract, because the present situation is exactly what the shareholders intended *ex ante*.[123] According to their approach, the fair value of the minority stock always equals the hypothetical market value of that stock, and disproportionate sharing of economic interests among shareholders is appropriate only as long as the distribution results from a bargain made by the shareholders.[124] Such a result would also be efficient if the disproportionate sharing will create an incentive to trade the majority stock.[125]

Contracts, however, are not almighty, particularly in the context of valuing stock of the closely held corporation. I present, at this juncture, counter-arguments to the "invisible hand," non-interventionist, contractarian approach.[126]

B. *Types of Contracts for Valuing Stock*

Close corporation investors employ wide varieties of contractual schemes for price setting, related either to restriction of stock transferability (first option) or to retirement (buy-sell agreement).[127] In using contractual schemes, the parties not only pursue the fair value, but also consider the feasibility of minimizing future controversies and minimizing the cost of valuation.[128] In practice, the following contractual valuing methods have been used: book value,[129] capitalization of earnings,[130] appraisal or arbitration,[131] fixed price,[132] and some combination of the above.[133]

By the bargain principle, the basic element of traditional contract law, the courts should enforce a bargain according to its terms, absent a traditional defense relating to the quality of consent.[134] The bargain principle, however, loses its authority as a vehicle of fairness and efficiency when the bargain is effected with a low quality of consent. Similarly, the

---

123. *See id.* at 272-73.

124. *See id.* at 293, 298.

125. *See* Easterbrook & Fischel, *Control, supra* note 3, at 709.

126. We will call the approach requiring judicial intervention to recognize a fair value higher than the *HMV* the "visible hand" approach.

127. *See* David K. Page, *Setting the Price in a Close Corporation Buy-Sell Agreement,* 57 Mich. L. Rev. 655 (1959).

128. *Id.* at 658, 659.

129. *Id.* at 664; Shannon P. Pratt, Valuing A Business: The Analysis and Appraisal of Closely-Held Companies 349 (1981).

130. *See* Page, supra note 127, at 669; Pratt, *supra* note 129, at 350.

131. *See* Page, *supra* note 127, at 672; Pratt, *supra* note 73, at 383.

132. *See* Page, *supra* note 127, at 674, Pratt, *supra* note 129, at 350.

133. *See* Page, *supra* note 127, at 678.

134. Traditional defenses relating to the quality of consent lie in two main categories: validity arguments and "obsolete afterwards" arguments. The validity argument includes situations such as duress, incapacity, misrepresentation, and mutual mistakes. *See* Melvin A. Eisenberg, *The Bargain Principle and its Limits,* 95 Harv. L. Rev. 741, 742 (1982). On the problem of "obsolete afterwards," see Easterbrook & Fischel, *Close Corporations, supra* note 3, at 282 & n.33.

principle of unconscionability may justify limiting the bargain principle.[135]

Easterbrook and Fischel appreciate the function of shareholder agreements as a monitoring device.[136] Further, they highly appreciate reputation mechanisms, *ex ante*, to keep the promises credible.[137] However, reputation mechanisms in closely held corporations do not work as well as in publicly held corporations. In many instances, the majority has few incentives to bolster its reputation: the majority will probably not be issuing stock in the future and so, *ex post*, will have little reason to worry about its reputation with outside investors.[138]

C. *Why Parties Make No Contracts or Incomplete Contracts*

Although contractual schemes are frequently used for protecting the interests of shareholders in closely held corporations, there are still many cases in which no contracts are formed.[139] If minority shareholders could have protected their interests by using contracts, why did they invest without this protection? Even when the parties do contract, there exists a wide range of contractual completeness between having no contract at all and having complete contracts with no room for judicial interpretation. Many types of incomplete contracts leave some issues open for future negotiations or judicial interpretation.[140]

In addition to problems of incompleteness, contracts also suffer from incompetence. Most importantly, typical contracting parties have a limited ability to structure long-term relationships—unless otherwise specified, corporations are perpetual entities. When the corporation is being formed, it is difficult to predict what will happen ten years into the future. Instead, the parties may favor flexible contracts, leading to controversy when the contracts must be executed or terminated.[141] Though most bargains are enforced according to their terms, long-term contracts purporting to use certain terms—for example, agreements to keep people in office, and voting trusts[142]—still suffer from uncertain enforcement.[143]

---

135. *See* U.C.C. § 2-302 (1987); Eisenberg, *supra* note 134, at 799.

136. *See* Easterbrook & Fischel, *Close Corporations, supra* note 3, at 291.

137. *See id.* at 272.

138. On the reputation argument, see generally Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 33 (Working Paper, January 1992). *See also* Benjamin Klein & Keith Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615, 641 (1981).

139. *See* O'Neal & Thompson, *supra* note 75, at § 1.18.

140. *See, e.g., In re* Pace Photographers, Ltd, 525 N.E.2d 713 (N.Y. 1988).

141. *See generally* Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 Nw. U. L. Rev. 854 (1978) (discussing contractual means of organizing the production and distribution of goods and services); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089 (1981).

142. *See* Easterbrook & Fischel, *Close Corporations, supra* note 3, at 282 & n.33 and accompanying text.

Furthermore, many of the disputes among shareholders occur more than ten years from the date of the contract.

Some shareholder agreements, if strictly enforced, would produce undesirable results. This is particularly true of contracts that restrict the discretionary power of management. For example, giving a minority shareholder a voice on dividend policy may conflict with corporate efficiency. Further, as some in the law and economics school have pointed out,[144] some contractual schemes that protect the minority, such as the unconditional right to buyout or dissolution, may lead to opportunistic behavior and encourage deadlocks. In short, shareholders may prefer no contract to incomplete and problematic contracts.[145] Rather than create such incomplete or incompetent contracts, the shareholders "consciously decide to delegate the dispute resolution function to a court."[146]

Another failing of the contractarian approach is that investors may simply fail to anticipate future problems that will require stock valuation.[147] Therefore, the parties fail to create contractual provisions that set a framework for stock valuation. This mistake may be borne of rosy optimism or mere short-sightedness. Such cases, however, seem to be rather few and unimportant, particularly in the United States. Easterbrook and Fischel credit attorneys with educating investors on the efficacy of such provisions.[148]

Another reason investors in closely held corporations fail to insert contractual provisions is that they lack incentives to bargain. The argument that a minority shareholder could have bargained with the majority does not reflect the reality of the situation. The problem is not that a minority shareholder has no bargaining leverage, but rather that she has no immediate incentive to bargain in the first place. The minority shareholder today may not have been in the minority from the very beginning. Reasonable people would be wary of assuming a minority holding. At first, there will be no rift between the current majority and minority. Therefore it is odd both to ask a minority shareholder why she failed to write a contract when she entered the situation where she has no bargaining

---

143. *See id.* at 282 & n.33. The following example indicates how time and normal corporate behavior can render relatively certain language obsolete.

Suppose a contract fixing the selling price or the method of calculation in cases of buyout or appraisal "at book value." The contract is between two brothers who created a company which owns and leases oil tankers. The brothers contracted that the surviving party would buy the equity of the dead party at the book value. In order to reduce corporate income taxes, they choose to accelerate the depreciation of the oil tankers. Therefore, the book value of the stock of the company is kept artificially low. Meanwhile, the demand for oil tankers grows and the company's asset value increases significantly. Suddenly, one brother dies. Should the surviving brother buy out the stock of the deceased at the "book value"?

144. *See id.* at 287.

145. *See id.* at 299.

146. *Id.* at 291.

147. *See id.* at 291.

148. *Id.* at 285.

power, and then to suggest that she could have bargained when she still had bargaining power, that is, before investing. She had no immediate reason to do so.

Easterbrook and Fischel do not recognize that investors in closely held corporations neither "consciously decide to delegate the dispute resolution function to a court" nor "simply fail to anticipate that dispute may arise."[149] Easterbrook and Fischel hypothesize only those situations where the minority invested as a minority.[150] If the courts, in cases where no contracts exist, reason that the bargain made by the shareholders was that the minority stock would be valued at the hypothetical market value, the courts will, in most cases, be imposing an unconscionable term because of the unfair surprise to minority shareholders.[151]

D. *Penalty Defaults*

One form of gap-filler is the penalty default approach. The penalty default approach would have the same effect as a hypothetical market value approach, which the minority shareholders would not want. If a court sets penalty defaults, or non-enforcement defaults,[152] it will create one-sided penalties.[153] "[O]ne side's penalty may be the other side's windfall. One-sided penalties can create incentives for opportunism."[154]

Generally, the "bargain situation" must have been mature to penalize the parties by saying "you could have bargained."[155] The bargain situation requires at least four conditions: (1) fairly equivalent bargaining power among the parties; (2) fairly equivalent access to critical information for bargain; (3) reasonable predictability of the event in dispute; and (4) incentive to bargain. Considering the history of relationships between shareholders in closely held corporations, the above four conditions are rarely satisfied at the same time and, therefore, the bargain situation is rarely mature.

E. *Corporate Law as a Standard Contract*

There are a number of reasons that shareholders may fail to make complete contracts, the most notable being the prohibitively high cost of complete contracts. There are other contributing reasons for incompleteness, which help explain why some parts of contracts—for example, stock valuation provisions—are more complete than others. In such in-

---

149. *See id.* at 291.
150. *See id.* at 272. A recent Delaware Supreme Court decision also failed to make this distinction. *See* Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993) ("a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive agreements").
151. *See* U.C.C. § 2-302 (1987); Eisenberg, *supra* note 134, at 752.
152. *See, e.g.*, Ayres & Gertner, *supra* note 43, at 97-98.
153. *See id.* at 97.
154. *Id.* at 98.
155. The bargaining situation referred to here, does not refer to the conditions required to enforce the bargain but, rather, the conditions required to apply a penalty default.

stances we may ask, what was the implied contract on stock valuation, in other words, what would the parties have wanted?

1.   Implied Contract

If the shareholders made no contract because either they failed to anticipate future squeeze-outs or they had no incentive to bargain, then they had no idea of what they would have wanted. If we try to find what the contracting parties wanted subconsciously, in the usual case, at least, we would find that they would never want the hypothetical market value of the minority stock. This is because a reasonable person would rarely invest in the minority stock without any discount or special arrangement. When the parties intended nothing and it is impossible to find what they would have wanted, it is reasonable to come back to the off-the-rack standard, in our case, corporate law. If the shareholders made no contract because they intentionally considered that no contract is better than an incomplete contract, they might have wanted to leave the future open, and expected to rely on corporate law as a standard contract in cases of dispute. In this case, then, they would have wanted corporate law rather than the market to govern disputes.

One might also compare a failure to contract to gambling. An investor might gamble to survive as a member of the majority and intend to buy future minority stock at its hypothetical market value. However, she would also have to bear the same risk as other investors of joining the minority and being forced to sell her stock at the minority hypothetical market value.[156]

If a court can reasonably interpret the implicit bargain as the gambling mentioned above, the court should enforce the bargain and give the loser, the minority shareholder today, only the hypothetical market value. Such a presumption seems inapposite for a number of reasons. First, it is hard to imagine that an investor would make such a gamble when every investor has almost the same risk of joining a minority. The risk would outweigh the potential gains. When the expected return from gambling and equal sharing are the same, most investors would choose not to gamble, but to take the safer way—equal sharing.[157] Second, parties who intentionally make no contract are governed by current legal rules, in-

---

156. *See* Page, *supra* note 127, at 657-58.

157. Consider the following case: investor A has a 50% probability of surviving in the majority ten years later when the present value of the *HMV* of the majority stock will be $100. A also has a 50% probability of falling into the minority and the present value of the *HMV* of the minority stock will be $20. The net present value of the gambling case where shareholders agree to trade at *HMV* is $60. On the other hand, under the equal sharing rule, A could sell her share at $60. The net present value of the equal sharing rule is $60.

	HMV	Probability	Present Value
A survives as a majority	$100	.50	$50
A falls to a minority	$ 20	.50	$10
Equal Sharing	$ 60	1.00	$60

cluding case law.[158] The current legal rule on judicial valuation of minority stock is not simply the invisible hand approach, but various approaches aimed at arriving at a roughly "fair" value.[159] It is difficult, therefore, to conclude that the parties bargained to be governed by the market without any contract. If the parties are in fact well educated on the law,[160] they should know that a contractual omission invokes corporate law rather than the market.[161]

In any event, when there is no contract, corporate law serves as an off-the-rack standard contract creating a basis for the fair value of the minority stock. Although Easterbrook and Fischel also recognize the appropriateness of applying corporate law as a standard contract when there is no explicit contract,[162] they are suspicious of applying fiduciary duty as a default rule. Easterbrook and Fischel are reluctant to favor a fairness argument.[163] If, however, the law is to apply the hypothetical market value approach in case of no contract,[164] Easterbrook and Fischel must advance a compelling reason for avoiding fairness as a default—fair (as opposed to equal) treatment of shareholders is an important part of corporate law.

A simple example illustrates this point. Consider the world with a sharing gap-filler, and, alternatively, a no-sharing gap-filler.[165] Suppose

---

If Investor A could predict these figures with certainty, she would take the rule whose net present value is highest. In the real world, however, it is hard to predict the future so A would be uncertain. If A is risk averse, as investors typically are, then given the choice between two alternatives with the same expected value, she would select the option with the least risk. In this case, that option would be equal sharing. *See* Richard H. Thaler, The Winner's Curse: Paradoxes and Anomalies of Economic Life 63 (1992); Daniel Kahneman, et al., *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5-1 J. Econ. Perspectives 193 (1991).

158. *See supra* text accompanying notes 19-26.

159. *See* Ronald v. 4-C's Electronic Packaging, Inc., 214 Cal. Rptr. 225, 229-32 (Cal. Ct. App. 1985); Brown v. Allied Corrugated Box Co., 154 Cal.Rptr. 170, 177-78 (Cal. Ct. App. 1979); Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1142 (Del. 1989); *In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1005 (Me. 1989). *But see* Perlman v. Permonite Mfg. Co., 568 F. Supp. 222 (N.D. Ind. 1984) (holding that fair market value is determined at a point before merger), *aff'd*, 734 F.2d 1283 (7th Cir. 1984); McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 241-42 (N.M. Ct. App. 1986).

160. *See supra* text accompanying note 148.

161. This Article does not discuss the arguments on which legal rule is mandatory and cannot be avoided by contract. *See generally* Lucian A. Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv. L. Rev. 1820 (1989); Coffee, *supra* note 42, at 1618; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum L. Rev. 1461 (1989).

162. *See* Easterbrook & Fischel, *Close Corporations, supra* note 3, at 299.

163. *See id.* at 291. *See also* Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 Wash. U. L.Q. 291, 295 (1992) (discussing Easterbrook's & Fischel's "argument against a broad implied duty of good faith").

164. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 123; Easterbrook & Fischel, *Close Corporations, supra* note 2, at 293; Easterbrook & Fischel, *Control, supra* note 3, at 726.

165. *See* Ayres & Gertner, *supra* note 43, at 113-14.

twenty percent of people are idiosyncratic and will never contract around any rule. X percent do not contract around the sharing gap-filler and Y percent do not contract around the no-sharing gap-filler. Thus, (100) - (X) - (20) percent will contract around the sharing gap-filler and (100) - (Y) - (20) percent will contract around the no-sharing gap-filler. First, by saying that "the parties could have contracted around," Easterbrook and Fischel do not provide a compelling reason to invoke a no-sharing rule—the same thing could be said under a sharing gap-filler analysis. Second, Easterbrook and Fischel would say that Y is much higher than X, so it will be more costly overall under a sharing gap-filler system. However, they provide no reason why Y is higher than X.

2.   The Extent of Judicial Intervention

Accepting corporate law as an implied contract is merely a start. The next step is asking under which circumstances should minority shareholders obtain judicial intervention to liquidate their investment, and how much should the majority give minority shareholders as the fair value. The first question can be reconceptualized as asking what situations may a court label as violations of the implied contract, and the second question as how should a court evaluate the damage caused by the violation of the implied contract.[166]

In some states, there are involuntary dissolution statutes for cases of deadlock and oppression.[167] Many of those statutes give the controlling shareholders an option to buy minority stock for avoiding dissolution. Therefore, minority shareholders in closely held corporations have a right of recouping investment when they are unfairly treated by the majority. One could consider, in the case where shareholders contracted neither an unconditional buyout right nor a buyout right for retirement, that the shareholders made an implied contract based on a state's corporate law as an off-the-rack standard. This contract would provide that every shareholder should be treated fairly. In other words they agree not to oppress. Thus, the shareholders have no buyout rights as long as they are fairly treated. Therefore, as with a remedy for breach of contract, the shareholders can only receive the fair value of their shares when they are unfairly treated—in other words oppressed.[168]

Finding a breach of the implied contract is by no means simple. A traditional approach is to interpret the oppression as a breach of the ma-

---

166. *See infra* text accompanying note 187.

167. *See supra* note 20.

168. Most American cases require "oppression" of the minority shareholders by the majority for the minority shareholders to be bought out. *See* Shishido, *supra* note 66, at 364; Murdock, *supra* note 20, at 452-61.

For cases defining oppressive activity by the majority, see Gidwitz v. Lanzit Corrugated Box Co., 170 N.E.2d 131 (Ill. 1960); Central Standard Life Ins. Co. v. Davis, 141 N.E.2d 45, 49 (Ill. 1957); Fix v. Fix Material Co., Inc., 538 S.W.2d 351, 358 (Mo. Ct. App. 1976); Gimpel v. Bolstein, 477 N.Y.S.2d 1014 (Sup. Ct. 1984); White v. Perkins, 189 S.E.2d 315, 319 (Va. 1972).

jority shareholders' fiduciary duty to the minority.[169] A more liberal approach does not even require oppression, but requires only frustration of "reasonable expectation" of a minority shareholder.[170] The latter approach is similar to the "what the parties would have wanted" approach, or "tailored default,"[171] and the former is similar to the "what the majority of contracting parties would want" approach, or "untailored default."[172]

If the implied contract is deemed violated, then the second issue arises—how to arrive at a fair value for the minority stock, in other words, how to evaluate the damage. This topic receives closer attention below. In summary, though, it should be apparent that the "could have bargained" theory does not solve the distinctive problems of the closely held corporation.

IV. NORMATIVE ANALYSIS OF FAIR VALUE

In this Part, as a matter of normative analysis, I argue what the fair value of the minority stock should be. These notions of a fair value flow from the analysis of shareholders' conflicting interests[173] and bargains.[174]

A. *Stock Valuation and Balancing the Conflicting Interests in Closely Held Corporations*

Normative analysis of fairness evolves from the premise that the sharing of economic interests should be determined by examining the proportional share held by each shareholder. In support of this position, it is well established that, although the majority shareholder can monopolize the election of board members and can run the corporate business freely (the principle of stock majority), he cannot monopolize the economic interests of the corporation.[175] In the close corporation setting, however, this principle is not self-enforcing.[176] Since there is no external stock monitoring device to protect the minority, the majority shareholder can often monopolize the economic interests of the corporation with a

---

169. *See* Robert C. Clark, Corporate Law 792 (1986); Shishido, *supra* note 66, at 364-65.

170. Topper v. Park Sheraton Pharmacy, Inc., 433 N.Y.S.2d 359 (N.Y. Sup. Ct. 1980); Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 Minn. L. Rev. 1, 75-87 (1982); Murdock, *supra* note 20, at 461-71.

171. Ayres & Gertner, *supra* note 43, at 91.

172. *Id.* at 96-97.

173. *See supra* part II.

174. *See supra* part III.

175. *See In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1004 (Me. 1989) (rejecting minority discount and lack of marketability discount by quoting a phrase in *Weinberger*: "his proportionate interest in a going concern" (Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983)); *see also* Shishido, *supra* note 66, at 361 & n.150.

176. Recall from Part III that majority shareholders do not have reputational concerns in closely held corporations. *See supra* text accompanying note 138.

squeeze-out.[177] Valuation is the primary judicial solution to rifts between majority and minority shareholders in closely held corporations; if the valuation is unfair, however, the majority will still be taking advantage of the minority.[178] The fair value determined by the court is an attempt at balancing the conflicting interests among shareholders.

Economic fairness among shareholders requires proportionate sharing of the economic interests which can be obtained by balancing the interests of shareholders. Proportionate sharing means simply a proportionate sharing of economic interests as a shareholder. It does not require that every shareholder share salary as an officer, a director, or an employee. Proportionate sharing is different from equal opportunity, which Easterbrook and Fischel regard as both inefficient and impossible to administer.[179]

Until now, the analysis has not differentiated between conceptions of fair value in the two major valuation settings under consideration— buyouts in cases of squeeze-outs and appraisals accompanying mergers. One has to answer the question whether one could have the same standard of fair value in both contexts. Although their origins and their legal purposes are not identical, one could have a single rule of valuation for

---

177. *See* Ronald v. 4-C's Electronic Packaging, Inc., 214 Cal. Rptr. 225, 230 (Cal. Ct. App. 1985); Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170, 176 (Cal. Ct. App. 1979); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989); *McLoon,* 565 A.2d at 1005; O'Neal & Thompson, *supra* note 70, at §§ 3.04, 3.06, 3.07.

178. There are few checks on squeeze-outs in close corporations other than judicial valuation. Though corporate law imposes fiduciary duties on directors, officers, and majority shareholders, it is not easy for aggrieved minority shareholders to enlist judicial intervention. *See generally* O'Neal & Thompson, *supra* note 70, at § 7.03 (describing the fiduciary obligations of officers, directors or controlling shareholders).

179. *See* Easterbrook & Fischel, *Close Corporations, supra* note 2, at 295. Although Easterbrook and Fischel observe that the court in Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976), repudiated the equal opportunity rule expounded in Donahue v. Rodd Electrotype Co., 307 N.E.2d 8 (Mass. App. Ct. 1974), *rev'd* 328 N.E.2d 505 (Mass. 1975), the two cases did not produce identical questions. *See* Easterbrook & Fischel, *Close Corporations, supra* note 2, at 296. In *Donahue,* the Supreme Judicial Court of Massachusetts ordered the defendant corporation either to purchase the plaintiff minority shareholder's stock at the same price per share as the corporation paid for the stock owned by a member of the majority or to rescind the purchase. In *Wilkes,* on the other hand, the same court allowed the defendant closely held corporation to fire an employee and shareholder only if there was a legitimate business purpose for doing so. *Donahue* requires the equal opportunity as a shareholder and *Wilkes* denies the right to share salary to shareholders because it is outside the "equal opportunity rule." A recent Delaware case, Nixon v. Blackwell, 626 A.2d 1366, 1375-79 (Del. 1993), however, goes further. Although the *Nixon* court used the entire fairness test, it denied the equal treatment requirement for non-employee shareholders on the liquidity afforded to employee shareholders through an Employee Stock Ownership Plan ("ESOP") as well as key man insurance policies. *See id.* The *Nixon* court also emphasized Easterbrook & Fischel's "equality is not equity." *Id.* at 1377. The *Nixon* decision may be interpreted more narrowly than the language of the court's holding indicates because the court also emphasized the original shareholder's agreement that distinguished between employee and outside shareholders. *See id..*

both buyout and appraisal cases because, in both situations, courts should balance the conflicting interests of the shareholders.

1. Buyout in the Case of Squeeze-Out

The threshold question of statutory buyout is: in which circumstances should courts allow involuntary dissolutions?[180] Valuation of stock is required when the majority chooses to buy out the minority stockholders to avoid dissolution.[181] As discussed previously, there exists a wide range of positions on this matter,[182] but most cases lie between the extremes by requiring some level of oppression or bad faith on the part of the majority.[183] Easterbrook and Fischel criticize the liberal approach invoked by Professors Hetherington and Dooley,[184] arguing that it allows minority shareholders to exploit the majority.[185] Although Easterbrook and Fischel correctly note that an automatic buyout right encourages opportunistic behavior by minority shareholders, this does not necessarily mean the best solution is to "let the parties solve their dispute by themselves."[186]

Investors in closely held corporations usually expect neither automatic buyout rights nor homemade dispute resolutions. They may, however, expect judicial intervention in certain circumstances where their "contract" is breached.[187] In such cases, courts should let the minority obtain "damages" from the majority. The extent of these damages is another way of looking at the fair value of the minority stock in buyout cases. The hypothetical market value cannot be equated with compensatory damages. Hypothetical market value just states the position of the minority shareholder after the majority's "breach of contract."

Buyout remedies are usually legislated as substitutes for involuntary

---

180. *See generally* Shishido, *supra* note 66, at 361-65; Murdock, *supra* note 20, at 426.

181. *See* Murdock, *supra* note 20, at 461.

182. *See supra* text accompanying notes 169-70. One extreme is to require either deadlock or misadministration. *See* Johnston v. Livingston Nursing Home, Inc., 211 So.2d 151 (Ala. 1968). The other is to admit non-conditional buyout. *See* John A. C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 Va.L. Rev. 1 (1977).

183. *See, e.g.,* Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 397-98 (Or. 1973) (taking a restrictive view on oppression); White v. Perkins, 189 S.E.2d 315 (Va. 1972) (taking a liberal view on oppression). A recent phenomenon has allowed involuntary dissolutions when the "reasonable expectations" of minority shareholders have been frustrated, without regard to any bad faith by the majority. *See supra* note 141. *See also In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984); Topper v. Park Sheraton Pharmacy, Inc., 433 N.Y.S.2d 359 (N.Y. Sup. Ct. 1980); *Hillman, supra* note 170, at 75-87.

184. *See* Hetherington & Dooley, *supra* note 182, at 1.

185. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3, at 241-42.

186. *Id.* at 241.

187. The meaning of the contract here is the same as "the bargain the parties themselves would have reached . . . . [F]iduciary duties should approximate the bargain the parties themselves would have reached had they been able to negotiate at low cost." Easterbrook & Fischel, *Close Corporations, supra* note 3, at 291. *See also* O'Kelley, *supra* note 57, at 216.

dissolutions.[188] Therefore, a possible interpretation of the fair value, as proposed by Professor Hillman, is that the liquidation value is enough because buyout is a substitute for liquidation.[189] But this proposed legislation does not necessarily mean that courts should equate liquidation value with the fair value.

In order to avoid involuntary dissolution, the majority is typically given the option of buying the minority stock as a whole.[190] If the majority had an automatic right to buyout the minority at liquidation value, the majority would choose buyout when the hypothetical market value of the corporation as a whole is greater than the asset-based liquidation value. But there is no reason for the majority to dominate and control the excessive value over the liquidation value.

If we take the liquidation value approach, it will lead to squeeze-outs, which the whole system is intended to eliminate. On the other hand, when dissolution is ordered, if the majority chooses not to buyout the minority, then the corporation will be liquidated by a trustee. Hillman suggests that the minority should receive only the liquidation value. If the trustee, however, succeeds in selling the corporation as a going concern at its cash flow discounted value,[191] when this price exceeds liquidation value, then the minority shareholders are as equally entitled as the majority to the difference.

2. Appraisal in the Case of Mergers

It is sometimes argued that the hypothetical market value is a sufficiently fair value in the appraisal context because appraisal statutes "require [that] shareholders receive the equivalent of what they give up[,] but do not require sharing of the gain from the change in control."[192] In closely held corporations, because of the greater controlling premium than exists in publicly held corporations,[193] the "what he had before" approach[194] would lead to using mergers as an alternate squeeze-out scheme. Although freeze-out of minority shareholders soon after a transfer in control may facilitate efficiencies,[195] the hypothetical market value approach, in closely held corporations, would give the majority not only a "disproportionate share of the gains from the acquisition,"[196] but also a

---

188. *See* O'Neal & Thompson, *supra* note 70, § 7.19.

189. *See* Hillman, *supra* note 170, at 82.

190. *See* Murdock, *supra* note 20, at 461.

191. *See supra* note 29; *see also* Cal. Corp. Code § 2000(a) (1990) ("the fair value shall be determined on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of sale of the entire business as a going concern in a liquidation.").

192. *See* Easterbrook & Fischel, *Control*, *supra* note 3, at 731.

193. *See supra* text accompanying notes 101-12.

194. *See* Easterbrook & Fischel, *Control*, *supra* note 3, at 731.

195. *See id.* at 723.

196. *Id.* at 723.

disproportionate share of the value of the corporation before the transaction.

Easterbrook and Fischel correctly explain that "[t]hese minimum payments, codified in most states by the appraisal statute, require that shareholders receive the equivalent of what they give up but do not require sharing of the gain from the change in control . . . . Gains need not be shared, and every investor receives at least what he had before."[197] Minority shareholders in closely held corporations are, however, worse off if their stocks are valued at the hypothetical market value in case of corporate control transactions. Not so simply put, the problem is defining "what they give up" and "what [they] had before."

In a publicly held company where the difference between the hypothetical market value of the majority and minority stock is created solely through the corporate control transaction, minority shareholders will not be worse off by obtaining the pre-transaction hypothetical market value of their stock. In a closely held corporation, on the other hand, the difference between the hypothetical market value of the majority stock and that of the minority stock existed *before* the corporate control transaction. The transaction, though, adds yet another premium to majority stock and forces minority shareholders to realize the discount.

Consider Figure 1. The horizontal scale is time and the vertical scale is the hypothetical market value of majority and minority stock. In publicly held corporations, the hypothetical market value of the majority stock and that of the minority stock are the same until the corporate control transaction occurs. The hypothetical market value of the majority stock will increase because of the gain from the change in control, which I call entrepreneurial rewards. Minority shareholders are not worse off.

In closely held corporations, however, even before the corporate control transaction, there may exist a difference between the hypothetical market value of the majority stock and that of the minority stock. At the beginning, when there is no diversification among shareholders, the hypothetical market value is the same for every stock. Once the diversification among shareholders starts, value differences will increase until the diversification is completed and the status of majority and minority is determined. The difference between the hypothetical market value of the majority stock and that of the minority stock before the corporate control transaction is either the hidden cash flow or the excessive assets. Upon execution of a control transaction, the majority stock will also gain the entrepreneurial rewards as in the case of publicly held corporations. Figure 1 shows that if the fair value is the same as the hypothetical market value of the minority stock, minority shareholders will be forced to realize the minority discount that already existed at the time of the corporate control transaction and will be worse off.

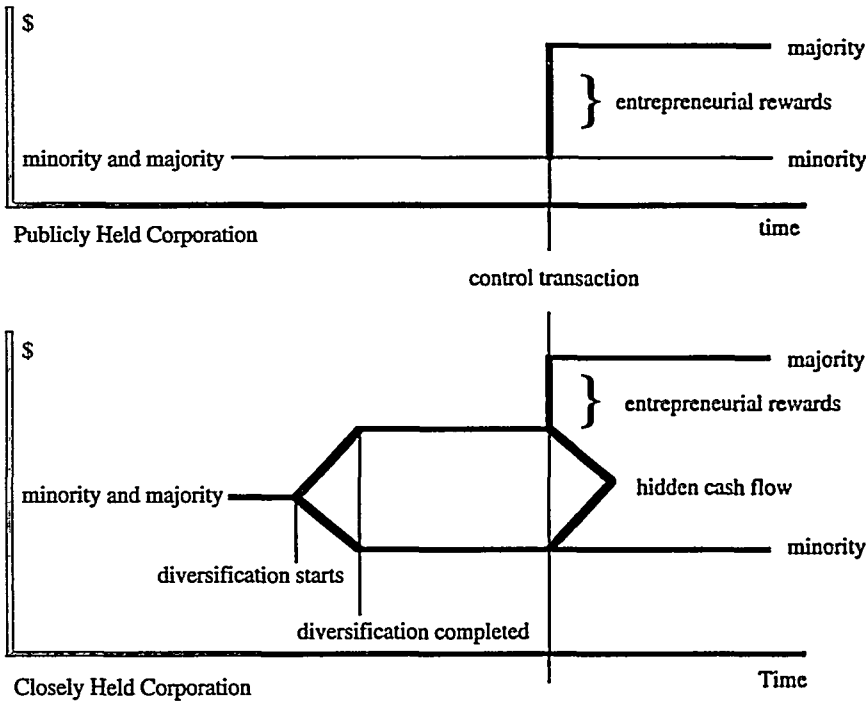197. Easterbrook & Fischel, *Economic Structure, supra* note 3, at 139.

Figure 1. Effect of control transaction on majority and minority share prices in publicly and closely held corporations.

Appraisal remedies in closely held corporations should be considered as an opportunity for the courts to balance the conflicting interests of the majority and the minority. Otherwise, an appraisal remedy could not fill its role as a check of unfair control transactions. Actually, appraisal remedies could work for the same purposes as buyout remedies because mergers and fundamental corporate changes are often used for squeezout purposes in closely held corporations. The court in *In re Valuation of Common Stock of McLoon Oil Co.*[198] noted, "[b]y the bargain struck in enacting an appraisal statute, the shareholder who disapproves of a proposed merger or other major corporate change gives up his right of veto in exchange for the right to be bought out—not at market value, but at 'fair value.' "[199]

B. *Fair Value and Apportioning the Controlling Premium*

I am now prepared to articulate a theory about the "fair" value of the minority stock in close corporations—in other words, which part of the

---

198. 565 A.2d 997 (Me. 1989).
199. *Id.* at 1004.

controlling premium should be shared—based on general principles of proportionate sharing and balancing of conflicting interests.

If corporate law requires proportionate sharing of economic interests as a shareholder's right, it would not be easy to apply the principle to specific cases of closely held corporations. It is not obvious which economic interests shareholders can claim as shareholders' rights in closely held corporations. This difficulty is well illustrated in the choices made by the Massachusetts Supreme Court. In *Donahue v. Rodd Electrotype Co.*,[200] the court found that a "right" existed to participate proportionately in stock buybacks,[201] but in *Wilkes v. Springside Nursing Home, Inc.*,[202] the court found that there was no "right" to a corporate salary.[203]

The difference between the economic interests of the minority and majority shareholders of closely held corporations parallels the difference between the hypothetical market value of majority and minority shares. If, normatively speaking, the economic interests per share of majority and minority stock must be the same, then the fair value of the minority stock would equal the hypothetical market value of the majority stock. This might be too extreme or too activist a stance for the judiciary. The central problem lies in determining which part of the controlling premium the majority holder may retain and which part he must surrender.[204]

It is useful at this juncture to reexamine the contents of the controlling premium in a closely held corporation.[205]

    a. Entrepreneurial Rewards:
- Reasonable Salary
- Synergistic Effects
- Expectation of Enhancing the Company's Value

    b. Hidden Cash Flow:
- Retained Earnings
- Hidden Retained Earnings
- Hidden Dividends

    c. Excessive Assets

These are the economic interests in which minority shareholders cannot participate without judicial intervention. The problem lies in determining which of these the minority shareholders may legitimately claim as a shareholders' right.

---

200. 307 N.E.2d 8 (Mass. App. Ct. 1974).

201. *But see* Nixon v. Blackwell, 626 A.2d 1366 (Del. 1993).

202. 353 N.E.2d 657 (Mass. 1976).

203. *See id.* at 851.

204. In spite of the different contexts, the analyses of the sale of control doctrine are relevant. *See* Easterbrook & Fischel, *Economic Structure, supra* note 3; Andrews, *supra* note 91, at 505; Easterbrook & Fischel, *Control, supra* note 3; Elhauge, *supra* note 101; Jennings, *supra* note 91, at 1.

205. *See supra* text accompanying notes 106-08.

1. When the Cash Flow Discounted Value Is Higher than the Asset Value

The first three elements that constitute the controlling premium—the reasonable salary of directors and officers, the synergistic effects, and the expectation of enhancing the company's value—need not be shared with minority shareholders. They are the reasonable entrepreneurial rewards of the majority's initiative—the minority can have no reasonable expectation of sharing them. Note also that, in the buyout setting, these three elements are highly subjective, varying from buyer to buyer.[206] Therefore, a court that has no expertise to calculate the "subjective controlling premium" derived from these three elements should not attempt to compensate for them.

Thus far, the apportionment is consistent with Easterbrook and Fischel's argument that a sharing requirement of the premium in corporate control transactions decreases the incentive to make value-increasing transactions, and as a result would reduce economic efficiency.[207] It is also true that the minority would not be worse off from a non-apportioning rule as far as a "subjective controlling premium" is concerned.[208]

On the other hand, the last three elements of the controlling premium—the retained earnings,[209] the hidden retained earnings,[210] and the hidden dividends[211]—should be shared with minority shareholders. They can be characterized as hidden cash flow and can be determined with more objectivity than the previous elements. A minority shareholder has an equal right to retained earnings because he owns the reinvestment of those earnings into the corporation.

In conclusion, the fair value of the minority stock can be defined by the following equation:

> Fair Value of Minority Shares
> = Dividend Value
> + Retained Earnings
> + Hidden Retained Earnings
> + Hidden Dividends

We need not account for the dissatisfied minority discount since, once the buyout or appraisal has been completed, the dissatisfied minority is already out of the corporation. This figure equals the cash flow dis-

---

206. The controlling premium represented by salary is also subjective because it must be discounted by the buyer's opportunity cost, which is not constant for all people.

207. *See* Easterbrook & Fischel, *Control, supra* note 3, at 709, 716, 721.

208. *See id.* at 715.

209. *See* text accompanying notes 107-112.

210. Examples of hidden retained earnings are exaggerated costs and excessive depreciation. The problem, however, is how much depreciation can be considered as a real cost.

211. Examples of hidden dividends are excessive compensation and the transferring of corporate assets by way of self-dealing. *See* Hendley v. Lee, 676 F. Supp. 1317, 1327-29 (D.S.C. 1987); Raskin v. Walter Karl, Inc., 514 N.Y.S.2d 120, 121 (N.Y. App. Div. 1987) (adjusted the corporate earning power by eliminating the excessive compensation from corporate expenses); Murdock, *supra* note 20, at 475-79.

counted value. We can thus conclude that, in cases where the cash flow discounted value is greater than the asset value, the fair value of the minority stock equals the cash flow discounted value.

2. When the Asset Value Is Higher than the Cash Flow Discounted Value

The arguments above are premised on the notion that the cash flow discounted value exceeds the asset value.[212] In most cases in Japan[213] and in no small number in America,[214] however, the asset value exceeds the cash flow discounted value. In these cases, the hypothetical market value of the majority stock equals the asset value. After all, where the asset value exceeds earnings value, nobody cares about the cash flow discounted value because a sale of the corporation's assets will be more profitable. The minority shareholder has as much right to the company's assets as the majority shareholder, and there exists no reason to discount the high asset value to the lower cash flow discounted value. Moreover, if the going-concern approach is used, then the majority shareholder would receive a windfall.

Thus, our final equation becomes:

Fair Value of Minority Shares
= Greater of Cash Flow Discounted Value or Asset Value
= Best-Use Value[215]

It will no doubt be argued that this concept of fair value errs by not assigning the cash flow discounted value to minority shares even when the asset value is higher. This argument is premised on the fact that the majority might choose not to liquidate the corporation but to run the corporation on the principle of stock majority.[216] Such an approach may appear consistent with the notion of proportional sharing of economic interests, which would in turn consider that the hypothetical market value of the corporation should be decided by the business judgment of the majority. However, as stated earlier, in this context the business judgment rule is inapplicable to closely held corporations because of the conflict of interests between the majority and the minority on whether to liquidate the corporation.

Also, taking the higher asset value in cases of buyouts or appraisals is different from giving a court authority to compel the majority's decision whether to liquidate or remain a going concern. Buyouts and appraisals are the triggers that reveal hidden value. It is the majority that initiates these triggering events.[217] As a matter of economic fairness, the majority

---

212. On the meaning of the asset value, see *supra* notes 29, 112 & 113.
213. *See* Shishido, *supra* note 66, at 367.
214. *See* Note, *supra* note 115, at 1469.
215. *See* Schaefer, *supra* note 40, at 1031, 1038-39.
216. *See* Note, *supra* note 115, at 1457.
217. "Indeed, a take-out merger is a form of liquidating the target's assets by a 'sale' to the surviving corporation or shareholders." Cohen, *supra* note 28, at 137.

shareholder should pay for the luxury not to maximize the corporate value but to run the less profitable business rather than liquidating it.

It would, however, be a windfall for the minority shareholders to receive the same valuation as the majority stock if they had bought their stock knowing it was minority stock and therefore priced at a discount. To prevent a windfall, the fair value of minority shares in this case must be less than the value of majority shares. This creates an added complexity, for different minority shares of the same closely held corporation may have different fair values depending on the history and circumstances of ownership of different shares.

C. *Case Law Approach to Fair Value*

The approach of this Article to fair value differs from the case law approach to fair value in its sequencing of events. The analysis started from the hypothetical market value of the minority stock, then considered which part of the controlling premium—the difference between hypothetical market value of the majority stock and that of the minority stock—should be shared with minority shareholders. This Article asks which part of the controlling premium should be added to the hypothetical market value of the minority stock to find the fair value. This analysis need not talk of minority discounts or illiquidity discounts.

Case law, on the other hand, starts with the hypothetical market value of the corporation per share, then considers whether and how much minority discount[218] and illiquidity discount[219] should be subtracted from it

---

218. For examples of cases accepting minority discounts in appraisal proceedings, see Hernando Bank v. Huff, 609 F. Supp. 1124 (D. Miss. 1985), *aff'd*, 796 F.2d 803 (5th Cir. 1986); Perlman v. Permonite Mfg., Co., 568 F. Supp. 222 (N.D. Ind. 1983), *aff'd*, 734 F.2d 1283 (7th Cir. 1984) (also accepting illiquidity discounts); Atlantic States Constr., Inc. v. Beavers, 314 S.E.2d 245 (Ga. Ct. App. 1984) (same); Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill. App. Ct. 1989) (same); Moore v. New Ammest, Inc., 630 P.2d 167 (Kan. Ct. App. 1981).

For an example of cases accepting minority discounts in buy-out proceedings, see McCauley v. Tom McCauley & Son, Inc. 724 P.2d 232 (N.M. Ct. App. 1986).

For cases rejecting the discounts in appraisal proceedings, see Cavalier Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989); *In re* Valuation of the Common Stock of McLoon Oil Co., 565 A.2d 997 (Me. 1989) (also rejecting illiquidity discounts).

For cases rejecting minority discounts in buy-out proceedings, see Brown v. Allied Corrugated Box Co., 154 Cal. Rptr. 170 (Cal. Ct. App. 1979); Ronald v. 4-C's Elec. Packaging, Inc., 214 Cal. Rptr. 225 (Cal. Ct. App. 1985); Eyler v. Eyler, 493 N.E.2d 1071 (Ind. 1986); Raskin v. Walter Karl, Inc., 514 N.Y.S.2d 120 (N.Y. App. Div. 1987) (but accepting illiquidity discounts); Blake v. Blake Agency Inc., 486 N.Y.S.2d 341 (N.Y. App. Div. 1985) (but accepting illiquidity discounts).

219. For cases accepting the illiquidity discounts in appraisal proceedings, see Perlman v. Permonite Mfg., Co., 568 F. Supp. 222 (N.D. Ind. 1983) (also accepting minority discounts), *aff'd*, 734 F.2d 1283 (7th Cir. 1984); Atlantic States Constr., Inc. v. Beavers, 314 S.E.2d 245 (Ga. Ct. App. 1981) (same); Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill. App. Ct. 1989) (same); Ford v. Courier-Journal Job printing Co. 639 S.W.2d 553 (Ky. Ct. App. 1982).

For cases accepting illiquidity discounts in buyout proceedings, see *In re* Gift Pax, Inc., 475 N.Y.S.2d 324 (N.Y. Sup. Ct. 1984), *aff'd*, 486 N.Y.S.2d 272 (N.Y. App. Div. 1985);

to find the fair value of the minority stock. The conclusion should, theoretically, be the same whichever approach we take,[220] but the difference in sequence may have a psychological influence.[221]

D. *Efficiency Argument—Ex Ante Approach*

Some law and economics scholars may note that *ex ante* efficiency is sacrificed by this approach. They would argue that distributing the controlling premium will reduce the availability of appraisal for minority shareholders. As a result, the market value criteria will maximize shareholder welfare in the long run.[222] The *ex ante* efficiency argument does not recognize, however, that the controlling premium in the publicly held corporation and that in the closely held corporation are different.[223] If we apply this market value criteria to closely held corporations, then unequal financial treatment of the majority and minority will become excessive.

My argument is different from the equal sharing argument.[224] I suggest that courts adjust the level of controlling premium in closely held corporations to that in publicly held corporations. Such a judicial intervention will never lead to a decrease of mergers.[225]

In perfectly efficient capital markets, as I already discussed, the market price of the minority stock theoretically reflects both the hidden cash flow and the entrepreneurial rewards.[226] Therefore, the controlling premium of a corporation in a perfect capital market will not include hidden

---

In re Joy Wholesale Sundries, Inc., 508 N.Y.S.2d 594 (N.Y. App. Div. 1986); Blake v. Blake Agency, Inc., 486 N.Y.S.2d 341 (N.Y. App. Div. 1985) (but rejecting minority discounts); Raskin v. Walter Karl, Inc., 514 N.Y.S.2d 120 (N.Y. App. Div. 1987) (but rejecting minority discounts).

For an example of a court rejecting illiquidity discounts in appraisal proceedings, see *In re* Valuation of Common Stock of Mcloon Oil Co., 565 A.2d 997 (Me. 1989) (also rejecting minority discounts).

220. Minority discount from the hypothetical market value of the corporation per share consists either of hidden cash flow (retained earnings, hidden retained earnings and hidden dividends) or excessive assets. Normatively, these items should be shared with the minority shareholders. *See supra* text accompanying notes 204-10. *See also* Robert B. Heglar, Note, *Rejecting The Minority Discount,* 1989 Duke L.J. 258 (1989).

The illiquidity and minority discounts are effectively the same, since illiquidity relates to risk of squeeze-out, which is already counted as the minority discount. *See supra* note 95. If both minority and illiquidity discounts are applied, as some courts have done, it amounts to double counting. *See* Perlman v. Permonite Mfg., Co., 568 F. Supp. 222 (N.D. Ind. 1983), *aff'd,* 734 F.2d 1283 (7th Cir. 1984); Atlantic States Constr., Inc. v. Beavers, 314 S.E.2d 245 (Ga. Ct. App. 1984); Independence Tube Corp. v. Levine, 535 N.E.2d 927 (Ill. App. Ct. 1989).

221. It may not be the same to start from a lower figure and add value as to start from a higher figure and then decrease value because of the status quo effect. On the status quo effect, see Thaler, *supra* note 157, at 63; Kahneman, *supra* note 157, at 193.

222. *See* Easterbrook & Fischel, *Control, supra* note 3, at 736; Daniel R. Fischel, *The Appraisal Remedy in Corporate Law,* 1983 Am. B. Found. Res. J. 875, 886.

223. *See supra* text accompanying notes 101-12.

224. *See supra* note 179.

225. *See supra* text accompanying notes 192-98.

226. *See supra* text accompanying notes 84-85 and *supra* note 92.

cash flow (objective controlling premium), nor entrepreneurial rewards (subjective controlling premium). In a publicly held corporation, the controlling premium includes only entrepreneurial rewards and the hidden cash flow is only negligible.[227] In a closely held corporation, on the other hand, the controlling premium includes both entrepreneurial rewards and hidden cash flow.[228] Allowing the majority shareholder to monopolize both controlling premiums gives him a windfall, not just reasonable entrepreneurial incentives.[229]

Even the people who take the *ex ante* efficiency approach recognize the constraint that "no investor [should] be made worse off by the transaction."[230] If we take their hypothetical market value approach, and do not apportion the controlling premium in the closely held corporation, the minority shareholders will be worse off.

Judicial intervention in closely held corporations should treat the retained earnings portion of the controlling premium differently from the entrepreneurial rewards portion of the controlling premium.[231] The majority does not deserve the retained earnings portion of the controlling premium because the minority had a legitimate right to those earnings. Allowing the majority shareholder to monopolize the controlling premium of the closely held corporation—in other words, taking the market value criteria—gives her not only the reasonable entrepreneurial rewards, but also a windfall,[232] and may encourage squeeze-outs.[233]

CONCLUSION

Easterbrook and Fischel declare that " 'fairness' plays little role in the fiduciary principle, and perhaps it should play none."[234] Their *ex ante* efficiency approach is, however, too simple, at least in closely held corporations. They do not recognize the difference between the controlling premium in the publicly held corporation and that in the closely held corporation. They also fail to discuss the feedback between judicial decisions and markets.

This Article has proposed a more thorough treatment of minority stock valuation. I have shown how important judicial stock valuation is in the close corporation context and how crucial the theoretical analysis of stock valuation is. I have analyzed the conflicts of interest in the closely held corporation by finding hypothetical market values of the majority stock and the minority stock. I found the contents of the control-

---

227. *See supra* notes 86-91 and accompanying text.

228. *See supra* text accompanying notes 106-10.

229. *See In re* Valuation of Common Stock of McLoon Oil Co., 565 A.2d 997, 1005; Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989).

230. *See* Easterbrook & Fischel, *Control, supra* note 3, at 715.

231. *See supra* text accompanying notes 205-10.

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

233. *See In re* Valuation of the Common Stock of McLoon Oil Co., 565 A.2d 997, 1005 (Me. 1989).

234. *See* Easterbrook & Fischel, *Control, supra* note 3, at 737.

ling premium are different in publicly held corporations and closely held corporations. Also, I have shown that the mutuality of the bargain varies depending on the situation and on the shareholders, and that therefore the contractarian approach is too simple.

Finally, out of this groundwork springs a coherent normative analysis of the fair value. When determining the fair value of minority shares, the entrepreneurial rewards (subjective controlling premium) should not be apportioned, but the hidden cash flow (objective controlling premium) should be apportioned. That means the fair value of the minority stock is the proportionate share of the best-use value of the corporation, which is the greater of the cash flow discounted value or the asset value. By using the best-use value method of stock valuation, the courts will grant the majority its rightful rewards while preventing the undervaluation of the minority's shares. My concluding formula adjusts the level of the controlling premium of closely held corporation to equal normatively that of the controlling premium of a publicly held corporation.