IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

IN RE PNB HOLDING CO.	)	Consolidated
SHAREHOLDERS LITIGATION	)	C.A. No. 28-N

MEMORANDUM OPINION

Date Submitted: July 25, 2006
Date Decided: August 18, 2006

Ronald A. Brown, Jr., Esquire, and Bruce E. Jameson, Esquire, PRICKETT, JONES & ELLIOTT, P.A., Wilmington, Delaware; Arthur T. Susman, Esquire, John R. Wylie, Esquire, Matthew T. Heffner, Esquire, and Matthew Hurst, Esquire, SUSMAN, WATKINS & WYLIE, LLP, Chicago, Illinois, *Attorneys for Plaintiffs.*

Thomas A. Beck, Esquire, RICHARDS, LAYTON & FINGER, P.A., Wilmington, Delaware; W. Scott Porterfield, Esquire, Annaliese F. Fleming, Esquire and Barack Ferrazzano Kirschbaum, Esquire, PERLMAN & NAGELBERG LLP, Chicago, Illinois, *Attorneys for Defendants.*

STRINE, Vice Chancellor.

This post-trial opinion addresses the claims of stockholders of a rural Illinois bank holding company, PNB Holding Company, who were cashed out in a merger that had the purpose and effect of allowing PNB to reclassify itself as a subchapter S corporation (the "Merger"). To have that effect, the Merger had to reduce the number of PNB stockholders remaining after the Merger to no more than seventy-five. The stockholders of PNB were offered $41.00 per share in the Merger. Several stockholders dissented from the Merger and perfected their appraisal rights. The remaining stockholders accepted the Merger consideration but through class counsel now complain that the directors of PNB breached their fiduciary duties and that the Merger was unfair. That is, this opinion resolves both an appraisal claim and an equitable challenge to the Merger.

A major issue decided in this opinion is whether the Merger is subject to entire fairness review. The plaintiffs claim that it is subject to heightened review because the PNB directors, and many members of their families, remained in the "golden circle" of PNB ownership after its conversion into an S corporation while the numerical majority of PNB stockholders were cashed-out. Because the directors and their family members who would remain collectively held 59.5% of the stock, the plaintiffs claim the Merger was destined to receive the required vote. As a result, the plaintiffs argue that this case should be analyzed as a controlling stockholder merger, governed by *Kahn v. Lynch Communications Systems, Inc*.[1] I reject that argument, however, because the largest bloc held by any PNB director was 10.6%, and the directors were not bound together by

[1] 638 A.2d 1110 (Del. 1994) (hereinafter, "*Lynch*").

voting agreements or other material, economic bonds to justify treating them as a unified group.

Although I do not believe *Lynch* governs review of the Merger, I do find that the Merger is presumptively subject to entire fairness review. By deciding to embark on the Merger, the PNB directors created a zero-sum game. Each of them (and their family members) stood to gain by paying as little as possible to the departing PNB stockholders. The Merger contemplated only sixty-eight of PNB's more than 300 stockholders remaining in the new S corporation. The reality, then, was that the PNB directors were assured of remaining in this golden circle and far more than half of the remaining PNB stockholders would be on the outside. In this conflicted situation, the PNB directors are bound to show that the Merger was fair to the departing stockholders or to point to the presence of a cleansing device, such as approval by a special committee of independent directors or an informed majority-of-the-minority vote, in order to justify review under the business judgment rule. The first device was not employed here, and a majority of the minority was not obtained. Therefore, the entire fairness standard applies.

The question then becomes whether certain members of the equitable class are precluded from recovery. I conclude that those stockholders who voted for the Merger are barred from recovery. The PNB directors, I find, despite the plaintiffs' arguments to the contrary, disclosed all material facts in connection with the Merger. Thus, these plaintiffs are barred by the doctrine of acquiescence from challenging the fairness of the Merger. By contrast, I conclude that those stockholders who did not vote for the Merger, but who simply forewent appraisal and accepted the Merger consideration, are not barred

from recovery. The consequence of that ruling is that those members of the plaintiff class will receive the difference between the fair value of PNB's shares on the Merger date and the consideration paid to them in the Merger. That is, the recovery of the stockholders who did not seek appraisal will track the recovery of the plaintiffs who perfected their appraisal rights. After performing an independent valuation, I conclude that the fair value of a share of PNB on the date of the Merger was $52.34, which is $11.34 per share higher than the consideration offered in the Merger. Therefore, the appraisal plaintiffs are entitled to $52.34 per share, while the remaining plaintiffs (all of whom accepted the Merger consideration) will receive $11.34 — the damages resulting from the unfair Merger. Those awards will be subject to pre-judgment interest at the legal rate, compounded quarterly.

I. Factual Background

These are the facts as I find them after trial.

A. The Parties

The respondent in the appraisal portion of this combined appraisal/equitable action is PNB Holding Company. PNB is a bank holding company that, at all relevant times, owned only one bank — Pontiac National Bank. For the sake of simplicity, I refer to PNB and the Bank interchangeably.

The defendants in the equitable action were PNB's directors at the time of the challenged Merger. Defendant H. Edward Vogelsinger was the only PNB board member in management, and served both as Chairman and Chief Executive Officer of PNB. The remaining defendant-directors are Alonzo W. Clay, John G. Dargan, Richard Y.

Dievendorf, Henry J. Eppel, Thomas W. Ewing, J. Alan Gschwendtner, John J. Kelly, and Stephen W. Snyder.[2]

The parties seeking recovery consist of two groups. The class of appraisal petitioners is comprised of eighteen stockholders, representing 5,846 shares of PNB, who voted against the PNB conversion and perfected their appraisal rights (the "Appraisal Class"). There is a dispute, resolved later, about whether 3,000 other shares are in the Appraisal Class. The Appraisal Class seeks an appraisal of the fair value of PNB as of the date of the Merger by which PNB converted into an S corporation. The second group seeking recovery consists of the plaintiffs in the equitable action. The plaintiffs' counsel seeks recovery on behalf of all former PNB stockholders who were cashed out in the Merger (the "Plaintiff Class"). That Class, which was certified on February 23, 2006, has "roughly 159 members" who represent 85,896 shares.[3]

The Plaintiff Class alleges that the Merger is subject to the entire fairness standard and that the defendant-directors caused PNB to cash out their shares at an inadequate price. As this court has become accustomed to in combined appraisal/equitable actions, the actual relief sought by the Appraisal Class and the Plaintiff Class is identical, consisting of the gap between what the complaining Classes believed was the fair value of their shares and the Merger price. Because of this identity in interests, I will refer to the two Classes collectively as the plaintiffs, for the sake of giving them a simple moniker.

---

[2] For reasons that are not apparent, one director, Ralph B. Mandell, was not named as a defendant in this action.
[3] Order Certifying Class at 1.

B. PNB And The Vogelsingers

PNB is headquartered in, and its original operations were located in, Livingston County, Illinois. The parties describe Livingston County as a place lifted from a Grant Wood painting. According to them, Livingston County consists of farming communities located in north central Illinois with a population of approximately 40,000 people, though the county has experienced "almost no population growth . . . in nearly 150 years."[4] In fact, the plaintiffs contend that they primarily consist of "farmers and their wives . . . who held shares . . . for a long time and had a sense of pride in ownership of a local business."[5] PNB was started as a small community bank in 1934 after its predecessor, National Bank of Pontiac, became a casualty of the Great Depression in 1933. It was formed by the grandfather of defendant Vogelsinger and other members of the Pontiac business community. After serving in World War II, Vogelsinger's father took over the reins of PNB from his grandfather in 1948. Vogelsinger's father retired from his role as president of the bank in 1982.

During his father's tenure, Ed Vogelsinger was not involved in the affairs of PNB. Instead, he pursued a career in accounting in Chicago and Milwaukee. A year after his father retired, however, Ed Vogelsinger joined the board of the Bank.

In 1994, Vogelsinger returned to live in Livingston County and took over as Chairman of the Bank. Upon his arrival in 1994, the Bank's operations were confined to the town of Pontiac. Although PNB was a well-capitalized institution, it was not an

---

[4] Def. Op. Post-Trial Br. at 2.
[5] Pl. Op. Post-Trial Br. at 1.

impressive performer. With Vogelsinger at the helm, PNB's board embarked on plans to change that by expanding PNB to markets adjacent to Pontiac and Livingston County.

Despite the lengthy involvement of the Vogelsinger family in PNB, Ed Vogelsinger's ascendancy to the Chairmanship did not result from the exercise of voting control. At no time did the Vogelsinger family have anything approaching voting control. Rather, the Vogelsinger family was just one of many area families that owned shares in PNB, and the larger stockholder families had representatives on the board.

C. The Expansion Of PNB

PNB opened its first non-Livingston County branch in 1995 in Bloomington, Illinois, which is located in McLean County. In contrast to Livingston County, McLean County had a rising population, more wealthy residents, a younger population base, and "one of the strongest economies in Illinois outside of Chicago."[6] The expansion into McLean enabled PNB to rapidly expand its lending in 1996 and 1997. Unfortunately, that expansion was tainted by imprudent practices.

In 1997, as a result of bad loans made at the Bloomington branch, the Office of the Comptroller of the Currency (the "OCC") declared PNB unsafe and unsound. In addition, around this same time, the OCC gave the trust department of the Bank an unsatisfactory rating.

As one of the steps taken in 1997 to address these regulatory issues, PNB hired Thomas Criswell, an experienced commercial banker and hospital CFO, to become the chief lending officer of the Bank. Vogelsinger also expanded his own role at PNB and

[6] *Id*. at 3.

the Bank, assuming the top managerial role of CEO at both as well as becoming President of PNB, the holding company. In addition, the Bank hired a new trust officer and increased its allowance for loan losses in order to adequately handle the bad loans made at the Bloomington branch. In 1998, as a result of the increased loan loss reserve, PNB reported negative earnings of $145,000 — only the second annual loss in its operating history.

PNB began to recover in 1999, reporting annual earnings of $1.2 million, which was lower than PNB's earnings of $1.686 million in 1996, the year before the regulatory issues began to affect earnings. The next two years saw continued earnings growth, with net income of $1.635 million in 2000 and $1.917 million in 2001. As a result of the improvement, PNB decided to continue its expansion into McLean County. In 2001, PNB purchased a bank in order to establish a branch in Gridley, which is a suburb of Bloomington. PNB also decided to lease office space in a building known as the Brickyard in order to establish a second branch in Bloomington (the "Brickyard Branch").[7]

In addition to leasing space for the Brickyard Branch, PNB convinced the real estate investors who owned the Brickyard building to become investors in PNB. Initially, those real estate investors intended to open their own bank, but PNB negotiated with the group to instead invest in PNB and to allow PNB to open its new branch in their building. Using projections compiled by the investors that detailed their forecasted cost of starting

[7] Around this time, PNB also purchased the right to use the name "People's Bank" for its McLean County branches because that had been the name of a former bank with a strong presence in that county.

a bank, PNB offered the investors the opportunity to purchase PNB shares at the price of $38.75 per share.

When the board of PNB was considering this expansion into Gridley and the opening of the Brickyard Branch, Criswell created a set of five-year projections for the Bank (the "Criswell Projections"). By this time, Criswell had become the Bank's Chief Financial Officer and had assumed the title of Bank President.

Criswell created the projections in December 2000 and presented them to the PNB board in February 2001. The Criswell Projections involved a forecast of the Bank's future earnings based on its existing business and the addition of the Gridley and Brickyard branches. The projections initially were created by Criswell, but, after PNB secured the new investors who had been planning on opening a bank in McLean County themselves, Criswell incorporated some of their initial projections into his own. The final projections that were presented to the board were comprehensive and presented a detailed five-year forecast for PNB's income, beginning in 2001. According to the Criswell Projections, the expected net income for PNB was $1.708 million in 2001, $2.011 million in 2002, $2.408 million in 2003, $2.753 million in 2004, and $3.132 million in 2005. In 2001, the first year of the Criswell Projections, PNB reported a net income of $1.917 million, which exceeded the Criswell Projections by approximately 12%. In 2001, then, PNB was expanding and managed to achieve income greater than forecast in the Criswell Projections.

D. PNB Decides To Convert Into An S Corporation

In July 2002, even with the success of the McLean County expansion, the PNB board began considering more fundamental strategic options than simple expansion. At a board meeting on July 11, 2002, Vogelsinger outlined a variety of strategic possibilities that PNB might pursue, including merging with another bank of similar size, acquiring smaller banks, converting to a so-called "S corporation," or continuing to operate PNB under its current business plan. The board decided to "continue to evaluate all strategic options in future meetings and have a final decision by the end of the third quarter of 2002."[8]

In order to help the board in its deliberations, Vogelsinger drafted a July 22, 2002 memorandum to the board that provided more detail with respect to the options mentioned at the July 11 meeting. That memo discussed two options: "the sell option" and "the grow to $500MM option."[9] The issues raised concerning the sell option involved the universe of potential buyers and how an appraiser would value PNB. The issues raised concerning the growth option involved whether PNB could achieve that level of assets through acquisitions or, potentially, a merger with another bank, and whether achieving an asset level of $500 million would allow PNB to continue to operate efficiently. As to either of the two basic options that involved a sale of the Bank or a stock-for-stock merger, Vogelsinger expressed concern about whether "CONTROL passed from the current Board to another group and will we have been paid for that

[8] JX 2 at 3.
[9] JX 16 at 2-3.

change of control."[10] That memo promises "more to come" about the possibility of an S corporation conversion.[11] The essence of an S corporation conversion is simple: by converting to the S corporation form, PNB would be relieved of the duty to pay corporate level taxes and its stockholders would be directly taxed, at individual rates, for income earned by the company.[12]

Additional information about conversion to an S corporation came in the form of a presentation by Vogelsinger to the PNB board at its next meeting on August 30, 2002. Vogelsinger listed the advantages of S corporation status, including the increased return that would result to continuing stockholders through the elimination of double taxation on distributions, and the disadvantages, including the requirement to reduce the number of PNB stockholders to seventy-five to attain eligibility as well as the inability to use PNB stock for future acquisitions.[13] Vogelsinger also briefly addressed the option of seeking out a merger of equals with another small, regional bank and informed the board that the Bank's returns likely would not be enhanced by that type of business combination. The board then had a "lengthy and meaningful discussion," and a motion carried to allow Vogelsinger to "take such steps as may be necessary to position the Company for conversion to a Subchapter S company, while at the same time continuing to look at possible stock mergers with banks located in Northern Illinois."[14]

---

[10] *Id*. at 4 (emphasis in original).
[11] *Id*. at 5.
[12] *See Delaware Open MRI Radiology Assoc., P.A. v. Kessler*, 898 A.2d 290, 328 (Del. Ch. 2006).
[13] JX 3 at 2.
[14] *Id*.

Given this authorization from the board, Vogelsinger sent a letter to PNB stockholders on September 23, 2002, informing them that a series of informal dinners would be held where he would present information on PNB and its "future direction."[15] At those dinners, Vogelsinger gave a PowerPoint presentation to the stockholders titled "Controlling Our Destiny" that discussed the S corporation structure and the benefits it would provide to PNB, including a higher return on equity and the ability for PNB to remain an "independent institution."[16] Vogelsinger also presented information to the stockholders concerning the implementation of an employee stock ownership plan ("ESOP"). Vogelsinger touted the ESOP as a benefit to the Bank's staff and a way to infuse PNB with cash as the ESOP purchased shares from PNB.[17] Finally, Vogelsinger informed the stockholders that a necessary consequence of converting PNB to an S corporation would be reducing the number of stockholders to a maximum of seventy-five.

On November 18, 2002, Vogelsinger sent out a letter to PNB stockholders who were unable to attend the informal dinners that essentially provided a recap of the presentation he gave at the dinners and stated that "the S Corporation model reduces taxes, makes your Bank more competitive and results in a more attractive investment to shareholders."[18] Shortly after sending this letter, the PNB board formed an "S Corporation Conversion Committee" on November 12, 2002 to "work with . . . attorneys

[15] JX 25.
[16] JX 26 at 1.
[17] *Id.*
[18] JX 27.

and advisers on the conversion to S Corporation Status."[19] PNB then retained Prairie Capital Services, Inc. to appraise PNB and determine the "fair value" of PNB common stock.[20]

The Prairie Capital valuation was dated as of December 31, 2002 and arrived at a value of $40.74 per share of PNB common stock.[21] The Prairie Capital conclusion, which is described in more detail later, was based on a weighting of three major valuation analyses: 1) a discounted cash flow valuation (20% weight); 2) a comparable companies valuation (40% weight); and 3) a comparable acquisitions valuation (40% weight). The Prairie Capital DCF used projections Prairie Capital developed after considering PNB's business plans and results, the Criswell Projections and a set of draft projections given to them by Vogelsinger, which Prairie Capital revised to come up with its own estimates.

The S Corporation Conversion Committee next met on February 6, 2003 to discuss the Prairie Capital report and to determine what recommendations it would make to the PNB board. Relying on the valuation work done by Prairie Capital, and the fact that the Merger would take place months after the date of the Prairie Capital report, the Committee recommended payment of $41.00 per share to stockholders cashed out in the conversion.[22] The Committee further stated that the proxy materials would be distributed to stockholders in early April and recommended that a shareholder meeting take place on April 30. The full PNB board met four days later, on February 10, 2003, and

[19] JX 31 at 1.
[20] JX 29.
[21] JX 38 at 13.
[22] JX 34 at 2.

representatives of Prairie Capital were present to discuss the valuation report. After discussion and a presentation by Prairie Capital, the board voted to accept the appraisal and concluded that $41.00 per share would be fair to the cashed-out stockholders.[23]

Before going on with the rest of the story, let me put to rest one argument made in a cursory fashion by the plaintiffs. That is the notion that the record reflects that the PNB board ruled out options like a sale of the Bank in order to entrench itself. The plaintiffs did not bother to present any director other than Vogelsinger as a witness. As will be discussed, Vogelsinger is the only director also involved in management. Almost all of the directors own sizable blocs of PNB stock. Nothing in the record indicates that they chose to turn their backs on attractive merger or acquisition options to preserve their board positions, which the plaintiffs do not even argue provide them with material fee income. In fact, the large stock ownership of the independent board majority suggests that they had a healthy incentive to pursue a sale or merger of the Bank if that promised to benefit stockholders. The mere fact that Vogelsinger's July 22, 2002 memorandum notes the reality that, in certain types of mergers, the existing board could lose control of the Bank's destiny, and raises the question of whether the stockholders would receive an appropriate premium for that transfer of control, does not, in itself, come close to convincing me that the board acted to entrench itself. The Merger price may be tainted, but the record does not support the inference that the board fixated on the S corporation conversion, and rejected other options, because those other options would risk the loss of their board seats.

[23] JX 33 at 2.

E. The Proxy Materials

After the board voted in February to approve the Merger at a price of $41.00 per share, PNB sent the proxy materials to stockholders on April 9, 2003. The proxy statement scheduled a special meeting of stockholders to occur on April 30, 2003 to "elect ten directors and to vote on an Agreement and Plan of Reorganization."[24] The proxy statement further stated that "the Board of Directors unanimously recommends that you vote for the directors and for the approval of the reorganization"[25] and also established the criteria for remaining a shareholder in the new S corporation, which was to own at least 2,000 shares and be one of the largest sixty-eight stockholders as of May 2, 2003.

The proxy statement further disclosed that all of PNB's "executive officers and directors hold of record 2,000 or more shares or are otherwise expected to qualify to receive shares of New PNB in the reorganization" and that the Merger would "increase their percentage ownership interest in New PNB."[26] The proxy statement stated that all directors and officers were expected to vote their shares in favor of the Merger, and that in the aggregate, the directors and officers of PNB owned 33.5% of PNB's outstanding shares.[27]

---

[24] JX 12 ("Proxy").
[25] *Id*.
[26] *Id*. at 3-4.
[27] *Id*. at 6.

The proxy statement further detailed what each of the directors and officers controlled, and the holdings of other shareholders owning more than 5% of PNB, as follows:

Beneficial Owner	Beneficial Shares Owned	% of Outstanding Shares Owned
Mary K. Dievendorf	35,406	5.6%
Anne M. Vogelsinger	44,120	7.0%
Alonzo M. Clay	44,400	7.1%
Thomas L. Criswell	100	0.1%
John G. Dargan	66,568	10.6%
Richard Y. Dievendorf	22,400	3.6%
Henry J. Eppel	7,940	1.3%
Thomas W. Ewing	10,026	1.6%
J. Alan Gschwendtner	14,305	2.3%
John J. Kelly[28]	1,900	0.3%
Ralph B. Mandell	4,170	0.7%
Stephen W. Snyder	10,422	1.7%
H. Edward Vogelsinger	28,950	4.6%

The proxy statement, as is evident from, though not explicitly stated in, the table, made it plain that several of PNB's other largest stockholders were relatives of the directors. For example, the proxy statement indicated that Mary K. Dievendorf (mother of director Richard Dievendorf) controlled 5.6% of the shares, and that Anne Vogelsinger (mother of director Ed Vogelsinger) controlled 7.0% of the shares. That table also includes the shares owned by the spouses of the directors and other stockholders.

Aside from information on the criteria to remain a shareholder and information about the directors, the proxy materials also included the Prairie Capital report. Notably, that report included the projections for years 2003-2007 that Prairie Capital utilized in its

[28] Kelly, although he owned fewer than 2,000 shares, was not cashed out in the Merger for unknown reasons.

discounted cash flow analysis. The proxy statement did not disclose the Criswell Projections, which had been prepared in 2000.

The proxy statement also contained other PNB financial information. The proxy statement provided the consolidated financial statements of PNB, including its income statements, balance sheets, and return on assets and equity data, for 1998-2002. The Prairie Capital report contained PNB's financial statements for the years 1996-2002. The proxy statement also provided the unaudited income and balance sheet data from the first quarter of 2003 and offered a comparison with the financial results from the same quarter of 2002. It listed the book value per share of PNB stock as $36.50 as of December 31, 2002 and the high market value for 2002 as $38.75 per share.[29] That is, the $41.00 per share offered to cashed-out stockholders represented approximately a 12% premium over PNB's book value and a 6% premium over market value. As to market value, it is worth observing here that PNB's stock did not trade on a stock exchange; rather, when its shares traded, they did so sporadically through transfers within the community or as a result of over-the-counter or broker-to-broker trades on the pink sheets.

F. The Shareholder Vote

As of March 1, 2003, PNB had approximately 360 stockholders of record and 629,452 shares outstanding.[30] As mentioned, the directors held 33.5%, or 211,181, of the outstanding shares. According to an affidavit filed by Vogelsinger later that month, on March 31, 2003, there were actually 630,097 shares authorized to vote on the

---

[29] *Id*. at 5.
[30] *Id*. at 19.

conversion.[31] Of the outstanding shares, 582,293 returned a proxy or attended the shareholder meeting on April 30, 2003, and the remaining 47,804 neither returned a proxy nor attended the shareholder meeting.[32] Of the 582,293 shares that were actually voted, 538,951 shares (92.6%) voted in favor of the Merger, 30,872 (5.3%) shares voted against the Merger, and 12,470 (2.1%) shares abstained.[33]

Those figures represent the aggregate vote of all PNB stockholders, including the directors and other stockholders who would remain in the S corporation. When looking at a vote of only those PNB stockholders who were not eligible to remain stockholders after the Merger, who held a total of 94,742 shares, 35,346 shares (37.3%) did not return a proxy, 46,224 shares (48.8%) voted in favor of the Merger, 5,846 (6.2%) dissented and sought appraisal, 4,066 shares (4.3%) voted against the Merger, and 3,260 shares (3.4%) abstained.[34] By a margin of 1,147 shares, then, PNB failed to get a majority of the outstanding shares to be cashed-out to vote in favor of the Merger. Following the vote, though, the owners of all the shares that failed to return a proxy, abstained, or voted against the Merger exchanged their shares for the $41.00 per share consideration except the 5,846 shares represented in the Appraisal Class and the 3,000 disputed shares.

II. The Equitable Claim

As noted, this is a consolidated equitable/appraisal action. At bottom, both the equitable claim and the appraisal claim rest on the notion that the $41.00 per share paid in

---

[31] Vogelsinger Aff. ¶ 3.
[32] *Id*.
[33] *Id*. at ¶ 4.
[34] This figure counts the 3,000 disputed shares of Ethel Carlson Hoerner in the category of shares that did not return a proxy, rather than as members of the Appraisal Class who dissented.

the Merger was unfair. Before the plaintiffs in the equitable action can proceed to a value determination, however, they have to do some convincing that the appraisal petitioners need not. In view of that reality, I therefore consider the key issues unique to the equitable claim first.

The thrust of the plaintiffs' argument in the equitable action is simple. They contend that the Merger is subject to stringent entire fairness review under two alternative theories. The first is that the PNB board should be considered as a monolith and that given the board's voting power and board control, the Merger should be analyzed as if it were a squeeze-out merger proposed by a controlling stockholder and subjected to the rule of *Lynch*.[35] Alternatively, the plaintiffs argue that the PNB board was comprised of large PNB stockholders, who would remain as stockholders after the Merger and, therefore, had a financial interest in ensuring that PNB paid as little as possible to the departing stockholders. Having devised and implemented an "us versus them" business strategy, the board, the plaintiffs argue, must prove that they were fair to the "them."

A. Is The PNB Merger Presumptively Subject To Entire Fairness Review?

One important threshold question is whether the Merger by which PNB converted into an S corporation should, as a presumptive matter, be reviewed under the deferential business judgment standard or whether it should be reviewed under the more exacting entire fairness standard.

The plaintiffs advance two theories why entire fairness review should apply. One of them can be disposed of easily. That is the theory that the PNB directors could be

[35] 638 A.2d 1110.

conceived of singularly, as comprising a "controlling stockholder" group. That the plaintiffs would like to characterize this situation as involving a squeeze-out merger of minority stockholders by a controlling stockholder is not surprising. Absent clarifying guidance from our Supreme Court, after *Lynch*, it is difficult for this court to subject such a merger to anything but entire fairness review, regardless of whether the proponents of the transaction employed all the procedural protections necessary to replicate an arms-length merger, by negotiating the transaction with a special committee of independent directors and conditioning the transaction on a non-waivable majority-of-the-minority vote.[36]

The problem for the plaintiffs here is that they did not prove that the PNB board may be conceived of as a single, monolithic controller. Remember that the Delaware case law in this area (that is, the *Lynch* line of jurisprudence) has been premised on the notion that when a controller wants the rest of the shares, the controller's power is so potent that independent directors and minority stockholders cannot freely exercise their judgment, fearing retribution from the controller.[37] For this reason (which is in great tension with other aspects of our law),[38] the jurisprudence has required that such transactions always be subject to fairness review.

---

[36] *See Lynch*, 638 A.2d 1110. The evolution of this body of jurisprudence is detailed in, among other decisions: *In re Pure Resources,* 808 A.2d 421 (Del. Ch. 2002); *In re Cysive S'holders Litig.*, 836 A.2d 531 (Del. Ch. 2003); *In re JCC Holding Co., Inc.*, 843 A.2d 713 (Del. Ch. 2003); *In re Cox Commc'ns S'holders. Litig.*, 879 A.2d 604 (Del. Ch. 2005).
[37] *See In re Pure Resources*, 808 A.2d at 443-45.
[38] *E.g.*, *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984); *see also* Leo E. Strine, Jr., *The Inescapably Empirical Foundation of the Common Law of Corporations*, 27 DEL. J. CORP. L. 499, 506-07 (2002) (describing this tension).

The present context is far removed from that which gave rise to the *Lynch* line of cases. Under our law, a controlling shareholder exists when a stockholder: 1) owns more than 50% of the voting power of a corporation; or 2) exercises control over the business and affairs of the corporation.[39] Here, neither test is satisfied.

For starters, even taken together, the directors and officers of PNB did not control a majority of the company's voting power. Thus, the first test is not met without considering other individuals in addition to the directors themselves.

Nor is the second test met. The second test exists to allow the law to impose fiduciary obligations on stockholders who, although lacking a clear majority, have such formidable voting and managerial power that they, as a practical matter, are no differently situated than if they had majority voting control. But the second test is not an easy one to satisfy and stockholders with very potent clout have been deemed, in thoughtful decisions, to fall short of the mark.[40] Nonetheless, it is clear that there is no absolute percentage of voting power that is required in order for there to be a finding that a controlling stockholder exists; in *Lynch* itself, the controller owned 43.3% of the shares.[41]

Here, though, the plaintiffs start from an overall level of ownership that is relatively low. Taken as a group, the directors and officers owned 33.5% of PNB's outstanding shares. At that level of ownership, a single stockholder would not be deemed

---

[39] *Lynch*, 638 A.2d at 1113-14.
[40] *E.g.*, *In re Western Nat'l Corp. S'holders Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000); *Citron v. Steego*, 1988 WL 94738 (Del. Ch. Sept. 9, 1988).
[41] *Lynch*, 638 A.2d at 1112.

a controller without additional facts supplementing his clout.[42] For example, in *Cysive*, a person holding 35%, and an option to purchase another 0.5% to 1.0%, of the stock was deemed to be a controller because he was also Chairman and Chief Executive Officer, and his brother and brother-in-law, who were both employed by the company, held another 0.5% of the stock.[43] In addition, after trial, he was deemed to wield influence over another director who owned 1% of the company's shares with an option to purchase 3-4% of the shares.[44] Given his managerial clout over his siblings and the fact that he brought them into the company, his overall managerial dominance, and the practical blocking power he had over other transactions, that person was deemed a controller in the context of a challenge to his merger proposal to acquire the rest of the company.[45]

Here, the facts are strikingly different. The CEO of PNB, Ed Vogelsinger, owned only 4.6% of the stock. Except for Vogelsinger, none of the PNB directors was a member of PNB management. The largest bloc, 10.6%, was held by another director, John Dargan. All told, some twenty people (directors, officers, spouses, children, and parents) comprise the supposed controlling stockholder group. The record, though, does not support the proposition that these various director-stockholders and their family members were involved in a blood pact to act together. To that point, there are no voting

[42] *E.g.*, *Kaplan v. Centex Corp.*, 284 A.2d 119, 122-23 (Del. Ch. 1971) ("Stock ownership alone, at least when it amounts to less than a majority, is not sufficient proof of domination or control."); *In re Western Nat. Corp. S'holders Litig.*, 2000 WL 710192, at *6 (Del. Ch. May 22, 2000) (same).
[43] *In re Cysive*, 836 A.2d 531, 535 (Del. Ch. 2003).
[44] *Id*. at 552.
[45] *Id*.

agreements between directors or family member. Rather, it appears that each had the right to, and every incentive to, act in his or her own self-interest as a stockholder.[46]

To find that this board was a unified controlling stockholder would be unprincipled and create a negative precedent. As a general matter, it is useful to have directors with, as Ross Perot was wont to say, skin in the game. Such directors have a personal interest in ensuring that the company is managed to maximize returns to the stockholders. Glomming share-owning directors together into one undifferentiated mass with a single hypothetical brain would result in an unprincipled Frankensteinian version of the already debatable 800-pound gorilla theory of the controlling stockholder that animates the *Lynch* line of reasoning. Precisely because each director of PNB had a personal self-interest in the firm's performance as a stockholder, but none had enough shares to control the corporation and employ herself, PNB's board was arguably comprised in an ideal manner.[47] There is no factual basis to ascribe to the individual

---

[46] Evidence in the record indicates that as some of the board began focusing on converting PNB to an S corporation, at least one director wanted to keep open the option of "stock for stock mergers with banks in the northern part of [Illinois]." JX 3 at 2. That director, Dargan, happened to own a larger bloc of PNB stock, 10.6%, than any other director or individual PNB stockholder. Proxy at 41. Vogelsinger, referring to Dargan, also recalled that "one director in particular . . . wanted to see the bank sold in a stock transaction." Tr. at 697. Dargan also favored an attempt by PNB to grow to an asset size of $500 million rather than convert to an S corporation. Tr. at 698.

[47] For a sampling of thoughtful views favoring the ownership of equity by non-management directors, *see* Charles M. Elson, *Enron and the Necessity of the Objective Proximate Monitor*, 89 CORNELL L. REV. 496, 499 (2004) ("It is important to note that while equity ownership provides the incentive to monitor, it alone does not provide the proper objectivity to foster effective oversight. Independence creates this objectivity, and that is why modern governance theory demands both equity ownership and independence. Independent directors without equity ownership may be objective, but they have little incentive to engage in active oversight. Equity ownership provides the incentive to exercise objective oversight. On the other hand, equity-holding directors who are not independent may have the proper incentive but lack the necessary

PNB stockholder-directors a lack of autonomy or a cult-like devotion to Vogelsinger. The best that the plaintiffs can do is to point to the fact that director Dievendorf, who owned 3.6% of the shares, is a cousin of Vogelsinger. That simple fact does not come close to demonstrating that they should be considered part of a unified bloc.

I also reject another related aspect of the plaintiffs' controlling stockholder argument. At an inexcusably late stage, the plaintiffs attempted to argue that any PNB stockholder with the same name and some of the same blood as a PNB director must be deemed one and the same with them. The plaintiffs did that without fair notice before trial and without putting this issue in play in discovery. There was no reason for the defendant-directors to believe they had to confront the notion that their cousins or nieces, etc. should be deemed under their command and control. Moreover, the idea that children and parents always see eye-to-eye is not a premise of our law. One can have a healthy family relationship and still feel free to vote one's stock differently than a parent. Absent some reason to believe that the vote would work a serious injury on the close

---

objectivity. Independence and equity ownership, acting in tandem, are the keys to effective corporate governance."); R. Franklin Balotti, *Equity Ownership and the Duty of Care: Convergence, Revolution, or Evolution?*, 55 BUS. LAW. 661, 692 (2000) ("The intuitive and experiential foundations for these principles now find additional support in empirical research that shows that substantial equity holdings in fact promote superior board monitoring and effective corporate decision making. To the extent corporations respond to an equity-based presumption of care by increasing the equity holdings of board members, the result should be improved corporate performance and the creation of greater wealth for the economy as a whole."); R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 MERCER L. REV. 829, 840-41 (2003) (" . . . the lack of incentive to question the judgment of the CEO is exacerbated by a lack of financial interest by board members in the corporations on whose boards they serve. There is a sense that in the long run, it is not their money at stake. Without an equity stake in the corporation to align their interests with those of the shareholders, directors have less personal incentive to ensure positive corporate performance.").

relative — for example, a vote that would ask a child to unseat her CEO father in favor of another director candidate, knowing that the loss of his seat would mean the loss of his job — the mere fact that relatives both own stock means little. Rather, what is critical is whether there is a reason to believe that the familial relationship, coupled with other important facts, is so thick that the stockholders should be treated as essentially a voting group.[48] In this case, the plaintiffs have simply advanced the notion that all the relatives of PNB stockholder-directors, none of whom owns anywhere near a controlling interest and only one of whom is a manager, would necessarily vote as those who share their surname suggest. Our law does not embrace that idea.

The plaintiffs' alternative argument has more potency, although it is by no means doubtless. That argument consists in the notion that the Merger presented a situation when the stockholder-directors' personal self-interest left them disabled from disinterestedly setting the transaction price. The economics of this argument are simple. Through the Merger, the sixty-eight remaining stockholders of PNB would gain the advantages of being stockholders in an S corporation.[49] Any upside in PNB's future would belong to them, exclusive of their departing brethren. To the extent that the price paid in the Merger was lower, rather than higher, the stockholder-directors stood to benefit as all but one of them was expected to remain in the golden circle of sixty-eight and share in the excess value retained by PNB. Even defendant-director Snyder, the

---

[48] *See, e.g.*, *Harbor Finance Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 2003) (discussing that a familial relationship coupled with a history of investing in, starting, and managing companies together was sufficient to show that a director was not able to impartially consider suing his brother-in-law) (hereinafter, "*Huizenga*").
[49] *See Delaware Open MRI*, 879 A.2d at 328.

exception, was not necessarily an exception because trusts for which he served as trustee were expected to remain. Interestingly, because the corporation was paying the consideration, the PNB board did not face a situation where they were at odds with the entity. Rather, the conflict they faced was between themselves, as major stockholders who would remain, and the more numerous PNB stockholders who would be cashed-out. This conflict does not depend on believing that the stockholder-directors were an undifferentiated mass, without independent perspectives on many things, but rather it arises from the obvious fact that they stood to benefit personally if the price PNB paid was lower rather than higher.

Although the question is not free from doubt, on this record I conclude that this conflict is sufficient to invoke the entire fairness standard of review. In *Aronson v. Lewis*,[50] in the context of demand futility, our Supreme Court stated that the business judgment rule would protect only "disinterested directors whose conduct otherwise meets the tests of business judgment,"[51] which occurs only when directors "neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[52] The Supreme Court later refined the language of *Aronson* and determined that director self-interest exists "whenever divided loyalties are present, or a director has received, or is entitled to receive, a personal financial benefit from the

---

[50] 473 A.2d 805 (Del. 1984).
[51] *Id*. at 812.
[52] *Id*.

challenged transaction which is not equally shared by the stockholders."[53] This analysis "flows from . . . the factual allegations pertaining to the influences upon the directors' performance of their duties generally, and more specifically in respect to the challenged transaction."[54] This court has employed the *Rales* analysis of whether a director received a personal financial benefit not shared equally by stockholders in making the determination whether a transaction is subject to entire fairness or business judgment review.[55] Therefore, when determining whether the PNB directors were financially interested in the Merger, I must determine whether they had divided loyalties or received a financial benefit not available to stockholders equally.

The type of financial benefit that the defendants received from the Merger is not a paradigmatic example of a benefit that is not equally shared by the stockholders. For example, in *Gentile v. Rossette*, the stockholders alleged that a director, who was also the company's controlling shareholder, conditioned approval of the merger on his receipt of a special benefit, namely a put agreement, that was not made available to the other stockholders at all.[56] Similarly, in *Orman*, shareholders cashed out in a merger alleged that two of the company's directors received benefits, one allegedly received fees from a consulting contract while the other director's company stood to receive $3.3 million in

---

[53] *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993) (internal emphasis omitted).
[54] *Id.*
[55] *See Orman*, 794 A.2d at 29; *see also Feldman v. Cutaia*, 2006 WL 920420, at *6 (Del. Ch. Apr. 5, 2006) (discussing interestedness in the context of a motion to dismiss under Rule 12(b)(6) and Rule 23.1); *Gentile v. Rossette*, 2005 WL 2810683, at *8 n.79 (Del. Ch. Oct. 20, 2005) (addressing director interestedness at the summary judgment stage), *rev'd on other grounds*, No. 573, 2005, slip op., __ A.2d __ (Del. 2006); *In re Freeport-McMoran Sulphur, Inc. S'holders Litig.*, 2005 WL 1653923, at *7 (Del. Ch. June 30, 2005) (same).
[56] *Gentile*, 2005 WL 2810683, at *5.

fees if the merger closed, that clearly were unavailable to the stockholders of the target company.[57]

What is different here is that the defendant-directors created, by definition, a transactional context that created subclasses of the PNB common stockholders.[58] One class would remain; the other would go. The class that would remain would profit, at the other's expense, if it underpaid those departing.

On the facts here, I conclude that the defendants' status as major stockholders who were eligible to remain rendered them conflicted. As fiduciaries for all the common, they were obliged to treat all stockholders fairly. That does not mean that they could not propose a transaction whereby certain common stockholders would be cashed-out against their will. Of course, they could. The question is how the board could discharge its obligation to the departing stockholders in a situation when the board's own self-interest conflicted with the interests of stockholders generally. In such a circumstance, the core insight of the entire fairness standard comes into play: to wit, even when acting in

---

[57] *Orman*, 794 A.2d at 29-31.

[58] The predicament that the PNB directors faced is analogous to, but more serious than, the situation that a board faces in a self-tender offer, where "the interest of the corporate offeror . . . is to pay the lowest price possible; the interest of the stockholders . . . is to receive as high a price as possible." *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1057 (Del. Ch. 1987). Here, the structure of the Merger also "gives rise to a potential conflict of the directors, which calls for procedural protections for the stockholders whose interests may not be adequately represented." *Id.* In *Eisenberg*, then-Vice Chancellor, now Justice, Jacobs went on to conclude that adequate disclosure was an adequate safeguard of the shareholders' interest because a self-tender is voluntary. Here, though, the Merger contemplated that shareholders would be cashed-out involuntarily. That is, shareholders would be cashed out regardless of their vote so long as a majority of shareholders, which included 33.5% ownership by the directors, approved the transaction.

subjective good faith, a person who stands on one side of a transaction may not act fairly towards the person on the other side.

That insight is relevant here. Unlike the defendants, I cannot conclude that the defendant-directors did not have a material interest in the Merger. Most of them had significant blocs of stock in PNB, ownership that seems to have preceded and inspired their willingness to serve as directors. The stock was not an after-the-fact indicia of ownership resulting from board service.[59] Given what the defendants have said about the community in which PNB operates, and given what one knows about the median income in this nation,[60] it would be difficult to call the annual dividends received by the directors trivial. Notably, one of the purposes of the transaction was to reduce the effective taxation of those dividends. Upon consummation of the Merger, the directors and officers of PNB stood to capture nearly 42% of those dividends for themselves, and would comprise ten of the sixty-eight eligible stockholders.[61] In concluding that the directors faced a conflict, I do not wish to be exaggerative. It was not as if they were selling their homes to the corporation in the Merger and setting the price. But nor was this an every day transaction; it was a major transaction for PNB and its directors were among the company's largest stockholders. On this record, I cannot conclude that the pricing of the transaction was immaterial to these directors.

[59] In other words, these directors were not given stock as an emolument for service on a public company board in a hoped-for attempt to make them think like owners. These directors, I infer, came to the board because they were owners.
[60] The median household income in Livingston County in 2002 was $44,712. JX 22 at 9. Nationally, the median household income was $51,742. *See* UNITED STATES CENSUS BUREAU, MEDIAN FAMILY INCOME (IN 2002 INFLATION-ADJUSTED DOLLARS) (2002), *available at* http://www.census.gov/acs/www/Products/Ranking/2002/R14T040.htm.
[61] Proxy at 3-4.

In this context, the family ties between the directors and non-director stockholders are relevant. Although I cannot conclude that the PNB board can be considered a single mind, comprised of all shares owned by individuals related in any way by blood, there is evidence in the record that directors communicated with certain family members and aided them in remaining within the PNB stockholder family.[62] Although the defendants say that any PNB stockholder could have sought out to buy up enough shares to make it to the golden circle, PNB shares did not trade regularly. To get them, one had to find someone in the community willing to sell.

In that respect, it appears that several of the directors actually transferred some shares to family members in order to help them gain eligibility. To put this in perspective, of the sixty-nine stockholders[63] remaining after the Merger, twenty-seven are related to the directors.[64] Many of those relatives held in excess of 2,000 shares well in advance of the Merger, but testimony from Vogelsinger himself indicated that several of the relatives, specifically the children of directors Gschwendtner, Dargan, and Clay, were able to survive the fate of being cashed out by receiving "shares as a gift from their parents."[65] In fact, the stockholders list as of March 28, 2003 indicates that Michael Spence, Dargan's stepson, increased his PNB ownership from 300 shares to 2,532 shares as a result of a transfer of shares from Dargan.[66] Similarly, the shareholder list indicates

---

[62] Tr. at 774-77.
[63] As discussed earlier, the proxy materials indicated that the largest sixty-eight shareholders would remain shareholders, but after the vote and Merger, sixty-nine shareholders remained.
[64] Def. Ltr. at 2 (June 30, 2006).
[65] Tr. at 775.
[66] JX 54.

that Virginia Clay Welch, Clay's daughter, owned only 1,500 shares as of March 28, 2003, but Vogelsinger testified that she remained a shareholder in PNB after the Merger.[67] In the quest to remain a PNB stockholder, the families of PNB directors were more equal than others. When the race ended, the results were that of the hundreds of PNB stockholders before the Merger who were not related to a member of the board, only thirty remained after the Merger. Put simply, a majority of the individuals who owned PNB stock before the Merger ended up on the outside looking in. That the directors of PNB took steps to include members of their family in the class of remaining stockholders is indicative of the importance they ascribed to continued ownership in PNB. Given that, I find it impossible to infer that the economics of the Merger were immaterial to them.

In view of all the facts, the PNB board majority was not positioned to make a judgment about the Merger consideration that is entitled, as a presumptive matter, to business judgment rule protection.[68] Rather, the conflict they faced requires that they

---

[67] *Id.*; Tr. at 777.

[68] I do not believe that this situation can be pigeon-holed into the case law addressing situations when a board must balance the interests of two existing classes of stock authorized in the corporation's charter. In those situations, the law has looked to whether the directors had a material interest in favoring one class over the other in determining how to review their decision, recognizing that the stockholders knew that the directors would face situations when they had to balance the interests of the different classes. *See, e.g.*, *In re General Motors (Hughes) S'holder Litig.*, 2005 WL 1089021 (Del. Ch. May 4, 2005); *Solomon v. Armstrong*, 747 A.2d 1098, 1117 (Del. Ch. 1999); *In re General Motors Class H S'holders Litig.*, 734 A.2d 611, 618-19 (Del. Ch. 1999).

Here, the directors themselves classified, by unilateral action, the common stockholders of PNB. One class, to which the directors belonged, would remain; the other would go. Having come up with a transactional structure with such a divisive effect and having their financial interests overwhelmingly aligned with one side of the divide, the directors fairly bear the burden to prove the fairness of the price they set, if they cannot prove that another procedural safeguard or indicia of fairness justifies invocation of the business judgment rule.

prove the fairness of the price paid, unless they can point to some other circumstance relieving them of that burden. Those circumstances traditionally include approval of the transaction by disinterested directors, preferably constituting a board majority or as a special committee.[69] But the PNB board all suffered the same conflict and made no attempt to add directors representing the stockholders to be cashed-out. At best, the board employed an investment bank to give them an opinion about the price to be paid. But that move, in itself, does nothing to invoke the business judgment rule.

Therefore, the only basis for the defendants to escape entire fairness review is by showing that an informed majority of the departing PNB stockholders approved the Merger. I turn to that issue next.

III. Did A Majority Of Disinterested Shareholders Approve, And Ratify, The Merger?

Having determined that the directors were interested in the Merger, subjecting the Merger to entire fairness review, I must now address the consequences for that entire fairness review, if any, of the shareholder vote on the Merger. As discussed, the Merger was conditioned upon stockholder approval "by a majority vote," not a vote of a

[69] *E.g.*, DAVID A. DREXLER, LEWIS S. BLACK, JR. & A. GILCHRIST SPARKS, III, DELAWARE CORP. LAW AND PRAC. § 15.05[5] at 15-33 (2005). In my view, the rule of *Lynch* would not preclude business judgment rule protection for a merger of this kind so long as the transaction was approved by a board majority consisting of directors who would be cashed-out or a special committee of such directors negotiated and approved the transaction. The special rule of *Lynch* for mergers with controlling stockholders should, if anything, be curtailed to promote the use of special committees and majority-of-the-minority votes in effecting going private mergers so as to most effectively protect minority stockholders, by giving the proponents of such transactions the certainty of business judgment rule protection if they use that deal structure. *See, e.g.*, *In re Pure Resources*, 808 A.2d 421; *In re Cox Commc'ns*, 879 A.2d 604. I do not assume that *Lynch* and its progeny impose a fairness standard of review on any transaction involving a conflicted director or even a conflicted board majority, thereby eliminating decades of law on the ratification effect of disinterested director and/or stockholder approval.

majority-of-the-minority. Under Delaware law, however, the mere fact that an interested transaction was not made expressly subject to a non-waivable majority-of-the-minority vote condition has not made the attainment of so-called "ratification effect" impossible.[70] Rather, outside the *Lynch* context,[71] proof that an informed, non-coerced majority of the disinterested stockholders approved an interested transaction has the effect of invoking business judgment rule protection for the transaction and, as a practical matter, insulating the transaction from revocation and its proponents from liability.[72]

Essentially, the most important preliminary issue raised by the plaintiffs in response to the defendants' ratification argument is mathematical. The plaintiffs question whether or not a majority of the disinterested shareholders in fact voted in favor of the

---

[70] Ratification is, as certain of our cases note, a bit of a misnomer. Our courts have historically employed the term shareholder ratification in "highly diverse sets of factual circumstances," which "suggests that 'shareholder ratification' has now acquired an expanded meaning intended to describe any approval of challenged board action by a fully informed vote of shareholders, irrespective of whether that shareholder vote is legally required for the transaction to attain legal existence." *In re Wheelabrator Tech., Inc. S'holders Litig.*, 663 A.2d 1194, 1202 n.4 (Del. Ch. 1995); *see also Huizenga*, 751 A.2d at 900 n.78 (describing the oddity in referring to ratification of a transaction that has no legal effect until the "ratifying" vote occurs). Therefore, the fact that the shareholder vote was required to give legal significance to the Merger does not affect whether or not the vote itself has ratification effect.

[71] In the context of a going private transaction with a controlling stockholder, there are reasons why the simple fact that a majority of the disinterested electorate votes yes on a merger might be deemed insufficient to be given ratification effect. As noted in other decisions, in that special context, an alteration of *Lynch* to give more effect to disinterested stockholder choice might more soundly rest on a requirement, at the very least, that the transaction be expressly conditioned, on a non-waivable basis, on approval by a majority of the minority, and that such approval be preceded by negotiation and approval of the transaction by disinterested directors. *In re Cox Commc'ns*, 879 A.2d at 606.

[72] *See, e.g.*, *Huizenga*, 751 A.2d 879 (recognizing this effect and describing the practical lack of meaning to the exception that the transaction may be attacked as waste in such circumstances because approval by a disinterested, informed majority of the minority undercuts the viability of any waste claim); *In re Wheelabrator*, 663 A.2d at 1203 (also recognizing that an informed, non-coerced vote of minority shareholders will insulate the directors and corporation from claims other than for waste).

Merger. That this issue even requires discussion now results largely from the plaintiffs' failure to raise the issue of numerical adequacy until trial. I therefore permitted the defendants to submit additional evidence after trial. With that evidence, and with helpful commentary from the parties on that evidence and the stipulated facts in the pre-trial order, I was able to make a responsible count. That count, as noted previously, indicates that only 48.8% of the 94,742 departing shares voted for the Merger.

Recognizing that result, the defendants advance an argument that I reject. The defendants argue that the only relevant question is whether a majority of the departing shareholders who returned a proxy cast a vote in favor of the Merger. Thus, in the defendants' view, departing stockholders who did not return a proxy do not count in the denominator. I disagree.[73]

The cleansing effect of ratification depends on the intuition that when most of the affected minority affirmatively approves the transaction, their self-interested decision to approve is sufficient proof of fairness to obviate a judicial examination of that question. I do not believe that the same confidence flows when the transaction simply garners more votes in favor than votes against, or abstentions from, the merger from the minority who actually vote. That position requires an untenable assumption that those who did not return a proxy were members of a "silent affirmative majority of the minority." That is

[73] In prior decisions, this court has been able to side-step this issue and therefore there is mostly dictum on the topic. *See, e.g.*, *Van de Walle v. Unimation, Inc.*, 1991 WL 36477, at *14 (Del. Ch. Mar. 6, 1991) ("One formulation of such a veto requirement . . . would call for the approval of a majority of all minority shares entitled to vote. Under that formulation the requisite approval was not obtained . . . . If, however, the requirement had called for the approval of a majority of the minority shares actually voted, that approval clearly was obtained.").

especially so in the merger context when a refusal to return a proxy (if informedly made) is more likely a passive dissent. Why? Because under 8 *Del. C.* § 251, a vote of a "majority of the outstanding stock of the corporation entitled to vote" is required for merger approval, and a failure to cast a ballot is a *de facto* no vote. Therefore, giving ratification effect only if a majority of the disinterested shares outstanding were cast in favor of the transaction also coheres with § 251.[74]

Because a majority of the minority did not vote for the Merger, the directors cannot look to our law's cleansing mechanism of ratification to avoid entire fairness review. The most they can expect to do is to bar those stockholders who voted in favor of the Merger from recovery based on the doctrine of acquiescence. To invoke that doctrine, though, the defendants must show that the yes voters were informed of the material facts. I turn to that issue now.

IV. Did The Directors Breach Their Duty Of Disclosure?

The plaintiffs allege that yes voters are not subject to an acquiescence defense because the directors failed to disclose all necessary information in the proxy materials and therefore breached their fiduciary duties to the shareholders. The standard for the required disclosure in Delaware is well-settled. The PNB directors had "the duty to

---

[74] I need not, and do not, hold that a qualifying ratification vote always needs to track the percentage approval required for the underlying transaction. One can posit a situation when a particular type of transaction requires, by charter, a 66.67% supermajority vote, and a conflicted stockholder holds 40% of the total vote, with the rest of the votes held by disinterested stockholders. To promote fair treatment, the board makes approval subject to a majority of the minority vote condition. Nothing in this opinion suggests that ratification effect would not be given if an informed majority of the minority of the remaining 60% of the electorate voted in favor of the transaction.

disclose in a non-misleading manner all material facts"[75] that bear on the decision of the PNB shareholders whether or not to approve the Merger. The plaintiffs allege two disclosure violations. First, the plaintiffs challenge the defendants' failure to disclose the Criswell Projections in the proxy statement. Second, the plaintiffs contend that the defendants' disclosures relating to the Prairie Capital valuation and fair value were misleading.[76]

A. Were The Defendants Required To Disclose The Criswell Projections?

The most contentious issue at trial, aside from the valuation, was over the proxy statement's omission of the Criswell Projections. I begin my analysis by a clarifying

---

[75] *In re Staples, Inc. S'holders Litig.*, 792 A.2d 934, 953 (Del. Ch. 2001); *see Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998).

[76] The plaintiffs also raise another issue that warrants no textual discussion. The plaintiffs claim that the defendants' failure to disclose only their interests, including interests as a trustee or executor, and those of their spouses, as opposed to the interests of their entire families, constituted a failure to disclose material information. That is not a sound argument. The defendants disclosed that, collectively, they owned 33.5% of PNB and would own 41.9% after the Merger. Proxy at 3-4. In addition, the proxy statement cautioned that the post-merger shareholders "may lack an effective vote with respect to the election of directors and the direction and operation of the Company." *Id*. at 7. Further, the proxy statement lists the shareholdings of all directors and their spouses along with other holders of more than 5% of PNB's shares. *Id*. at 41. Those individuals owning more than 5% include Mary K. Dievendorf and Anne M. Vogelsinger. Although the actual relationship of those individuals to the directors is not stated in the proxy statement, the plaintiffs themselves have painted such a close, communal portrait of PNB's town and shareholders, that it is entirely rational to infer that a reasonable PNB stockholder would have concluded that there was a familial relationship between Anne Vogelsinger and Ed Vogelsinger, a director, and between Mary Dievendorf and Richard Dievendorf, a director. The table, when the shares are aggregated, reveals that 46% of the shares of PNB were owned by the directors and the other individuals, who happen to be the mothers of the directors. The plaintiffs belatedly tried to raise the notion that others in the directors' families — children, parents, and siblings — held shares and that disclosure of their holdings should have been made. But the plaintiffs have not shown that these other family members should be considered mere appendages of their relatives or that the disclosure of their holdings would have altered materially the mix of information. The proxy statement clearly indicated that the PNB directors as a group held a very large percentage of the voting power — 33.5%. Lastly, this issue (like several others, *see infra* n.96) was not fairly raised before trial and the plaintiffs therefore waived their right to rely upon it.

concession to the plaintiffs. Had the Merger been proposed in 2001, months after Criswell prepared the projections, the failure to disclose those projections would have created a material deficiency. That is because omitted facts are material if "there is a substantial likelihood that a reasonable stockholder would consider them important in deciding how to vote."[77] That is, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."[78] In the context of a cash-out merger, reliable management projections of the company's future prospects are of obvious materiality to the electorate. After all, the key issue for the stockholders is whether accepting the merger price is a good deal in comparison with remaining a shareholder and receiving the future expected returns of the company.[79]

The projections at issue fall into the category of documents that courts have referred to as "soft information," and the standard by which to determine whether or not soft information, such as pro formas and projections, must be disclosed has troubled courts and commentators.[80] Projections of future performance are the kind of soft information that necessarily bespeaks caution, but they are also useful, particularly in the context of a cash-out merger.[81] Even in the cash-out merger context, though, it is not our law that every extant estimate of a company's future results, however stale or however

---

[77] *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170, 1172 (Del. 2000) (internal citations omitted).
[78] *Id.* (internal citations omitted).
[79] The information also bears on the question of whether to seek appraisal.
[80] *Weinberger v. Rio Grande Indus., Inc.*, 519 A.2d 116, 127 (Del. Ch. 1986).
[81] *E.g.*, *Zirn v. VLI Corp.*, 681 A.2d 1050, 1059 n.4 (Del. 1996) (discussing that "the Court of Chancery has recognized greater disclosure, including disclosure of 'soft' information, may be required in cases involving corporate self-tenders and cash-out mergers" because "disclosure to shareholders is normally one-sided").

prepared, is material. Rather, because of their essentially predictive nature, our law has refused to deem projections material unless the circumstances of their preparation support the conclusion that they are reliable enough to aid the stockholders in making an informed judgment.[82]

The word reliable is critical here. Here, I conclude that the Criswell Projections were stale by 2003 and no longer provided reliable information bearing on the future prospects of PNB. The evidence supporting that conclusion is abundant and clear from comparing the actual results of 2001 and 2002 to the Criswell Projections for that period.

Despite their vintage, the plaintiffs assert that the Criswell Projections were being used by management in the operation of PNB and were still relevant in early 2003, over two years after they were created. The plaintiffs point to PNB's 2003 Business Plan, which states that in 2003 PNB "will begin its third year of the five-year financial projection previously provided by the management team."[83] In addition, the Business Plan indicates that PNB "exceeded its profit projections and also met its goals with respect to asset size. 2003 assumes the bank will continue to grow and income to be at $2.4 million."[84] The Business Plan then includes the entire five-year Criswell Projections with the projection for 2003 highlighted, even though the Plan also attached a different, more current, budget estimate for 2003, which was prepared by Criswell. The plaintiffs

[82] *E.g.*, *McMillan v. Intercargo Corp.*, 1999 WL 288128, at *6-7 (Del. Ch. May 3, 1999) (stating that "projections must be material in the context of the specific case" and that projections must be "sufficiently reliable evidence of value"); *Van de Walle v. Unimation, Inc.*, 1991 WL 36477, at *16 (Del. Ch. Mar. 6, 1991) ("To be the subject of a disclosure obligation, information relating to the value must be considered reliable.").
[83] JX 11 at 2.
[84] *Id*.

also rely heavily on the fact that PNB hit the targets in the Criswell Projections in 2001 and 2002 and that the Criswell Projections were the only management projections available for 2004 and 2005. The defendants, and also Criswell himself, take the position that the Criswell Projections were a "reference point or a look-back" and that the detailed annual budgets created each year were the basis for evaluating and gauging PNB's performance.[85]

Understandably, given their arguments, the plaintiffs declare that *Lynch v. Vickers Energy Corp.*[86] seals the deal that the Criswell Projections were material. In *Vickers*, management presented an estimate of the value of certain assets in a tender offer circular, but it failed to disclose a more optimistic estimate of value also calculated by a member of management.[87] The Supreme Court declared that when management "was in possession of two estimates from responsible sources using a 'floor' approach defining value in terms of its lowest worth, and the other a more 'optimistic' or ceiling approach defining value in terms of its highest worth it is our opinion that complete candor required disclosure of both estimates."[88] In its *Vickers* decision, the court also indicated that the more optimistic valuation was created contemporaneously with management's pessimistic valuation and that both pertained to the same asset and the same economic conditions. Both were estimates from reliable sources.

---

[85] Tr. at 580-82.
[86] 383 A.2d 278 (Del. 1977).
[87] *Id*. at 280.
[88] *Id*. at 281.

The problem for the plaintiffs is that this case can be decided against them without any conflict with the holding in *Vickers*. By contrast with the situation in *Vickers*, the non-disclosed Criswell Projections were not updated, were not prepared contemporaneously, and management did not disclose its own pessimistic projections to further its cause.[89] Here, the proxy statement contained only a valuation of PNB performed by an independent appraiser, Prairie Capital, which was done more than two years after the Criswell Projections. Prairie Capital's projections were disclosed and prepared considering input from PNB management, PNB documents, and market information.

The plaintiffs also fail to grapple with the reality that *Vickers* represents the minority of cases where this court has found that the disclosure of projections was required. More frequently, this court has found projections too unreliable to warrant disclosure.

The plaintiffs also contend that, because there are no other management projections for 2004-2005, the Criswell Projections should have been disclosed. The plaintiffs, though, miss the point here. Those projections for 2004 and 2005 were based on the state of PNB as it existed at the end of 2000. The first projections were for years 2001 and 2002, and as was made clear at trial, the Criswell Projections may have

[89] The lack of pessimistic projections in the proxy statement is relevant. Vogelsinger provided projections to Prairie Capital in January 2003 that were less optimistic than the independent projections used by Prairie Capital in performing its DCF. JX 17. The directors, then, had a set of internal projections created by Vogelsinger, not Criswell, which painted a gloomier picture of PNB's future prospects. Those were not disclosed, and the independent projections done by Prairie Capital were not done in lock-step with those pessimistic projections. Indeed, Prairie Capital had access to both Vogelsinger's new rainy-day and Criswell's stale sunny-day projections.

somewhat tracked the performance of PNB accurately, but it did so in a manner that did not accurately or reliably track the "revenue mix" of PNB. A brief examination of PNB's actual performance in 2001 and 2002, which was disclosed accurately and completely in the proxy statement, shows that the Criswell Projections were not accurate enough for those years as to be considered reliable for future years.

In 2001, year one of the Criswell Projections, PNB ended the year with $219.5 million in assets, whereas the Criswell Projections forecast assets of $198.3 million, or 10% less than the actual performance. In 2002, PNB ended the year with $222.5 million in assets, and Criswell's projection was closer to the actual, $219.6, than in 2001. But, in 2002, Criswell also projected interest income for PNB of $16.3 million, whereas PNB actually achieved only $13.1 million in interest income, or 20% more than the actual result. Similarly, in 2001 — the first year of the projections and clearly the year for which Criswell had the most reliable hard information upon which to base his projections — the Criswell Projection missed the interest income mark by 8%. Conversely, Criswell greatly undershot non-interest income by 35% in 2002 and 30% in 2001. Therefore, even though Criswell only undershot PNB's net income by 5% in 2002 and 10% in 2001, he did so by drastically overestimating interest income and drastically underestimating non-interest income.

Credible evidence at trial proved one of the primary reasons that the Criswell Projections failed to reliably predict PNB's source of income.[90] In 2001 and 2002, due to

[90] The plaintiffs declare that this line of testimony was unfair surprise and lacked credibility because Criswell and PNB's other witnesses never mentioned mortgage fee income in deposition

favorable interest rates, PNB experienced a huge increase in mortgage fee income. In fact, Criswell projected mortgage fee income to be $60,000 in 2001 and $60,825 in 2002. In reality, PNB received $298,000 in mortgage fee income in 2001 and $741,279 in 2002. That is, in 2001 and 2002, mortgage fee income contributed $1,039,279 to PNB's income, and the Criswell Projections had mortgage fee income of $120,825, or 88% lower than PNB's actual mortgage fee income. PNB itself did not expect to continue to reap the larger-than-expected income from mortgage fees as long as it did.[91] Therefore, the Criswell Projections completely missed an increase in a significant portion of PNB's income.

Also, as stated earlier, the Criswell Projections were never updated. This is particularly important because Criswell himself prepared the annual budget and forecast for PNB. For example, in 2003, Criswell created a detailed budget for PNB's performance that projected PNB's income to be $2.28 million as opposed to the $2.408

---

testimony when asked why the Criswell Projections were not reliable or disclosed. But a cursory review of the Criswell Projections juxtaposed with PNB's actual performance reveals the stark difference between the interest income and non-interest income numbers. In addition, the proxy statement itself states that "Noninterest income has shown material gains over the five year period . . . with most of the increases coming in 2001 and 2002. Nearly all of these gains related to mortgage banking activity originating in the Bloomington-Normal market." Proxy, App. B at 6; *see also* Proxy at 44 ("The primary reason for the growth [in other income] was the significant amount of mortgage refinance business resulting from the reduced interest rates experienced during 2002 as compared to 2001, which led to the origination and sale of fixed rate mortgage loans and thus generated operating gains on the sale."). That this material increase in mortgage income was not a last-gasp trial invention is borne out by other parts of the documentary record, which contain references in pre-Merger documents to this important development. *See* JX 14 at 1 (January 2003 board minutes stating that "Mortgage fee income is assured to reduce significantly in 2003.").

[91] JX 14.

million projected in the Criswell Projections.[92] In addition, in that detailed budget, Criswell forecast interest income of $11.8 million in 2003, whereas the Criswell Projections contained expected interest income of $17.7 million. That budget indicates that by 2003 Criswell himself no longer believed in the reliability or accuracy of the estimates in his own prior projections.

Finally, as to the reliability of the Criswell Projections, it is telling that neither Prairie Capital[93] nor Clarke,[94] the plaintiffs' own expert, relied upon the Criswell Projections in performing a DCF analysis of PNB. Essentially, then, the plaintiffs' argument boils down to the theory that because management had in its possession a set of old projections that it sometimes referred to but did not update, it should disclose those because some of the projections were more optimistic than the ones used by a professional valuation company in performing a DCF. That is not the case.

In sum, given the departure of the Criswell Projections from PNB's actual income stream in 2001 and 2002 and the further departure in Criswell's own detailed budget for 2003, the Criswell Projections appear to be no more than "outdated . . . financial forecasts, now obsolete in light of the recent . . . forecasts and actual results."[95] Because the Criswell Projections were outdated and unreliable, they would not have significantly

[92] JX 11.
[93] Tr. at 492-93 (testimony from Downen of Prairie Capital that he reviewed the Criswell Projections and did not rely on them because they were "two or three years old" and PNB was not meeting the projections).
[94] Tr. at 115-16 (testimony from Clarke that "I guess also in my thinking, they may not hit year three, but they would hit year four, maybe do better in year five"); *id*. at 123 (Clarke stating that although he thought the Criswell Projections were "reliable" he still decided to take "a more conservative position in projecting the cash flows of the company").
[95] *Ivanhoe Partners v. Newmont Min. Corp.*, 533 A.2d 585, 713 (Del. Ch. 1987).

altered the "total mix" of information made available to shareholders, including the actual, audited financial statements, results from the first quarter of 2003, and the valuation report of Prairie Capital, which contained Prairie Capital's projections of PNB's performance for 2003 through 2007. Therefore, the inclusion of the Projections in the proxy statement was unnecessary.

ii. Was The Disclosure Of Prairie Capital's Valuation Work Misleading?

The second disclosure violation alleged by the plaintiffs is not an issue of material omission, but rather of materially misleading disclosure. Specifically, the plaintiffs accuse the defendants of mischaracterizing Prairie Capital's valuation report. The supposed mischaracterization results from the proxy statement's description of the $41.00 per share figure reached by Prairie Capital as being its estimate of fair value. The defendants respond both that this argument is untimely made and not viable on its merits. Both of the defendants' contentions are correct. The argument is untimely because it was not addressed in the pre-trial order and was not raised until trial.[96] It is unfair, then, to

[96] Although the plaintiffs, in the pre-trial stipulation and order, broadly framed the question by inquiring "[w]hether defendants can satisfy their burden of proof regarding shareholder ratification by showing they provided all material information to the shareholders in the Proxy Materials," the pre-trial order is devoid of any challenge to the characterization of Prairie Capital's valuation as "fair value" in the proxy statement, or the proxy statement's failure to disclose the share ownership of directors' families. Pre-Trial Stipulation and Order at ¶ 49. The amended complaint itself contains six challenges to disclosure in the proxy materials. Am. Compl. ¶ 21. Five of those disclosure challenges were dismissed from this litigation after a motion for summary judgment was granted in favor of the defendants. The only disclosure claim in this litigation that ever challenged Prairie Capital questioned the independence of that firm, not the disclosure of its methodology. Am. Compl. ¶ 21(E). The amended complaint makes limited mention of Prairie Capital's methodology. It states that Prairie Capital based its valuation on a projected dividend stream, not dividend-paying capacity. Am. Compl. ¶ 13(B). The amended complaint, as mentioned, does not list this error in methodology as a disclosure violation in Count II. The failure to disclose family share ownership is not mentioned anywhere.

expect the defendants to confront it now. The argument, therefore, was waived. Even if this argument was not waived, the plaintiffs lose on the merits. The same type of argument has been rejected convincingly by this court before.

In *Nebel v. Southwest Bancorp, Inc.*,[97] then-Vice Chancellor, now Justice, Jacobs wrote:

> The first claim is that the Notice improperly disclosed that the Southwest board had determined that the merger consideration represented the "fair value" of Bancorporation. In fact (it is alleged) the board had determined that the merger consideration represented only the "fair market value" of the shares after applying a minority and/or nonmarketability discount.
>
> The infirmity of this allegation is that the Notice does not misdisclose the fact that the plaintiffs claim was omitted. The Notice states that (a) "Southwest retained Alex Sheshunoff, Investment Banking, to determine the *fair market value* of the shares for which payment is to be made" . . . (b) Sheshunoff opined that the fair market value was $41 per share . . . and (c) and Southwest believed that that valuation was the "fair value of such shares" as of the merger date. The Sheshunoff report, which was attached to the Notice sent to Bancorporation shareholders, also discloses that what Sheshunoff valued was the 8.38% minority block of shares, *not* the entire corporation as a going concern. Manifestly that valuation methodology was legally improper, but the Notice plainly disclosed that the (incorrect) valuation approach had been employed. No shareholder reading the Notice could have been misled into concluding that the entire corporation had been valued as a going concern.[98] (internal citations omitted)

That is virtually the same claim that the plaintiffs now make with respect to Prairie Capital's valuation methodology.

The proxy statement did state, in fact, that Prairie Capital concluded that it valued PNB as a "going concern"[99] and that Prairie Capital was hired to "conduct an appraisal

[97] 1995 WL 405750 (Del. Ch. July 5, 1995).
[98] *Id*. at *4.
[99] Proxy at 3.

. . . to determine the fair value of the Company as a going concern."[100] The proxy, though, like the notice discussed in *Nebel*, contained an accurate statement of the actual valuation methodology used by Prairie Capital to value PNB. The proxy statement disclosed that, for the purpose of its DCF analysis, Prairie Capital "assumed that the stockholders would receive dividends equal to 35% of net income" and discounted that stream of dividends to present value.[101] The proxy statement also lumped additional disclosures onto the correct statement of how Prairie Capital performed its DCF. The proxy stated that "the valuation of the fair value of the Company is subjective and is based on Prairie Capital's experience and judgment and not merely the result of mathematical analysis. You should not view the analyses and resulting values described below as indicative of actual value or future results of PNB or New PNB."[102] Finally, the proxy statement informed the shareholders that the "Delaware Court of Chancery's appraisal may be more than, less than or equal to the $41.00 per share consideration paid in the reorganization."[103]

The underlying problem, of course, is that a determination of fair value under 8 *Del. C.* § 262 that comports with the Supreme Court's interpretation of that term through a DCF involves the calculation and valuation of a company's free cash flows to come up with the value of the entity as a going concern value, which then must be ratably shared

---

[100] *Id*. at 15.
[101] *Id*. at 17. This language is then repeated in Appendix B to the Proxy. Proxy, App. B at 11.
[102] Proxy at 16.
[103] *Id*. at 25.

among the stockholders according to their share ownership.[104] A calculation and valuation of a company's typical dividend payout rate does not value the entity, it values minority expectation because one of the benefits of control is to "declare and pay dividends."[105] Assuming that the controller will continue to pay dividends below the level of free cash flow necessarily embeds a minority discount, which is not permitted under the "fair value" rubric.[106] Therefore, the plaintiffs state that the proxy statement's characterization of Prairie Capital's valuation as "fair value" is misleading because its DCF contained a minority discount. The inaccurate description of the valuation methodology or results of a financial advisor, in the right circumstances, can constitute a disclosure violation.[107] In this case, though, the actual methodology used by Prairie Capital was clearly and accurately disclosed. That is, as in *Nebel*, any shareholder who read the proxy statement was put on notice that Prairie Capital valued a projected dividend stream rather than PNB's dividend paying capacity or free cash flow.

Nebel teaches that the discrepancy between Prairie Capital's DCF and the Delaware fair value standard does not support a disclosure claim. To rule otherwise would turn proxy statements into law review surveys, with directors having to describe the twists and turns of § 262 jurisprudence — such as how to make a comparable

---

[104] *See Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 299 (Del. 1996); *Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340, 355 (Del. Ch. 2004).
[105] Shannon P. Pratt, et. al., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 245-46 (4th ed. 2000) ("If the valuation is of a controlling interest, dividend-paying capacity is more important than actual dividends paid, since the controlling stockholder has the discretion to pay or not pay dividends as long as the company has the capacity to do so."); Shannon P. Pratt, THE LAWYER'S BUSINESS VALUATION HANDBOOK: UNDERSTANDING FINANCIAL STATEMENTS, APPRAISAL REPORTS, AND EXPERT TESTIMONY 199 (2000).
[106] *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137, 1144 (Del. 1989).
[107] *In re Staples*, 792 A.2d at 955.

company analysis comport with the fair value standard and relate that to the banker's work.[108] Our law does not require that. So long as the valuation work is accurately described and appropriately qualified, that is sufficient. Here, the disclosure met that mark. Moreover, the Prairie Capital methodology was fairly disclosed. Stockholders were cautioned that the value reached was a "subjective" estimate and that an appraisal in this court could result in a different value. Finally, in terms of materiality, it is worth noting that the proxy statement disclosed that Prairie Capital gave only a 20% weight to its dividend-based DCF analysis, with 80% of the final weight resting on its other analyses.[109]

V. Did Shareholders Who Voted In Favor Of The Merger Or Tendered Their Shares Acquiesce In The Unfair Transaction?

Because I have concluded that there were no disclosure violations and that the proxy statement fairly disclosed the material facts bearing on the advisability of the Merger, the question arises as to the effect of that reality on two related, but distinct, groups of the PNB stockholders who were departing. The first group is those who voted for the Merger. The second group is those who did not vote for the Merger, but later accepted the Merger consideration and did not seek appraisal.

In pondering the treatment they should receive, I begin with the important recognition that this is not a transaction governed by the *Lynch* doctrine. In that context, the law presumes that stockholder votes and tenders are not acts of free will and requires

[108] For a discussion of the effect of legal doctrine on conducting a comparable company analysis in the context of 8 *Del. C.* § 262, *see Union Illinois*, 847 A.2d at 355-57; *Agranoff v. Miller*, 791 A.2d 880, 897-98 (Del. Ch. 2001).
[109] Proxy at 18.

entire fairness review regardless of whether the transaction received the support of an informed majority-of-the-minority. Because of that, this court has held that the concept of acquiescence cannot logically apply in a case governed by *Lynch*.[110]

Here, however, the Merger is one that is subject to possible ratification. As a result, the traditional complementary concept of acquiescence also remains viable. Traditionally, acquiescence has required "a showing that the plaintiff, by words or deed, has acknowledged the legitimacy of the defendants' conduct."[111] That historical test is obviously met when an uncoerced stockholder, acting on an informed basis, casts an affirmative vote in favor of a transaction. If informed, uncoerced stockholders wish to challenge a transaction, the least that can be expected of them is that they not endorse it through a yes vote in the first instance. That is, if a stockholder says "yea" in the election, she cannot say "nay" in court if her vote was informed and uncoerced. The ballot box is the most important place to register opposition, not the courthouse. Therefore, the PNB stockholders who cast yes votes are barred by the doctrine of acquiescence from challenging the Merger. A judgment against them on that basis therefore will be entered.

The more arguable question is whether the group that never endorsed the Merger by voting yes is also barred by acquiescence. In an 8 *Del. C.* § 251 context, all of them,

---

[110] *See In re JCC Holding Co., Inc.*, 843 A.2d 713, 723-24 (Del. Ch. 2003).
[111] *Clements*, 790 A.2d at 1238 n.46. *See Frank v. Wilson & Co.*, 32 A.2d 277, 306 (Del. 1943) ("Acquiescence properly speaks of assent by words or conduct during the progress of a transaction . . . .").

by not voting or abstaining, effectively cast a no vote. But this group later accepted the Merger consideration and did not seek appraisal.

Under the language in some decisions, notably the Supreme Court decision in *Bershad v. Curtiss-Wright Corp.*, the mere acceptance by stockholders of the transactional consideration constitutes acquiescence, barring them from recovering in an equitable action.[112] The defendants embrace that language and say it governs here to bar all stockholders but the Appraisal Class from a recovery.

I disagree. In two opinions issued close in time in 2001, this court thoroughly examined the current contours of the concept of acquiescence in Delaware corporate law.[113] I will not rehash that discussion here, but rely on their bottom-line conclusion, which is that stockholders who do not vote for a transaction and who simply accept the transactional consideration rather than seek appraisal are not barred from making or participating in an equitable challenge to the transaction. Notably, that conclusion did not rest simply on an examination of this court's case law, but more importantly a consideration of the issue in the light of our Supreme Court's jurisprudence, which among other things had made it clear that appraisal was simply one means by which to challenge a long-form merger, with the bringing of an equitable action being another, even more common means.

---

[112] 535 A.2d 840, 848 (Del. 1987) (stating that "when an informed minority shareholder either votes in favor of the merger, or . . . accepts the benefits of the transaction, he or she cannot thereafter attack its fairness").

[113] *See In re Best Lock Corp.*, 845 A.2d 1057 (Del. Ch. 2001); *Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001).

In *Clements v. Rogers*, this court noted that the mere acceptance of the merger consideration by a stockholder who did not vote yes cannot rationally be considered acquiescence in the original sense of the term, which meant to show by words or deeds an acceptance of the legitimacy of the defendants' conduct.[114] And with the recognition that appraisal was not the exclusive way to challenge a merger's fairness, that inference is even less justifiable. Acceptance of the merger consideration is simply an abandonment of the appraisal right, no more and no less, at least in the usual case. As *Clements* noted:

> This is especially so in the case of a [stockholder] who forewent appraisal. Having abandoned the right to seek a fair value award that was not dependent on a showing of breach of fiduciary duty, [the stockholder] became entitled to the merger consideration regardless of the outcome of [an equitable action challenging the merger]. Because of this factor, it is unclear exactly what purpose would be served by denying her the ability to proceed [as a plaintiff].[115]

In view of this background, I cannot perceive a rational basis for finding that those PNB stockholders who did not cast yes votes acquiesced simply because they accepted the Merger consideration.[116] Therefore, these stockholders may participate in any recovery.

---

[114] *Clements*, 790 A.2d at 1238 n.46 (citing authorities).
[115] *Id*. at 1238.
[116] A different context was presented to this court in the case of *Norberg v. Security Storage Co. of Washington*, 2000 WL 1375868 (Del. Ch. Sept. 19, 2000). In *Norberg*, a squeezed-out minority shareholder filed a complaint alleging breach of fiduciary duty against the company's directors and majority shareholders. *Id*. at *1-2. While that action was pending, the defendants offered the dissenting shareholders who sought appraisal a settlement, which was approved by the court, that would allow them to accept the merger consideration even though § 262's sixty-day window for plaintiffs to accept the consideration, as a right, had passed. *Id*. at *3. That agreement was originally subject to a twenty-day deadline, but the defendants agreed to leave the offer open beyond the deadline. *Id*. Approximately seventeen months after filing his original unfairness claim and a year after this settlement agreement was offered, Norberg tendered his shares to the company for the merger consideration without any caveat that he would continue to

VI. Were The Shareholders Of PNB Paid Fair Value In The Merger And Was The Merger Entirely Fair?

Having concluded that the Merger is subject to entire fairness review and determined which stockholders are eligible to benefit from any finding of unfairness, I reach the confluence of two jurisprudential rivers. The first is that of equity. Here, although I do not find any evidence that the defendants consciously intended to pay an unfair price,[117] the only procedural safeguard used was the employment of an investment

---

pursue litigation. *Id*. at *7. After the agreement had closed, then, it was reasonable for the defendants to believe that Norberg's tendering of shares constituted an acceptance of the terms they offered in that settlement agreement. That is, Norberg had tendered his shares when he otherwise had no entitlement to receive the merger consideration, and the court found that Norberg had acquiesced because he "abandoned his appraisal claim, challenged the fairness of the price and process and later, despite his declared assessment of the unfairness of the transaction, freely and voluntarily accepted the merger consideration." *Id*.

[117] In a motion in limine filed during pre-trial briefing, the plaintiffs moved to bar the defendants from relying on the exculpation clause, authorized by 8 *Del. C.* § 102(b)(7), that is contained in the PNB certificate of incorporation. As the plaintiffs point out, the first time that the defendants pointed to the exculpation clause was in their pre-trial opening brief. By that time, discovery in the case was closed and the parties were on the eve of trial, having already shaped their trial plans.

Although in my opinion, the better view is that an exculpatory charter provision is best viewed as a statutorily-authorized immunity, our Supreme Court has viewed it somewhat differently, terming it "in the nature of an affirmative defense." *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223 (Del. 1999). Given that reality, it is important for defendants to raise the exculpation clause defense early in a case. Here, the defendants waited until after the plaintiffs had shaped their trial plans to inject this defense into the case. I believe that was prejudicial. In an analogous case involving the exculpatory defense available to a partner of a limited partnership under 6 *Del. C.* § 17-1101(d)(1), I held that a defense raised on the eve of trial was barred. *In re Nantucket Islands Assocs. Ltd. P'ship Unitholders Litig.*, 2002 WL 31926614, at *2 (Del. Ch. Dec. 16, 2002). I find the same here. Had the defendants raised the defense, the plaintiffs may well have tried the case very differently and insisted on calling as witnesses each of the PNB defendant directors in order to cast doubt on their good faith. Confronting no defense of this nature, the plaintiffs simply focused on proving that the Merger was unfair.

Because the defense was not timely presented, I do not address the question of whether the exculpatory defense would have shielded these defendants from liability. The sort of interest that the PNB directors had here was not of a classically self-dealing nature; indeed, the PNB

bank to give a fairness opinion, and the record does not give one confidence that the work of Prairie Capital was a sufficient guarantee that a fair price was paid. As in most fairness cases,[118] the ultimate issue of fairness turns on my perception of the economics. That is, did the defendants cause the corporation to pay a fair price? Here, where there is no useful market information about PNB's value, the court must necessarily look to valuation metrics. In other words, to measure whether the Merger price was unfair, the court must conduct the same essential inquiry as in an appraisal, albeit with more leeway to consider fairness as a range and to consider the remedial objectives of equity.

---

directors were aligned with PNB itself. Thus, there is, at least to this mind, a ponderable question whether directors in this context have committed a breach of the duty of loyalty and/or received an improper personal benefit, in the sense intended by the General Assembly when it crafted those two (arguably redundant and certainly overlapping) carve-outs in § 102(b)(7). Doubtless the idea of the entire fairness doctrine is to ensure that those who self-deal with the corporation do so fairly regardless of their subjective good faith. Whether that idea is as strong in this precise context, when the PNB directors were aligned with PNB itself and the other remaining stockholders, is at least worthy of some consideration. Here, though, I need not concern myself with this question regardless of whether the § 102(b)(7) defense was waived. The defendants did not take on these questions in the briefs. Instead, the defendants expressly conceded that they "are not insulated against money damages [by the § 102(b)(7) clause] for any finding of liability under Count I." Def. Op. Pretrial Br. at 13. Count I charges the defendants with a breach of the fiduciary duty of loyalty and entire fairness. Am. Compl. at ¶¶ 17-19.

In fairness to the defendants, I do make one observation about the question of their state of mind because of the possible implications it might have for their ability to seek indemnification from PNB or their D & O carrier. I perceive no basis in this trial record to conclude that the PNB directors intended to deal unfairly with the departing PNB stockholders; that is, that they in bad faith sought to underpay in the Merger. Any underpayment benefited PNB directly (as the purchaser in the Merger) and all its remaining PNB stockholders derivatively and equally, and did not inure exclusively to the PNB directors. In other words, although I find for structural reasons that the directors owed a duty of fair treatment to the departing minority, and fell short of meeting that duty, I do not find that they fell short out of bad faith. Rather, they simply missed the mark in attempting to set a fair price, perhaps partially because Prairie Capital did not perform a DCF analysis consistent with Delaware's § 262 jurisprudence.

[118] *E.g.*, *Onti, Inc. v. Integra Bank*, 751 A.2d 904, 930 (Del. Ch. 1999) ("[W]here the claims of unfair dealing do not rise to the level of fraud . . . the Court should primarily focus on whether the price was unfair."); *Delaware Open MRI Radiology Assocs.*, 898 A.2d at 311 (same).

In this case, the plaintiffs and the defendants actually agree on one thing, which is that my determination of appraisal value for the Appraisal Class should also serve as the measure of any damage award for the Plaintiff Class. For that reason, I concentrate the next sections on the common question of whether the Merger price equaled my perception of PNB's value. Because the defendants employed no effective mechanism to protect the cashed-out stockholders' interests, it is more than just to require them to pay the non-acquiescing class members any deficiency between the Merger price and my assessment of fair value. I begin that assessment by reviewing the findings of, and the differences between, the experts retained by the plaintiffs and defendants. Then, I will proceed to undertake the appraisal of PNB's shares as of the Merger date and use that result to determine the damages award for the Plaintiff Class.

A. The Experts

As mentioned, the valuation of PNB that served as the basis for the consideration paid to shareholders cashed out in the Merger was conducted by Prairie Capital. But, PNB opted not to use Prairie Capital as its expert at trial. Rather, PNB retained Chris Hargrove of Professional Bank Services to conduct another independent valuation of PNB and testify as PNB's expert. The plaintiffs retained David Clarke of the Griffing Group, Inc. to testify as their expert at trial.

In valuing PNB, both experts, Hargrove and Clarke, used the same three methods employed by Prairie Capital in the initial valuation. The experts valued PNB using a: 1) comparable publicly traded company approach; 2) comparable acquisition method; and 3) discounted cash flow analysis. The "experts" nonetheless drew the depressingly familiar

parentheses — $40 for Hargrove[119] and $61 for Clarke — within whose capacious bounds I am to identify a single estimate of PNB's value.

1. Hargrove

The defendants' expert Hargrove first valued PNB based upon the share prices of comparable publicly-traded companies. He relied upon data from thirteen comparable bank holding companies located in the Midwest that were traded on the NYSE, NASDAQ, and AMEX. Those companies had a median price-to-book-value ratio of 1.49, which would have resulted in a per share price of $55.26 for PNB. Because PNB had lower returns on assets and equity than most of the comparables, Hargrove looked at three banks within the group that demonstrated financial performance he viewed as more similar to PNB's. For those three banks, the price-to-book-value ratio was a more modest 1.16, which, if used, results in a share price of $43.02 for PNB. Finally, using the group of thirteen comparable companies, Hargrove calculated a median core price-to-earnings multiple of 13.44, which would result in a share price of $42.55 for PNB. Again, the three bank holding companies in the group that Hargrove viewed as most comparable had a lower P/E ratio of 12, resulting in a share price of $37.99 for PNB. He then averaged the two values, $37.99 and $43.02, that he calculated for the banks he considered most comparable. He then took the resulting value, $40.51, and applied a 7.37% control

[119] A cynic might wonder about the bona fides of Hargrove's valuation, which was within a dollar of Prairie Capital's flawed DCF valuation and the deal price. *See Le Beau v. M.G. Bancorporation, Inc.*, 1998 WL 44993, at *7 (Del. Ch. Jan. 29, 1998) ("The fact that Reilly's per share fair value determination serendipitously turned out to be only 90 cents per share more than Sheshunoff's legally flawed $41 valuation, cannot help but render Respondent's valuation position highly suspect and meriting the most careful judicial scrutiny."). Notably, Hargrove made the same mistake of valuing PNB's expected dividend stream, not its free cash flows.

premium (derived from the difference in the P/E ratios between his comparable acquisition group and his comparable publicly-traded group) to reach his ultimate value of $43.50 per share based upon comparable publicly-traded bank holding companies.

Next, Hargrove valued PNB by examining comparable acquisitions of bank holding companies. In determining comparable acquisitions, Hargrove examined only cash acquisitions because "in a dissenter's action, you receive cash."[120] Hargrove found eleven comparable acquisitions, nationwide, after June 2001. Using those eleven acquisitions, Hargrove calculated a median price-to-book-value ratio of 1.42 and a median P/E ratio of 14.43. Using the price-to-book-value ratio, a PNB share would have been valued at $52.58, and using the P/E ratio, a PNB share would have been valued at $45.69. Hargrove then took the average of those two figures, or $49.14, and decided to apply a 20% discount "solely based on the Company's lower financial performance compared to the Acquisition Comparables."[121] The resulting value was $39.31 per share.

Finally, Hargrove conducted a DCF analysis of PNB. In conducting that analysis, Hargrove, like Prairie Capital, valued a future stream of dividends payable to PNB shareholders based on its historic dividend-paying practices, rather than the available cash flow that constituted PNB's dividend-paying capacity. Hargrove's DCF incorporated a discount rate of 14%, an annual asset growth rate of 5%, and returns on assets ranging from 1.03% to 1.07%. He then assumed that PNB would continue to pay a dividend stream of 30% of net income, and he then used the P/E ratio of 14.43 that he

---

[120] Tr. at 188.
[121] JX 22 at 54.

derived from his comparable acquisition group as his exit multiple to reach a terminal value. Hargrove's DCF resulted in a value of $39.49 per share of PNB, which he ultimately relied upon most heavily, but without precise weighting, in determining that the fair value of a PNB share at the time of the merger was $40 — that is, a dollar below the Merger price.

2. Clarke

The plaintiffs' expert Clarke relied upon the same three valuation techniques as the defendants' expert Hargrove when determining the fair value of PNB's shares. Clarke weighted his three techniques as follows: 60% DCF analysis, 20% comparable company approach, and 20% comparable acquisitions approach. The result was a fair value of $61.00 per share of PNB.

In performing his comparable company approach, Clarke attempted to find a very limited set of comparable bank holding companies. He looked for "bank holding companies in Illinois, if possible, that had a rural presence, but also had a presence in a major city in Illinois."[122] Given his criteria, Clarke found three bank holding companies that he felt comfortable using in his valuation of PNB. Clarke then found the median price to estimated earnings ratio of those three companies to be 13.6.[123] That P/E ratio resulted in a per share value of $51.82 for PNB. Second, Clarke calculated the price-to-book-value ratio for the three companies, and the ratio ranged from 1.7 to 3.2. Using his

[122] Tr. at 68.
[123] Clarke, when calculating his P/E ratio, used PNB's estimated 2003 earnings as opposed to its 2002 actual earnings. Hargrove, in contrast, used the actual 2002 earnings for PNB and his comparable companies.

own valuation judgment, Clarke used a 1.65 ratio for PNB because PNB had a lower-than-median return to equity. Using the 1.65 ratio, Clarke valued a PNB share at $51.37. He then averaged the P/E and price-to-book share prices, to reach a value of $51.60, to which he applied a 20% premium to correct for the minority discount he believed was reflected in the trading data. Clarke's guideline company approach, then, yielded a per share value of $61.91 for PNB.

Next, Clarke examined comparable acquisitions. Again, his methodology differed from Hargrove's. Hargrove looked nationally for cash acquisitions, and Clarke focused on either cash or stock-for-stock acquisitions of banks in Midwestern states. In deciding whether to consider certain acquisitions, he looked for deals with values between $10 million and $150 million and target banks with: 1) no more than $600 million in assets; 2) equity-to-asset ratios of 5% to 10%; and 3) returns on assets of between 0.7% and 1.45%.[124] He found seven transactions that met his criteria. For those seven transactions, the median P/E ratio was 15, and the median price-to-book-value multiple was 2.03. The resulting per share value for PNB was $51.90 per share using the P/E ratio and $66.07 per share when using the price-to-book multiplier. Clarke then averaged those values to reach a per share value of $59, and he then discounted that figure by 20% to exclude any synergy value, which resulted in a value of $49.17 per share of PNB.

Finally, Clarke performed a DCF analysis on PNB. Unlike Hargrove, who valued an expected stream of dividends, Clarke attempted to value PNB based on its dividend-paying capacity. In doing so, Clarke first reduced PNB's excess capital by an assumed

[124] JX 19 at 26.

dividend payment of $7.1 million, which he asserted still left PNB as a well-capitalized bank. Then, in the following years, he assumed that PNB's dividend-paying capacity would be that which would keep the bank well-capitalized at an equity-to-asset ratio of 7.5%. Both experts started from the same total asset base of $216,675,000 on March 31, 2003 and assumed a 5% annual growth rate for the assets. The only difference between the expected assets used by Hargrove and Clarke is that Hargrove used year-end assets, and Clarke used the average assets because PNB would be earning income on those assets throughout the year and not based solely upon the assets at year-end. Clarke then assumed that assets would grow at a rate of 5% per year, which was also the rate employed by Hargrove in his DCF analysis. Clarke assumed a return on assets of between 1.09% and 1.11%, which was higher than Hargrove's range of 1.03%-1.07%. Clarke then discounted back his estimated free cash flows using an 11.5% discount rate, which he arrived at using the capital asset pricing model. After doing that, Clarke arrived at a value of $64.33 per share of PNB. In order to check this calculation, Clarke performed a separate DCF without assuming the initial $7.1 million dividend, and he reached a value of $59.45 per share, to which he then applied a 10% control premium. The result of the second DCF, then, was $65.40 per share.

B. The Fair Value Analysis

As in any case like this, the court necessarily relies on the record the parties shape regarding the company and its value, and is not in a position to conduct a new search for data. For that reason, the testimony of experts is important. Here, although the experts had two different perspectives on PNB's future prospects, Clarke and Hargrove actually

came up with very similar cash flow estimates. Hargrove described PNB as being more in a steady state, without great growth prospects. Clarke emphasized PNB's potential and its improving ratios. But, in the end, their resulting projected cash flows (described later) are not materially different. Rather, the experts are primarily separated by other factors, such as the discount rate. It is on these key disagreements that I therefore concentrate most of my discussion.

Before delving into that task, I clear away some brush. Although the experts relied upon three basic valuation technologies, I conclude that only one technique can be reliably applied by me on this record — the discounted cash flow method. Neither of the market approaches — comparable company or comparable acquisition — relied upon by the parties' experts can be rationally deployed by me. Neither of those market-based methods is backed up by sufficiently reliable testimonial and record evidence. At trial, the experts evidenced little familiarity with the actual details of their comparables. Moreover, my own review of their comparables suggests reason to doubt that they provide a sound basis to assess PNB's value.[125] And as it happens, focusing exclusively

[125] For example, Clarke's comparable publicly-traded companies all were significantly larger than PNB, with one having total assets of $587 million as compared to PNB's assets of $216 million, and another "comparable" had sixty-four branches as opposed to PNB's seven. Clarke himself stated that it is "hard to find good comps, because the comps that are supposed to be the same size are illiquid." Tr. at 154. Hargrove's comparables were similarly questionable. The average total assets for his eleven comparables was $793 million, and the average number of branches for each bank was twenty-one. In addition, one of Hargrove's "most comparable" banks had a doggish ROAA of 0.81%, compared to PNB's of 0.97%. In terms of the comparable acquisition analysis, Clarke's range of ROAA that he looked for in target banks was a very wide one of 0.7% to 1.45%. Similarly, Hargrove's identified acquisitions did not strike me as convincingly similar. First, the transactions spanned a geographic area from Orange County, California, to Pawhuska, Oklahoma and ranged in deal value from $1.6 million to $27.6 million. Also, the median assets of the target banks in his analysis was $43 million, or about a quarter of

upon a DCF analysis is consistent with the heavy emphasis the experts themselves have given to this method.[126] Hargrove relied very heavily on his DCF analysis in concluding that fair value was $40 per share (his DCF figure was $39.49), and Clarke weighted his DCF 60%, his comparable company analysis 20%, and his comparable acquisition method 20%.

Because I am largely record-bound, it is natural and appropriate that I would gravitate toward focusing on one of the experts' DCF models as providing a basic framework for my analysis. Although Hargrove gave some helpful testimony and was a cooperative and direct witness, his approach to valuation was idiosyncratic and involved intuitive moves that might not be irrational, but which were not grounded in traditional valuation techniques. For example, as I will note, he: 1) calculated a minority share valuation using PNB's expected dividends rather than a DCF that was consistent with § 262; and 2) calculated PNB's cost of capital using an unusual approach that ignored an important component.

By contrast, Clarke's DCF approach, while not without its own problems, was easier to follow, as it tracked the methodology found in leading texts. Although Clarke made some moves I do not adopt, I generally use his model, except for where I expressly deviate from it. In jump ball cases, I have tended to give the ball to Clarke, both because

---

the size of PNB, the ROAA figures for the target banks ranged from 0.81% to 2.33%, and the P/E ratios for the transactions ranged from 6.88 to 23.11.

[126] Hargrove's expert report states that his discounted cash flow based on comparable acquisitions "is the superior valuation method." JX 22 at 54. Clarke similarly stated, at trial, that "it's hard to find good comps" when valuing a small bank holding company like PNB. Tr. at 154.

I found him the more convincing witness, and because of the lack of procedural protections in the Merger and the corresponding burden to prove fairness that rests on the proponents of the Merger. I will now turn to my independent valuation.

1. Discounted Cash Flow Analysis

The components of a DCF analysis are familiar and do not require repetition. In this instance, the experts disagree, primarily, on three major issues: 1) the acceptable capital ratio at which to keep the Bank, and the resulting effect on free cash flow; 2) the expected return on assets for the Bank; and 3) the discount rate. I therefore will focus my analysis on these key disagreements, in that order; otherwise, I adopt Clarke's model as reliable.

a. Determining The Acceptable Level Of Capital To Keep In PNB

The extent to which a bank, or a bank holding company, has free cash flows depends in material part on its ability to generate cash flow in excess of certain financial ratios that the Office of the Comptroller of Currency ("OCC") requires in order to consider a bank "safe and sound." Banks regulated by the OCC are evaluated on three specific ratios: 1) a total risk-based capital ratio; 2) a Tier-1 risk-based capital ratio; and 3) a leverage ratio.[127] The primary ratio the experts concerned themselves with in this litigation was the Tier-1 risk-based capital ratio (the "Tier-1 Ratio"). In order to remain a well-capitalized bank, the OCC requires a bank to maintain a Tier-1 Ratio of 6.0%.[128] In

[127] 12 Fed. Reg. § 6.4.
[128] *Id.*

addition, to remain well-capitalized, a bank must maintain a total risk-based capital ratio of 10%.[129]

If the OCC had a category of "exceptionally well-capitalized," PNB would fall within it. PNB maintained a Tier-1 Ratio of 13.98% in 2001, 14.29% in 2002, and 15.3% for the first quarter of 2003.[130] In addition, its total risk-weighted ratio was 15.67% in 2001, 15.54% in 2002, and 16.55% for the first quarter of 2003.[131] As to the OCC's third guideline, the leverage ratio, PNB was well above the 5% required by the OCC to remain well capitalized — 8.97% in 2001, 9.05% in 2002, and 9.49% in the first quarter of 2003.

Given that PNB was well above its required capital levels and was at no risk of becoming less than adequately capitalized, the plaintiffs' expert Clarke determined that in order to value PNB's free cash flows, he would build a one-time payout of $7.1 million into his discounted cash flow analysis. That payment would purportedly allow PNB to have an equity-to-asset ratio of 7.5%, which would permit it to remain adequately capitalized. In actuality, though, that move by Clarke would drop PNB's Tier-1 Ratio to 6.29% because Clarke used PNB's average assets and total equity without deducting intangible assets, intangible capital, and unrealized gains, which is required under the OCC's definition of Tier 1 capital.[132] Therefore, to achieve an actual Tier-1 Ratio of 7.5%, the Bank could have offered only a one-time payout of $4.375 million.

---

[129] *Id.*
[130] JX 22 at 19 (taking the data from the SNL Securities Financial DataSource).
[131] *Id.*
[132] 12 Fed. Reg. Pt. 3 App. A.

Despite its high Tier-1 Ratio as of the Merger date, though, there is no basis in equity to assume that PNB was required to premise the Merger price on a reduction of its starting Tier-1 Ratio. The Bank, which was subject to serious regulatory intervention as recently as 1997, was not required to operate in a manner that tied its Tier-1 Ratio to the lower regions of "well-capitalized." There was testimony that even at a Tier-1 Ratio of 7.5%, PNB would be in the 15th percentile of banks in the United States.[133] Even in a fairness case, one need not assume that the defendants would pay a price based on the notion that the entity should reside in the bottom quartile of its peers in terms of capitalization. That being said, it also is inappropriate to assume that PNB would retain cash simply to remain well above the well-capitalized threshold. From the record, I infer that PNB desired to make healthy dividend payments and to increase returns to its stockholders when it could do so safely. PNB candidly admitted in its proxy materials that "the reorganization and the amounts required to consummate the merger [some $5.125 million] will not have a material adverse effect on our capital adequacy, liquidity, results of operation or cash flow."[134] In view of this aspect of PNB's business goals, a reasonable middle ground is to assume that PNB would maintain a Tier-1 Ratio of 8.5%, which, as the defendants' own expert Hargrove, testified at trial, was a reasonable level that would keep PNB at the median of its peer group.[135]

Having determined that a sufficient Tier-1 Ratio for PNB is 8.5%, I will assume, going forward, that PNB will distribute all of its cash flow so long as it does not drop

[133] Tr. at 215 (testimony of Hargrove).
[134] Proxy at 19.
[135] Tr. at 241-42.

below that level. That is, I will not, as Clarke recommends, assume that PNB, in order to accurately value free cash flow, will reduce its starting Tier-1 Ratio at the outset. Rather, I assume that PNB will preserve sufficient cash to avoid dropping below a Tier-1 Ratio of 8.5%, then pay-out the rest. That PNB could do so safely is consistent with the proxy statement's disclosure that PNB could safely pay out over $5 million in Merger consideration.[136]

b. Determining PNB's Future Return On Assets

To wit, I next discuss another issue related to PNB's cash flows. Before doing so, I want to emphasize as the following tables suggest, that Hargrove and Clarke's bottom line cash flow estimates do not differ substantially. How they get there does differ, even though both experts agree with the fact that PNB's total assets at the end of March 2003 were approximately $216.676 million, and use a 5% annual growth rate. Hargrove, though, for his valuation, used year-end assets rather than average assets, which was the method used by Clarke. The experts disagree on how effectively the Bank will be able to generate income from its assets. For a bank holding company, one of the primary measures of performance is return on average assets ("ROAA"). During the years 1999-2002, the Bank's ROAA was 0.65, 0.89, 0.96, and 0.97 respectively. In addition, for the first quarter of 2003, the Bank's ROAA was 1.02, a 5% increase from 2002. Hargrove,

[136] Proxy at 19. At trial, there was testimony of inconclusive nature regarding whether a one-time payout of $7.1 million, as advocated by Clarke, would reduce PNB's profit margins. By using the approach I have selected, I have no basis to believe that dividends paid out above the 8.5% Tier-1 Ratio — an amount of about $8 million in the projection period — would reduce PNB's ROAA. As bears repeating, the proxy statement confidently opined that PNB's expected $5.125 million in expected Merger consideration would not have a "material adverse effect" on PNB's "capital adequacy, liquidity, results of operation or cash flow." *Id*.

in performing his discounted cash flow analysis, projected the following level of assets and return on assets during the period of his cash flow projections.

	Year 1	Year 2	Year 3	Year 4	Year 5
Assets (000)	$227,509	$238,884	$250,828	$263,370	$276,538
ROAA	1.03%	1.04%	1.05%	1.06%	1.07%
Net Income (000)	$2,343	$2,484	$2,634	$2,792	$2,959

In contrast, Clarke's DCF represents what he considers to be "an average banking franchise."[137] Clarke used a mid-year convention, which I find appropriate given PNB's practice of paying dividends quarterly, and grew assets by 5% per year in Years 2-5 of his cash flow projections, as did Hargrove. He also used PNB's average assets, which I will adopt in my own valuation. Clarke's assumptions are reflected in the following table.

	Year 1	Year 2	Year 3	Year 4	Year 5
Assets (000)	$222,093	$233,198	$244,857	$257,100	$269,955
ROAA	1.09%	1.09%	1.10%	1.10%	1.10%
Net Income (000)	$2,421	$2,542	$2,693	$2,828	$2,970

As the tables make evident, Hargrove uses a more conservative ROAA, ranging from 1.03% to 1.07%, while Clarke starts out with a base ROAA of 1.09% and increases it to 1.10% for Years 3-5. Of course, neither of the experts can forecast with precision what PNB's ROAA will be in the future. A number of factors, including the national economy and Federal Reserve interest rates, will affect how productively PNB will be able to use its assets.

[137] JX 19 at 12.

One thing is clear, though, from the Bank's performance — its ROAA was below that of its peer group. Clarke himself acknowledges, in his expert report, that "PNB's ROAA of 0.97% was below the average of 1.1% for the 867 peer bank holding companies as reported in PNB's March 31, 2003 Uniform Bank Holding Company Report."[138] Additionally, the peer group's median ROAA increased to 1.13% for the first quarter of 2003.[139] That said, PNB's ROAA was above the 0.91% median for selected publicly-traded bank holding companies tracked by Howe Barnes Investments.[140] Clarke, then, essentially jumped PNB's ROAA up from 0.97% in 2002 (and 1.02% in the first quarter of 2003) to 1.09% for the year that would end June 17, 2004. I am unable to conclude from PNB's historical performance, having reported an ROAA of 0.89% in 2000, 0.96% in 2001, and 0.97% in 2002, that PNB's ROAA would increase to 1.09%, a 12% increase from 2002's ROAA, by June 17, 2004.

At the same time, I also find that Hargrove's slow-growth expectations for ROAA are too conservative. PNB had sold one of its branches, the Piper City Branch, in order to reduce a number of PNB's underperforming loans. The immediate increase in ROAA in the first quarter of 2003 offers proof that this strategy was paying off. In addition, PNB's expansion into McLean County was a continuing success, as could be seen in the increase in ROAA from 2000 (0.89%) to 2001 (0.96%). Therefore, I find that although PNB was underperforming its peer group in 2002, it was experiencing good growth prospects and taking steps to improve its loan portfolio and shed underperforming assets. This strategy

---

[138] JX 19 at 14.
[139] JX 22 at 23.
[140] JX 18 at 14.

had been successful in increasing PNB's ROAA in earlier years. Therefore, while PNB would not experience an immediate and dramatic increase as projected by Clarke, it would work towards achieving the median ROAA of its peer group by the end of the projection period. I will apply an ROAA of 1.04% in Year 1, 1.05% in Year 2, 1.07% in Year 3, 1.08% in Year 4, and 1.10% in Year 5 to Clarke's expected average assets for PNB. The result is shown below:

	Year 1	Year 2	Year 3	Year 4	Year 5
Assets (000)	$222,093	$233,198	$244,857	$257,100	$269,955
ROAA	1.04%	1.05%	1.07%	1.08%	1.10%
Net Income (000)	$2,310	$2,449	$2,620	$2,777	$2,970

I will use those net income figures to determine the free cash flow available for distribution to shareholders that would allow the Bank to remain at a Tier-1 Risk-Based Capital Ratio of no lower than 8.5%.

c. Determining PNB's Discount Rate For Future Earnings

Before I can finalize my valuation, I must also determine the applicable discount rate. The experts of course disagree about the appropriate discount rate to use. For his part, Hargrove uses a discount rate of 14% that he calculated in two ways. First, Hargrove used a unique "in-house" method that involves looking at core earnings-to-price ratio for the banking industry and combining that with the sustainable growth rate to arrive at a discount rate. I could not grasp the explanation of this method or find a basis for it in respected valuation literature, and do not adopt it. More traditionally, Hargrove argued that he checked his in-house method calculation by using the capital asset pricing

model ("CAPM"), which yielded a discount rate of 15.43% for all publicly-traded banks as of June 17, 2003. What Hargrove did to calculate a required rate of return, though, was look at the required return for publicly-traded banks without accounting for the systematic risk of achieving those returns.[141] But, despite his belief that "beta should be zero,"[142] Hargrove applied an effective beta of 0.875, which he stated "implies the risk associated with the Company and its common stock embodies approximately 7/8 of the publicly traded bank stock market's risk,"[143] to the difference between the risk-free rate of 4.26% and his discount rate for all public banks of 15.43% in order to arrive at the 14% rate. Hargrove, however, provided no foundation for why he chose to imply this beta of 0.875. Indeed, he stated at trial that he believed the bank industry beta was around 0.69.[144] Essentially, it appeared as if he backed a self-invented beta into his calculation in order to achieve a discount rate of approximately 14%. Put directly, I am not persuaded that Hargrove's approach was sound, and I do not adopt his proposed rate.

By contrast, Clarke also calculated PNB's cost of capital using the capital asset pricing model, but did so in a more sound fashion. To determine PNB's cost of capital, Clarke used a risk-free rate of 4.3% and added to that an equity premium of 5.75%, which is 1.25% below the historically accepted equity premium of 7%.[145] He then

---

[141] Tr. at 366-67.
[142] Tr. at 194-95.
[143] JX 22 at 46.
[144] Tr. at 364.
[145] The use of this lower equity rate is based on a study by Roger G. Ibbotson and Peng Chen, in which the authors estimated the long-term supply of equity rate is estimated to be 5.9% on an arithmetic basis. That estimate is approximately 1.25% below the historical estimate of an equity risk premium. *See* Roger G. Ibbotson & Peng Chen, *Long-Run Stock Returns: Participating in the Real Economy*, 59 FIN. ANALYSTS J. 88, 96-97 (2003).

multiplied the equity premium by a beta of 0.5 and added a size premium of 3.6% to arrive at a discount rate of 10.8%. Clarke, however, opted not to use that discount rate because he determined that although he agreed that the equity premium likely was lower than the historical rate of approximately 7%, the line of empirical research tracking the long-term supply rate of equity has not gained "universal acceptance."[146]

Instead, Clarke used the more widely accepted equity premium 7.0% in his cost of capital calculation. Using that premium, 4.3% risk-free rate, the 3.6% size premium, and a beta of 0.5, Clarke calculated the discount rate to be 11.4%, which he rounded up to 11.5%.[147] To check this rate, Clarke also used the three-factor Fama-French Model, which is a variation on the traditional CAPM model. Using the Ibbotson peer group beta of 0.69, the Fama-French model yielded an average cost of equity of 11.5% and a median cost of equity of 11.2%. Overall, I find that Clarke's calculation of the interest rate was conservative and done in a manner consistent with accepted valuation techniques.

My one quarrel, though, involves his decision to use a beta of 0.5 in his traditional CAPM approach. To calculate this unlevered beta, Clarke multiplied the peer group beta of 0.69, reported by Ibbotson's, by 65% to reflect the fact that bank holding companies with no third party debt tended to have betas, in his estimation, 35% lower than the group's levered beta.[148] That resulted in beta being 0.45, and using his judgment that bank betas are often understated, Clarke increased beta to 0.5. Unlike the other components of his analysis, Clarke could not ground this move firmly in the valuation

[146] JX 19 at 26.
[147] *Id.*
[148] JX 19 at 25.

literature. Rather, it seemed a subjective exercise. For example, Clarke did not offer any supportable basis for choosing to reduce PNB's beta by 35%.

PNB, although it had no debt to increase the risk of equity going unpaid, also was not an ideal investment. The company reported subpar ROAA compared to its peer group, and it had been under regulatory scrutiny within six years of the Merger. It is not clear to me why diversified investors would see PNB as less subject to risk and as therefore having a lower hurdle than its competitors.[149] If such investors have opportunities to make comparable investments in listed bank holding companies with greater opportunity for liquidity, it is not apparent why they would accept a lower return from PNB. Therefore, I will calculate the CAPM discount rate for PNB's DCF using the median beta of 0.69 calculated by Clarke, a beta consistent with Hargrove's view of the banking industry's beta. Using that beta, a 7.0% equity premium, a 3.6% size premium, and a 4.3% risk-free rate, the discount rate for PNB's future earnings is 12.73%.

Notably, while adjusting Clarke's discount rate by using the 0.69 beta results in a rate of 12.73%, using Hargrove's formula, and applying a beta of 0.69 instead of his self-invented beta of 0.875, results in an even lower discount rate of 11.98%.[150] In addition, using the beta of 0.69, Clarke's use of the Fama-French Model resulted in a discount rate

---

[149] I put aside the question of whether beta has much relevance to regional banks like PNB, whose shares are not listed on an exchange, except insofar as it helps in determining the cost of capital for the comparable investments that diversified investors might make. To be quite direct, I am chary about concluding that corporations that issue illiquid securities for which beta – a measure of covariance of the company's trading price with overall market prices — is indeterminable have a lower cost of equity than publicly-listed corporations whose durability is reflected in a trading history producing a reliable beta. The real world capital markets seem to reject that odd notion.

[150] *See* JX 22 at 46.

of 11.5%. For my valuation, I will use that same industry beta of 0.69, and giving approximately equal weight to the pure CAPM and Fama-French methods, I will use a discount rate of 12%.

d. The Court's DCF Valuation Conclusion

Having determined the necessary DCF components for calculating its projected cash flows, the final issue is determining how to value PNB's terminal cash flows. The experts used different techniques for calculating terminal value. Hargrove used an exit multiple based on minority trading data from his dubious comparable companies, a less favored technique that raises questions about whether it embeds a minority discount. Clarke, by contrast, used the preferred method of estimating a perpetual growth rate. Clarke assumed a perpetual growth rate of 5%.[151] Although that rate may be a tad aggressive, the defendants did not spend time quarreling with that perpetual growth rate, either in Hargrove's pre-trial rebuttal report[152] or in post-trial briefing. Furthermore, PNB does have growth prospects. I have used modest growth assumptions during the projection period, and a 5% terminal value simply provides for some additional period of real growth higher than the growth of the economy as a whole. For these reasons, and because I generally find Clarke the more reliable expert, I will use Clarke's expected terminal growth rate.

---

[151] *See* Pratt, VALUING A BUSINESS at 186-87.

[152] The only mention of growth assumptions by Hargrove in his rebuttal is an assertion that PNB's five-year compound growth rate was 2.7%. JX 23 at 4. But, he does not attack Clarke's terminal growth rate and himself uses a 5% annual growth rate during his projection period.

Having determined all of the inputs necessary to perform a DCF of PNB, the results are presented in the table below.

(000)	Year 1	Year 2	Year 3	Year 4	Year 5	Terminal
Net Income	$2,310	$2,449	$2,620	$2,777	$2,970	$3,044
Less Additional Capital	(0)	(0)	(290)	(1,059)	(1,112)	(0)
Free Cash Flow	$2,310	$2,449	$2,330	$1,718	$1,858	$3,044
Present Value of Cash Flow	$2,182.52	$2,065.79	$1,755.12	$1,155.26	$1,115.45	$24,673

The sum of PNB's cash flows, then, is $32,947,040, which results in a fair value per share of PNB as of the merger date of $52.34.[153]

That represents a difference of $11.34 per share between the fair value of the shares and the $41.00 merger consideration paid to cashed-out shareholders. The award, then, is $11.34 per share to members of the Plaintiff Class, which consists of 39,672 shares that did not return a proxy (other than the 3,000 disputed shares), abstained from the vote, or voted against the merger but then took the Merger consideration. And, the award to the Appraisal Class is also $52.34 per share. I will now turn to the one minor issue that remains in the litigation: whether the 3,000 disputed shares are entitled to be considered in the Appraisal Class.

[153] That per share figure is based on the number of outstanding shares being 629,452. As mentioned earlier, there is a conflict as to the number of shares outstanding. The number of outstanding shares reported in the Proxy, though, was 629,452, which is the number I use for the per share calculation. Proxy at 19.

VII. Did PNB's Withdrawal As Trustee Permit The 3,000 Shares To Dissent?

The final dispute is whether 3,000 shares that were owned by the estate of a deceased shareholder, Ethel Carlson Hoerner, properly dissented and can be considered among the Appraisal Class. PNB was named as trustee of Hoerner's estate, and Hoerner's two daughters were named as the beneficiaries to receive her shares in equal parts. Both her daughters owned 500 shares of PNB stock in their own names and dissented from the Merger. Once PNB learned of their dissenter status, PNB promptly withdrew as executor for their mother's estate, leaving no time for the estate to perfect its appraisal rights. PNB admittedly resigned because it did not feel it appropriate to dissent (as an executor) from a Merger it was proposing and in which it would be the respondent to the appraisal proceeding. But PNB made no arrangement for a successor and simply resigned, leaving no way for Hoerner's estate to seek appraisal. In fact, it is not clear that PNB even gave notice of its resignation to the daughters before the deadline for seeking appraisal lapsed.

At this juncture, having found that the damages award to the Plaintiff Class is identical to the difference between the fair value of a PNB share and the merger consideration, this dispute is essentially meaningless. In either scenario, the 3,000 disputed shares are entitled to receive the equivalent of the fair value of $52.34 per share.

Nonetheless, I will now determine the proper entitlement of the estate. That is, I will determine whether the estate is a member of the Appraisal Class. The answer to that basic question is simply no — the estate did not perfect its appraisal rights under 8 *Del.*

C. § 262.[154] That said, the beneficiaries of the estate are not left high and dry. PNB, by its own admission, caused the estate to fail to perfect its rights. For that failure as a fiduciary, PNB, which benefited as an appraisal respondent, owes a duty to the estate's beneficiaries to pay the beneficiaries the amount necessary to make them whole — specifically, a quasi-appraisal award. A quasi-appraisal remedy is appropriate for plaintiffs "who may have been wrongfully deprived, even indirectly, of the statutory remedy of appraisal."[155] Here, the beneficiaries have made a showing that they suffered "an equitable injury at the hands of the respondent."[156] Simply stated, PNB withdrew as executor and did not find a replacement when it knew the beneficiaries of the estate were dissenting themselves and would likely request PNB to dissent on behalf of the estate's shares.

VIII. Pre-Judgment Interest

The final issue in this case is the rate at which to award pre- and post-judgment interest. This court has "broad discretion to determine the appropriate rate of interest."[157] The plaintiffs seek the legal rate of interest, which this court has used as a "benchmark" for determining an interest award.[158] The defendants, though, advocate a more nuanced approach — one that takes account of the company's borrowing rate and a prudent investor rate — which this court has employed in calculating a rate of pre-judgment

[154] *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 9.43[B] at 9-108 (stating that "only a stockholder of record has standing to pursue an appraisal" and listing several cases supporting that view).
[155] *Gilliland v. Motorola, Inc.*, 873 A.2d 305, 311 (Del. Ch. 2005).
[156] *Andaloro v. PFPC Worldwide, Inc.*, 830 A.2d 1232, 1233 (Del. Ch. 2003).
[157] *Montgomery Cellular Holding Co., Inc. v. Dobler*, 880 A.2d 206, 226 (Del. 2005).
[158] *Id.*

interest.[159] The reason for utilizing that interest calculation is that it takes account of the benefit received by the company, which was the interest free retention of the award, and the detriment to the plaintiff resulting from the lost opportunity to invest the award.[160]

Therefore, in the presence of a developed record on the prudent investor rate and company borrowing rate, this court typically will award interest using those factors. In this case, Criswell submitted an affidavit for the defendants containing PNB's average borrowing rate and purporting to calculate the prudent investor rate.[161] Criswell, though, offered a prudent investor rate with no equity component. Criswell looked to the average return of money market mutual funds rather than average risk mutual funds, including equity funds, as endorsed by *Chang's Holdings*. Criswell's calculation is not acceptable, as its exclusion of any equity component understated the prudent investor rate.[162] Therefore, I will use the default legal rate of interest, compounded quarterly.[163]

IX. Conclusion

For the foregoing reasons, I find that the Merger was financially unfair to the Plaintiff Class and award the Class the difference between the fair value of a PNB share on the date of the Merger, $52.34, and the Merger consideration, $41.00. That fair value amount, $52.34, also serves as my award to the Appraisal Class and as my quasi-

[159] *E.g.*, *Delaware Open MRI Radiology Assocs.*, 898 A.2d at 343-44; *Chang's Holdings, S.A. v. Universal Chemicals and Coatings, Inc.*, 1994 WL 681091, at *3-4 (Del. Ch. Nov. 22, 1994).
[160] *Ryan v. Tad's Enters., Inc.*, 709 A.2d 682, 705 (Del. Ch. 1996).
[161] JX 53.
[162] *See, e.g.*, *Doft & Co. v. Travelocity.com Inc.*, 2004 WL 1152338, at *11 (Del. Ch. May 20, 2004).
[163] *Ryan*, 709 A.2d at 705.

appraisal remedy for the 3,000 disputed shares. The parties shall prepare an implementing order. Costs to the plaintiffs.