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## Corporations - Appraisal Statutes - Elements In Valuation of Corporate Stock

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## COMMENTS

CORPORATIONS—APPRAISAL STATUTES—ELEMENTS IN VALUATION OF CORPORATE STOCK—Statutes have been enacted in forty-five states, the District of Columbia and the Territory of Hawaii giving a dissenting shareholder the right to demand an impartial appraisal

of the value of his stock in one or more of the following situations: merger, consolidation, charter amendment, or sale of assets.<sup>1</sup> Most of these statutes are silent as to the meaning of value or the elements to be considered in determining value.<sup>2</sup> The purpose of this comment is to consider the elements of stock valuation generally applicable under the statutory appraisal remedies, and to analyze in some detail the interpretation of such a statute in one jurisdiction—Delaware.

## I

Recently this question was examined by the Delaware Court of Chancery in *Sporborg v. City Specialty Stores*.<sup>3</sup> In that case a group of dissenting shareholders brought a proceeding for the appraisal of their shares following a merger.<sup>4</sup> The appraiser fixed the value of the shares at \$30.61. In so doing he used the following value elements and relative weights: (1) market value (10%), (2) earnings value (25%), (3) sales value (25%), and (4) asset value (40%). Both the corporation and the dissenting shareholders filed objections. On review, the court of chancery held that the appraiser erred in giving market value an independent weight since there was no dependable market at or about the effective date of the merger. It further held that the earnings value was miscalculated. The court found that the appraiser should have used not the earnings of a single year but rather the average earnings over a period of time, and it reduced the rate of capitalization from ten to eight in light of the nature of the enterprise (retail ladies' apparel). Sales value was held not acceptable as an independent element of value since it was but another means of reflecting earnings value. Asset value was held correctly determined. Accordingly the court revised the appraiser's valuation of the shares to \$24.74, using only asset value, which was then weighted 40%, and earnings value, which the court weighted at 60%.

## II

Market value, net asset value, and investment value are the three standards which have received almost unanimous recognition

<sup>1</sup> For citations of statutes as of 1952, see 38 VA. L. REV. 915 at 915 to 931 (1952). Since 1952 three other states have enacted appraisal statutes. See Miss. Gen. Laws (1954) c. 201, §3 (fair market value), S.D. Sess. Laws (1955) c. 17, §7 (value at time corporate action was authorized), and 3A Tex. Stat. Ann. (Vernon, 1956) §5.12 (fair value).

<sup>2</sup> Examples of more explicit statutes are Cal. Corp. Code Ann. (Deering, 1953) §§4300 to 4318 (fair market value); N.J. Stat. Ann. (1939) §§14:12-6, 12-7 (market value).

<sup>3</sup> (Del. Ch. 1956) 123 A. (2d) 121.

<sup>4</sup> Del. Code Ann. (1953) tit. 8, §262 (b).

in statutory appraisals of stock. The relative importance of each of these factors varies from one jurisdiction to another, and usually depends upon what the courts deem to be the function of the appraisal.<sup>5</sup> Even within a given jurisdiction the proportional weight assigned to these elements will usually be governed by the nature of the corporation and the type of stock.

A. *Market Value.* Market value generally refers to the price at which the stock was selling on the market prior to the action which is objected to, disregarding any change in price due to the action.<sup>6</sup> Delaware has held that the word "value" in its statute is not synonymous with market value, and that while market value is a factor to be considered, the value of the stock is not to be measured exclusively by market quotations prior to the date of the action complained of.<sup>7</sup> It seems that Delaware will not give a prominent weight to market value even where quotations from a well traded stock are available.<sup>8</sup> Further, Delaware courts have laid aside all consideration of market value where the merger complained of has distorted the entire market,<sup>9</sup> or, as in the *Sporborg* case, where there has been no reliable market for the stock.<sup>10</sup> While New York has also rejected the contention that market value alone is controlling,<sup>11</sup> its decisions in cases where there was a substantial market appear to have favored market value as being presumptively controlling under the New York statutes.<sup>12</sup>

<sup>5</sup> See 28 N.Y. UNIV. L. REV. 1021 at 1022 (1953).

<sup>6</sup> 2 BONBRIGHT, VALUATION OF PROPERTY 828 (1937), points out that market value in a more strict sense would be "utterly inapplicable," for it "reflects the influence of the very sale or merger against which the dissenter is seeking a remedy."

<sup>7</sup> *Chicago Corp. v. Munds*, 20 Del.Ch. 142, 172 A. 452 (1934); *In re General Realty & Utilities Corp.*, 29 Del.Ch. 480, 52 A. (2d) 6 (1947).

<sup>8</sup> *Coe & Co. v. Minneapolis-Moline Co.*, 31 Del.Ch. 368, 75 A. (2d) 244 (1950). This decision permitted a market value weight of 45% for common stock. Other Delaware decisions have seldom weighted market value above 30%.

<sup>9</sup> *Tri-Continental Corp. v. Battye*, 31 Del.Ch. 523, 74 A. (2d) 71 (1950); *Sterling v. Mayflower Hotel Corp.*, 33 Del.Ch. 293, 93 A. (2d) 107 (1952); 38 A.L.R. (2d) 425 at 442 (1954).

<sup>10</sup> *Accord*, *American General Corp. v. Camp*, 171 Md. 629, 190 A. 225 (1937), holding that the court could reject the market value of preferred shares where such were not listed and transactions in the stock were too few to have any effect.

<sup>11</sup> See, e.g., *In re Behrens*, 61 N.Y.S. (2d) 179 (1946), *affd.* 271 App. Div. 1007, 69 N.Y.S. (2d) 910 (1946); *In re Wood*, 103 N.Y.S. (2d) 110 (1951).

<sup>12</sup> *Matter of Marcus*, 191 Misc. 808, 77 N.Y.S. (2d) 529 (1948), *mod.* 273 App. Div. 725, 79 N.Y.S. (2d) 76 at 81, *affd.* 302 N.Y. 881, 100 N.E. (2d) 55 (1951); *In re Deutschmann*, 116 N.Y.S. (2d) 578 (1952); *In re Silverman*, 115 N.Y.S. (2d) 97 at 99 (1952), to the effect that where ". . . there are actual purchases and sales of such stock in substantial volume at and near to the date as of which value is to be determined . . . market value is controlling at least to the extent that it would take strong and convincing evidence of some other fact, as distinguished from mere opinion, to justify a departure from it. . . ."

In Ohio,<sup>13</sup> New Jersey,<sup>14</sup> and California,<sup>15</sup> the statute is expressly phrased in terms of "market value" or "fair market value." Where such language appears, market value has assumed a predominant, if not determinative, role.<sup>16</sup> Strong arguments have been raised, however, against a heavy reliance on market value even in the face of statutory direction in favor of fair market value. It has been pointed out that market processes are largely psychological, and that, because of its speculative nature, market value is frequently out of line with intrinsic worth.<sup>17</sup>

B. *Net Asset Value.* Net asset value is the share which the stock represents in the value of the net assets of the corporation. It is a value based on a hypothetical dissolution and distribution of the corporate assets.<sup>18</sup> The Delaware Supreme Court in *Tri-Continental Corp. v. Battye*<sup>19</sup> has taken the position that the share must be valued as a continuing interest in a "going concern," since this is what the shareholder has been deprived of by the merger or consolidation. Such a view necessarily denies a use of liquidating value as the sole measure of valuation. Broadly speaking, net asset value has assumed real significance (1) where, as in the *Sporborg* case, there has been no reliable market for the stock;<sup>20</sup> (2) where, due to the nature of the corporation, market value and asset value were virtually identical;<sup>21</sup> (3) where the corporation was bordering on dissolution;<sup>22</sup> or (4) where the dissenting shareholders were viewed as holding stock in a company whose legal existence had terminated, and were thus actually entitled to a distribution of its net assets.<sup>23</sup> Several authorities on security analysis

<sup>13</sup> Ohio Rev. Code Ann. (Page, 1954) §1701.80 (fair cash value).

<sup>14</sup> N.J. Stat. Ann. (1939) §§14:12-6, 12-7.

<sup>15</sup> Cal. Corp. Code Ann. (Deering, 1953) §§4300 to 4318.

<sup>16</sup> See *Prall v. U.S. Leather Co.*, 6 N.J. Misc. 967, 143 A. 382 (1928), *affd.* 105 N.J.L. 646, 146 A. 916 (1929).

<sup>17</sup> See 40 CALIF. L. REV. 140 at 144 (1952).

<sup>18</sup> 2 BONBRIGHT, VALUATION OF PROPERTY 831 (1937).

<sup>19</sup> 31 Del.Ch. 523 at 526, 74 A. (2d) 71 (1950). See also *Chicago Corp. v. Munds*, 20 Del.Ch. 142, 172 A. 452 (1934). *Accord*, *Porges v. Vadsco Sales Corp.*, 27 Del.Ch. 127, 32 A. (2d) 148 (1943), where court refused to use liquidation value as the sole test in an action to determine fairness of a merger.

<sup>20</sup> *In re Fulton*, 257 N.Y. 487, 178 N.E. 766 (1931).

<sup>21</sup> *In re General Realty & Utilities Corp.*, 29 Del.Ch. 480, 52 A. (2d) 6 (1947), where assets consisted of one-third cash and two-thirds securities.

<sup>22</sup> *Allaun v. Consolidated Oil Co.*, 16 Del.Ch. 318, 147 A. 257 (1929).

<sup>23</sup> *American General Corp. v. Camp*, 171 Md. 629 at 637, 190 A. 225 (1937): "The owner of shares of stock in a corporation whose legal existence is at an end would be entitled to receive the aliquot proportion . . . in the distribution of the net amount of corporate funds in which his particular kind of stock would be entitled to share."

have recommended that asset value should at best be a secondary consideration to investment (i.e., earnings, dividend) value.<sup>24</sup>

Delaware has recognized that net asset value may not properly be omitted as a value factor in an appraisal proceeding.<sup>25</sup> In practice, the relative weight given to asset value has been largely related to the nature of the corporation's business. Typically, net asset value has been weighted as high as 50% in the case of an investments and property holding company<sup>26</sup> and as low as 20% for an ordinary manufacturing company.<sup>27</sup> A net asset value weight of 40% was approved in the *Sporborg* case where the merging corporation was in the women's specialty sales business. The court stressed that the firm's investment and expansion policies accounted for the relatively heavy weight accorded asset value.<sup>28</sup> In ascertaining asset value, Delaware has approved recourse to reproduction cost rather than original cost, apparently allowing appraisers a discretionary choice between the alternative methods.<sup>29</sup>

C. *Investment Value.* Investment value is an estimate of present worth in light of past, present, and prospective financial records of the company. If the court takes the view, as does Delaware, that a shareholder is being deprived of his proportional share in a "going concern" in which he might otherwise continue to share in its earnings and dividends in the indefinite future, it would seem that investment value would most appropriately reflect this earnings and dividends loss.<sup>30</sup> Earnings are usually the key

<sup>24</sup> "In the case of stocks, however, earning power [must be] put ahead of the value of the assets. The return to stockholders is contingent on the net earnings per share . . . the primary purpose . . . is to avoid buying issues that are apt to fail." DICE AND EITEMAN, *THE STOCK MARKET*, 3d ed., 417 (1952). Cf. GRAHAM AND DODD, *SECURITY ANALYSIS*, 3d ed., 477 to 478 (1951); 40 CALIF. L. REV. 140 (1952).

<sup>25</sup> See *Sterling v. Mayflower Hotel Corp.*, 33 Del.Ch. 293 at 308, 93 A. (2d) 107 (1952); 38 A.L.R. (2d) 425 at 442 (1954).

<sup>26</sup> *In re General Realty & Utilities Corp.*, 29 Del.Ch. 480, 52 A. (2d) 6 (1947).

<sup>27</sup> *Heller v. Munsingwear*, 33 Del.Ch. 593, 98 A. (2d) 774 (1953) (established manufacturer of hosiery, underclothing, and sleeping wear). See *Coe & Co. v. Minneapolis-Moline Co.*, 31 Del.Ch. 368, 75 A. (2d) 244 (1950).

<sup>28</sup> (Del.Ch. 1956) 123 A. (2d) 121 at 127: "However, I believe the asset value element must be given somewhat greater weight here because, for some time, Opol was using more than an average amount of its assets to expand and improve its business activities and much of this was not yet reflected in earnings."

<sup>29</sup> *Heller v. Munsingwear*, 33 Del.Ch. 593 at 596, 98 A. (2d) 774 (1953). This seems to make it clear that net asset value is not necessarily synonymous with book value, though the court did take account of obsolescence by reducing the weight of net asset value.

<sup>30</sup> See 1 DEWING, *FINANCIAL POLICY OF CORPORATIONS*, 5th ed., 287 (1953): ". . . in spite of practical difficulty . . . the capitalization of earnings is the only means . . . for determining the value of a going business." *Dudley v. Mealey*, (2d Cir. 1945) 147 F. (2d) 268 at 270 (citing cases): "The Supreme Court has several times said that the best test of the value of a going commercial enterprise is its earning capacity."

factor in value and are what the dissenting shareholder surrenders.<sup>31</sup> Further, it is generally true that the trend of market prices is to a high degree dependent on the pattern of earnings.<sup>32</sup>

In calculating investment value, it is necessary (1) to establish an earnings figure and (2) to select an appropriate rate of capitalization.<sup>33</sup> In the *Sporborg* decision the Delaware court disapproved the appraiser's use of earnings derived only from the fiscal year immediately preceding the effective date of the merger, expressing its preference for an averaging of earnings over a reasonable period of time.<sup>34</sup> Delaware has also approved of the use of estimated future income rather than actual past earnings as a base for capitalization.<sup>35</sup> In regard to the rate of capitalization, close attention must be paid to the characteristics of the particular corporation, comparing each corporation's rate of earnings with those of other similarly situated enterprises. Recent Delaware cases have approved capitalization rates that are "within the range of reason,"<sup>36</sup> and the *Sporborg* case used the classifications of Mr. Dewing as a general guide to reasonableness.<sup>37</sup>

Though most jurisdictions recognize investment value as applicable in appraisal proceedings,<sup>38</sup> few have given this element particular emphasis, and only Delaware appears to have accorded it a consistently significant position. The first mention by the Delaware courts of the role of investment value was in *Allied Chemical*

<sup>31</sup> Cf. DOWRIE AND FULLER, INVESTMENTS, 2d ed., 512 (1950); GRAHAM AND DODD, SECURITY ANALYSIS, 3d ed., 410 to 411 (1951); Bonbright, "The Problem of Judicial Valuation," 27 COL. L. REV. 493 at 522 (1927).

<sup>32</sup> DICE AND EITEMAN, THE STOCK MARKET, 3d ed., p. 417 (1952). See 40 CALIF. L. REV. 140 at 144, 145 (1952): "In stripping the market value of its unfairness courts are in reality finding investment value. In reason, this should be so, for if the market were an unemotional, purely logical organism it would reflect only the investment value of securities."

<sup>33</sup> For a sampling of many of the factors entering into investment value, see 16 BROOKLYN L. REV. 86 (1950) and 24 TULANE L. REV. 464 (1950).

<sup>34</sup> (Del.Ch. 1956) 123 A. (2d) 121 at 124, 125. The court relied upon *In re General Realty & Utilities Corp.*, 29 Del.Ch. 480, 52 A. (2d) 6 (1947), and 1 BONBRIGHT, VALUATION OF PROPERTY 253 (1937), recommending a three to five year earnings figure. See also *Coe & Co. v. Minneapolis-Moline*, 31 Del.Ch. 368, 75 A. (2d) 244 (1950) and *Heller v. Munsingwear*, 33 Del.Ch. 593, 98 A. (2d) 774 (1953), where five year earning periods were approved.

<sup>35</sup> *In re General Realty & Utilities Corp.*, 29 Del.Ch. 480, 52 A. (2d) 6 (1947).

<sup>36</sup> See *Coe & Co. v. Minneapolis-Moline*, 31 Del.Ch. 368, 75 A. (2d) 244 (1950) and *Heller v. Munsingwear*, 33 Del.Ch. 593, 98 A. (2d) 774 (1953) where multipliers of 5 and 7, respectively, were approved.

<sup>37</sup> I DEWING, FINANCIAL POLICY OF CORPORATIONS, 5th ed., 390 (1953), cited in *Cottrell v. Pawcatuck Co.*, (Del.Ch. 1955) 116 A. (2d) 787 at 791 (multiplier of 7 or 8 approved for manufacturer having large assets).

<sup>38</sup> See *In re Behrens*, 61 N.Y.S. (2d) 179 (1946), *affd.* 271 App. Div. 1007, 69 N.Y.S. (2d) 910 (1946); *In re Northwest Greyhound Lines*, 41 Wash. (2d) 672, 251 P. (2d) 607 (1952). See also 38 A.L.R. (2d) 442 at 466 (1954).

and *Dye Corp. v. Steel and Tube Co.*,<sup>39</sup> where the court held that earning power controls over replacement cost. In 1947, the court of chancery approved a weight of 25% for earnings and dividends value in appraising the stock of an investment company,<sup>40</sup> and in 1950 expressed satisfaction with a weight of 30% to 35% for the same factors in the case of a manufacturing company.<sup>41</sup> Subsequently, in 1953, the court increased the influence of the dividend and earnings factors from 45% to 50% in the case of an ordinary manufacturing corporation.<sup>42</sup> A further extension of the Delaware courts' reliance on investment value is seen in the *Sporborg* case where investment value is given a final weight of 60% by the court with the indication that it would have received greater consideration but for certain special circumstances.<sup>43</sup>

### III

The question naturally arises as to what justification there is for the weighting which finally is assigned to the value elements in a given case. Initially, of course, the weights are assigned in the discretion of the appraiser who, in Delaware, is appointed by the court of chancery.<sup>44</sup> Prior to 1943 it seemed that neither the Delaware Court of Chancery nor the federal district court had the power to compel appraisers to modify their decisions as to the value of stock.<sup>45</sup> Since 1943, however, exceptions to the appraiser's report have been heard before the chancery court on both the law and the facts, and the court has determined the final value and directed payment.<sup>46</sup> The court has held that the appraiser should state the value of the elements given independent weight and the weight given to each in reaching the appraised value,<sup>47</sup> and it has felt free to make "such modifications as may be dictated."<sup>48</sup> In

<sup>39</sup> 14 Del.Ch. 64, 122 A. 142 (1923) (an action to enjoin the sale of assets).

<sup>40</sup> In re General Realty & Utilities Corp., 29 Del.Ch. 480, 52 A. (2d) 6 (1947).

<sup>41</sup> *Coe & Co. v. Minneapolis-Moline Co.*, 31 Del.Ch. 368, 75 A. (2d) 244 (1950).

<sup>42</sup> *Heller v. Munsingwear*, 33 Del.Ch. 593, 98 A. (2d) 774 (1953).

<sup>43</sup> Note 28 supra.

<sup>44</sup> Del. Code Ann. (1953) tit. 8, §262 (e). In some jurisdictions the appraiser is chosen by the parties themselves or the court makes the appraisal. See 38 VA. L. REV. 915 at 930 (1952).

<sup>45</sup> *Root v. York Corp.*, (D.C. Del. 1944) 56 F. Supp. 288 [under Del. Rev. Code (1935) §2093]. However, the state court could refuse to order the dissenting shareholders to deliver over their shares.

<sup>46</sup> Del. Code Ann. (1953) tit. 8, §262 (f).

<sup>47</sup> *Coe & Co. v. Minneapolis-Moline*, 31 Del.Ch. 368 at 372, 75 A. (2d) 244 (1950).

<sup>48</sup> In re General Realty & Utilities Corp., 29 Del.Ch. 480 at 490, 52 A. (2d) 9 (1947), quoting *Application of Behrens*, 61 N.Y.S. (2d) 179 at 182 (1946), affd. 271 App. Div. 1007, 69 N.Y.S. (2d) 910 (1946).



deciding whether changes should be made the court has taken the general position that the elements and weights assigned by the appraiser will be sustained if they are not "arbitrary or unreasonable."<sup>49</sup> The presumption in favor of the appraiser's determination, however, is at best a tenuous one, for the chancery court's determination of what weights are not arbitrary or reasonable appears to be highly discretionary<sup>50</sup> and predictable, if at all, only by reference to prior cases with analogous facts.

#### IV

It appears from the foregoing that the function of an appraisal has been held by the Delaware courts to be compensation of a dissenting shareholder for his loss in a "going concern." In measuring the present worth of this lost right, the *Sporborg* decision apparently reflects a trend of increasing judicial approval of a greater role for investment (including earnings and dividends) value in statutory appraisal proceedings.<sup>51</sup> It seems that such a trend has the dual desirability of diminishing the role of the many speculative factors found in market value and of avoiding excessive treatment of the appraisal as primarily a liquidation proceeding which seems contrary to valuation on a "going concern" basis<sup>52</sup> and inconsistent with the expectations of the average stockholder in making his investment. This is not to suggest that market value and asset value are irrelevant to a meaningful valuation or to say that these elements may not often be of great significance. The weight given to any value factor will always be closely related to the nature of the corporation and the character of the stock. It is felt, however, that investment value is the most realistic measure of the interest which the dissenting shareholder has lost in a "going concern" as a result of the merger, consolidation, amendment, or sale of assets.<sup>53</sup>

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<sup>49</sup> *Coe & Co. v. Minneapolis-Moline*, 31 Del.Ch. 368 at 374, 75 A. (2d) 6 (1950).

<sup>50</sup> *Tri-Continental Corp. v. Battye*, 31 Del.Ch. 101 at 115, 66 A. (2d) 910 (1949): "Any weighting of the factors is, of course, arbitrary. . . ."

<sup>51</sup> It is interesting to note that the increasing reliance by the Delaware courts on investment value has apparently not been affected by the nature of the enterprise. See notes 39 to 43 *supra*.

<sup>52</sup> See 2 BONBRIGHT, VALUATION OF PROPERTY 831 to 834 (1937).

<sup>53</sup> See *id.* at 834: "Value based on hypothetical market value of a continuing investment . . . should become the prevailing [standard], subject to modifications in special cases." Cf. *In re Fulton*, 257 N.Y. 487, 178 N.E. 766 (1931).