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CORPORATIONS-STANDARD OF VALUATION OF DISSENTERS' STOCK UNDER APPRAISAL STATUTES

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CORPORATIONS—STANDARD OF VALUATION OF DISSENTERS' STOCK UNDER APPRAISAL STATUTES—It was a well established rule at common law that fundamental changes in the character of a corporate enterprise could be accomplished only with the consent of all of the stockholders.[1] However, the growth and development of modern corporations necessitated abrogation of this rule of unanimity. As a result, state legislatures enacted statutes authorizing consolidations and mergers with the consent of only a prescribed majority of the shareholders.[2] It was recognized that for business convenience, the majority group must have power to determine the future course of the corporation's business and yet the individual stockholder should not be forced to remain in an enterprise substantially different from that in which he had originally invested. Therefore, provisions were adopted effecting a compromise between these divergent interests by giving the dissenters an opportunity to withdraw from the corporation and to receive payment of the appraised value of their shares.[3]

[1] 15 FLETCHER, CYC. CORP., perm. ed., §7063 (1932); Nice Ball Bearing Co. v. Mortgage Building and Loan Assn., 310 Pa. 560, 166 A. 239 (1933); Kean v. Johnson, 9 N.J. Eq. 401 (1853). These cases seem to base the rule on an implied contract between the stockholders that the corporate assets shall be employed only for certain uses and they recognize that the shareholders have a common ownership interest in the corporate assets. In Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209 (1920), the court considered an exception to the general rule where there is no reasonable prospect of future earnings. The minority stockholders had several remedies. They might enjoin or set aside the transaction or sue for the value of their shares on a theory of a wrongful conversion of their interest in the corporation. See Garrett v. Reid-Cashion Land & Cattle Co., 34 Ariz. 245, 270 P. 1044 (1928).

[2] The requirements of the different statutes vary. In Michigan, approval depends upon a vote of shareholders representing two-thirds of the total number of shares of each class of stock. 15 Mich. Stat. Ann. (1937) §21.52.

[3] A discussion of the general purposes of this type of legislation is found in Chicago Corporation v. Munds, 20 Del. Ch. 142 at 149, 172 A. 452 (1934). It has been suggested that these appraisal provisions were motivated in part by a fear that without such provisions these statutes authorizing fundamental changes in existing corporations might be declared unconstitutional. See BALLANTINE, CORPORATIONS 700 (1946); Lauman v. Lebanon Valley Railroad Co., 30 Pa. 42, 72 Am. Dec. 685 (1858).

The most difficult problem presented by this type of legislation is the determination of an adequate standard of valuation for the dissenters' stock. At the outset, it should be recognized that there are two separate elements of this problem. First, there is a need for a definition of value which is a matter of substantive law and which will constitute a delimitation of the rights of the dissenting shareholders. Second, there is the matter of estimating the value of a particular share of stock in a dollars and cents figure. This is a problem of evidentiary law.[4] Obviously, there must be a fairly precise definition of value as a prerequisite to an intelligent approach to the evidentiary problem. It is in this respect that the existing statutory provisions are inadequate. Most of the states make no real attempt to give a definition of value but speak in general terms of "fair value,"[5] "value,"[6] "fair cash value,"[7] "fair market value"[8] or merely provide that the dissenter shall receive payment for his shares.[9]

As a result of this failure to provide an adequate legislative standard for appraisal, when such a proceeding is instituted, the board of appraisers or the court[10] must determine not only the actual estimate of the value of given corporate shares, but they must also attempt to define the value concept suggested by the statute. This has the effect of increasing the burdens of this type of litigation and makes the appraisal remedy an expensive one, thereby seriously impairing its effectiveness.[11] The stockholder owning a small number of shares may be placed in a position where he is forced to accept the merger plan or concede to the settlement price offered by the corporation because he cannot withstand the expense of a full hearing on the question.[12] On the other hand,

[4] For an excellent general discussion of this valuation problem see 2 BONBRIGHT, THE VALUATION OF PROPERTY 811 (1937).

[5] Iowa Code (1950) §491.112; Ill. Rev. Stat. (1951) c. 32, §157.70.

[6] Del. Rev. Code (1935) §2093; 6 Ind. Stat. Ann. (Burns, 1948) §25-236.

[7] 15 Mich. Stat. Ann. (1937) §21.54; 1 La. Rev. Stat. (1950) §12:52.

[8] Cal. Corp. Code (1947) §4300. For a discussion of valuation under this statute see 40 CALIF. L. REV. 140 (1952).

[9] In general the terms used in the statutory provisions have had little effect on the results actually reached by the courts. For a general discussion of the various statutes see Lattin, "Remedies of Dissenting Stockholders Under Appraisal Statutes," 45 HARV. L. REV. 233 (1931); Weiner, "Payment of Dissenting Shareholders," 27 COL. L. REV. 547 (1927).

[10] Most of the statutes provide for the appointment of a board of appraisers selected by the parties. However, in some states the actual initial appraisal is made by the court.

[11] For a very critical analysis of the inadequacies of these statutory provisions see S.E.C. REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, Part VII, 590 at 604 (1937).

[12] The states vary in the manner of assessment of costs of the appraisal proceeding. Some require the corporation to pay them in all events. Others provide for a splitting of

the corporation may be seeking the merger because of an unstable financial position so that the threat of a prolonged appraisal proceeding makes it vulnerable to coercive settlement negotiations. At any rate, it does not present a situation where both parties may have a more or less definite idea of their respective rights in a particular situation so that fair and just negotiations may be made resulting in an extrajudicial settlement.[13] Lacking a clear definition of value in their present statutes, a number of alternatives have been considered by the courts of the several states.

I. *Judicially Recognized Standards*

A. *Hypothetical Dissolution and Distribution of Assets.* Several courts have equated the merger situation with a dissolution of the old corporation and therefore rule that the value to which the dissenter is entitled is the net asset value or "intrinsic value" of his shares.[14] This necessitates a general valuation of the physical assets of the corporation to determine what the dissenter would receive if an actual liquidation were effected.[15] There is a logical difficulty in this approach in that an analogy to a dissolution is paradoxical inasmuch as the purpose of the appraisal statutes is, in a sense, to prevent a dissolution which may otherwise result from an application of the common law rule of unanimity.[16] This standard is also objectionable from the practical standpoint of increasing the burdens of the appraisal proceeding, for the

costs between the parties or assess them against the party whose contention as to value is rejected. Also, it is not clear just what items will be included in recoverable costs. See S.E.C. REPORT cited in note 11 supra. It is interesting to note that in Louisiana, where the majority voting for the plan exceeds 80% of the voting power, dissenters have no right to appraisal and payment. This would appear to be based on the idea that such small minorities are merely harassing the corporation. See La. Rev. Stat. (1950) §12:52.

[13] A fair extrajudicial settlement is clearly the best solution to an intracorporate controversy. Some of the statutes recognize this fact by setting up procedural requirements which force the parties to enter into negotiations. See for example the provisions in the Ohio General Corporation Act, 6 Ohio Gen. Code Ann. (Page, 1939) §8623-72.

[14] American General Corp. v. Camp, 171 Md. 629 at 637, 190 A. 225 (1936), reached this result under a statute requiring appraisal at a "fair value." The court said the owner was entitled to the ". . . aliquot proportion which the number of shares held would be entitled to receive in the distribution of the net amount of the corporate funds in which his particular kind of stock would be entitled to share." See also Petry v. Harwood Electric Co., 280 Pa. 142, 124 A. 302 (1924); Roessler v. Security Sav. and Loan Co., 147 Ohio St. 480, 72 N.E. (2d) 259 (1947).

[15] The usual procedure is to appraise all of the corporate assets, including good will, and from the total of the asset values subtract all claims against the corporation having priority over the stock being appraised and divide the result by the number of shares outstanding.

[16] Where there is a substantial minority preventing a merger or consolidation under the common law rule, the only practical alternative is to agree to a dissolution.

evidentiary problems of working out a hypothetical dissolution of a large corporation would be enormously time-consuming and expensive.[17] Furthermore, it is more in accord with the realities of this situation to say that the effect of the appraisal provision is forcing a sale of the dissenter's interest in a going concern.[18]

Closely related to this standard of "intrinsic value" is the suggestion that the book value of the stock be taken as a minimum.[19] This is unsound since book value has almost no relation to actual worth of the stock.[20] Book value is often inflated or deflated for particular purposes irrespective of the actual earning power of the stock and the assets of the corporation. Neither reproduction value nor carrying assets at cost less depreciation reflects the essential element of the earning capacity of the assets.

B. *Market Quotations—Actual Market Price.* If the particular stock in question is a listed security on a national exchange and its market quotation has been relatively stable for some time prior to the consolidation or merger, appraisal proceedings will seldom be instituted because the dissenting shareholder will usually accept the market value of his shares. Therefore, these hearings ordinarily involve stock having a fluctuating market value or stock in a closely held corporation where the shares are traded in small over-the-counter transactions. In both of these situations, the adoption of actual market value as the general standard of appraisal gives rise to difficulty. Actual market quotations as determined from sales on the exchange will in many cases reflect the influence of the plan for merger or consolidation.[21] Often such a trans-

[17] In Matter of Marcus, 273 App. Div. 725, 79 N.Y.S. (2d) 76, affd. without opinion in 303 N.Y. 711, 103 N.E. (2d) 338 (1951), a New York court refused to consider net asset value because the plaintiff's small interest in the corporation did not justify the expense of a detailed asset valuation. This case is noted in 65 HARV. L. REV. 1243 (1952).

[18] This idea received recognition in the Indiana statute which expressly provides that the county courts in these appraisal hearings shall use the same practice and procedure, so far as practicable, as that used under the eminent domain laws of that state. 6 Ind. Stat. Ann. (Burns, 1948) §25-236.

[19] New Mexico has a special provision requiring that a dissenter be paid "the market value of his stock which shall in no event be less than the book value of the stock according to the last balance sheet of the selling corporation" where the transaction involved is a sale of the corporate assets. See 4 N.M. Stat. Ann. (1941) §54-231. No such language is found in §54-906 applicable to consolidations and mergers.

[20] For a general criticism of book value as a valuation standard, see Borg v. International Silver Co., (2d Cir. 1926) 11 F. (2d) 147 at 152; 2 PAUL, FEDERAL ESTATE AND GIFT TAXATION §18.33 (1942).

[21] See Robinson, "Dissenting Shareholders; Their Right to Dividends and the Valuation of Their Shares," 32 COL. L. REV. 60 at 73 (1932). The author points out the extreme case of a market such as that of 1929-31 as an example of an abnormal market which would make exchange quotations a completely unreliable valuation standard.

action will be anticipated in the market months in advance of its actual effectuation. Moreover, the taking of actual market price opens the door to manipulation of the underlying market forces by the promoters of the merger plan. In the case of the small corporation with closely held shares, the fact that there are few sales of the stock obviously precludes acceptance of the market value as an accurate appraisal of their worth. Most courts recognize these factors and refuse to apply market value as a general standard except in situations where the statute expressly calls for it.[22]

C. *Value Enhanced or Diminished By Sale or Merger.* Principles of fairness would seem to dictate that the shares should not be valued with consideration given to the effects of the proposed merger plan. The dissenting minority should not be given the advantage of a legitimate transaction which they have objected to and attempted to frustrate. Neither should they be penalized by it. Therefore, whatever standard is adopted, the shares should be valued as if the corporate action which the dissenters decline to ratify had not been taken or contemplated. Several states have statutes which expressly provide that the appraisers should exclude appreciation or depreciation of the shares' value resulting from the merger.[23]

D. *General Methods Used by the Appraisers.* Because of the confusion resulting from the failure to provide an adequate statutory definition of value, the ordinary appraisal proceeding is a complex aggregation of evidentiary detail. The appraisers will usually consider all of the alternative standards of value and admit all evidence having a possible relevance to any of them.[24] Commonly the result reached will constitute a compromise between several different possibilities, each

[22] See Chicago Corporation v. Munds, 20 Del. Ch. 142 at 150, 172 A. 452 (1934); Cole v. Wells, 224 Mass. 504 at 513, 113 N.E. 189 (1916); general collection of cases in 95 A.L.R. 922 (1935).

[23] New Jersey has such a provision. See N.J. Rev. Stat. (1937) §14:12-6: ". . . to appraise the full market value of his stock, without regard to any depreciation or appreciation thereof in consequence of the merger or consolidation." See also N.M. Stat. Ann. (1941) §54-906.

[24] Ahlenius v. Bunn & Humphreys, 358 Ill. 155 at 168, 192 N.E. 824 (1934), presents a typical decision. There the court reviews a number of cases and concludes that, "A situation is presented which calls for the exercise of judgment upon consideration of every relevant evidential fact and circumstance entering into the value of the corporate property and reflecting itself in the worth of corporate stock." Among the things which are ordinarily considered are earning capacity, dividends records, size of the accumulated surplus applicable to dividends, general business record of the corporation and its prospects for the future with relation to its position in the industry, value of the good will of the corporation, book value, etc. See cases collected in 162 A.L.R. 1237 (1946) and 174 A.L.R. 960 at 962 (1948).

being given a certain definite weight.[25] Consequently, it is almost impossible to predict in advance the outcome of a particular proceeding.

II. *Hypothetical Market Value as a Proposed Standard*

Reference has already been made to the suggestion that thinking on this valuation question may be clarified somewhat by dividing the general problem into its constituent elements: (1) a definition of the rights of the dissenting shareholders, (2) a definition of the standard by which these rights are to be measured, and (3) the actual measurement of these rights by an application of the standard of valuation. The first two elements of this problem would seem to be a matter for legislative determination while the third is clearly more of an administrative nature which will be the function of the appraisal boards and courts. It has previously been pointed out that in most states at the present time the entire problem is left with the courts. The judicial process by its very nature is directed toward a determination of the particular facts presented in the litigation before it and cannot adequately provide general guides to future action.[26] Therefore, an attempt should be made to find a better solution on the legislative level.

Historically, judicial thinking on the rights of a corporate shareholder has followed the logical pattern of private property. The courts have considered stockholders as proprietary owners of the corporate business, contributing capital to the enterprise and sharing a common ownership of the physical assets of the corporation.[27] However, the development of the corporate form of business enterprise has in reality destroyed this concept. Control over the actual physical assets of the corporation has been greatly centralized in the management group.[28] The economic concept of the corporation is that the management or control group will take charge of the physical property of the corpora-

[25] Thus in Re General Realty & Utilities Corp., 29 Del. Ch. 480, 52 A. (2d) 6 (1947), the Delaware court appraised the stock by giving asset value 50% weight, market value 25% weight and value based on estimated future earnings 25% weight.

[26] In most of the appraisal cases the courts expressly refuse to lay down a general valuation standard and limit their opinions to the facts presented before them. See Ahlenius v. Bunn & Humphreys, 358 Ill. 155, 192 N.E. 824 (1934).

[27] This would appear to be the basic philosophy behind the common law rule of unanimity.

[28] Limitations of space preclude an extended discussion of this proposition. However, consideration might be given to the present position of the individual stockholder with regard to such matters as participation rights in corporate assets, the right to a fixed position in a fixed capital structure, the right to invest additional capital in the enterprise, changes in the corporate charter, and the general control over the future course of the business. These matters are discussed in BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, chapters I, II, and III of Book II (1932).

tion and utilize it to produce earnings which may then be distributed to stockholders. In practical effect, the modern stockholder is little more than a risk-taker, a supplier of capital for a profit-seeking enterprise.[29] It would appear then that we are not really dealing with property in the traditional sense and the logic applicable to the stockholder's interest in the corporation may also be changed. Actually, this has already been done by the law without an express recognition of it. The very matter giving rise to the appraisal problem is a tacit recognition of this development. The legislature's provision that a merger or consolidation may be effected with less than unanimous approval of the shareholders is in itself a part of this separation of control from the individual stockholders. Therefore, it is suggested that the basic consideration behind any proposed standard is that what the dissenting shareholder must forego is the expectation of a participation in the earnings of the corporation. This, in effect, is the interest which must be valued.

As a theoretical proposition, a dollars and cents appraisal of this expectation of earnings is provided by the securities market. The measure of worth given by the market is the result of agreement between a willing buyer and a willing seller, assuming that there is available an adequate supply of information upon which to make such an appraisal. It is true of course that in practical effect there may be conditions and factors operating in the market which would upset this theoretical determination. It would not be sufficient, then, in most cases to accept the market quotations as the actual appraisal of corporate shares. Yet, the fact that actual market value is not conclusive and is not strictly accurate does not detract from the proposition that the general standard of value should correspond to a theoretical market appraisal. In a given case, the appraisers should ask: "Upon what price would a willing buyer and a willing seller agree if no merger had been contemplated?"[30] Admittedly such a definition of value is quite general. However, it is clear that this matter does not admit of the establishment of a common mathematical formula.

Given such a standard with which to work, the appraisers may then consider the relevant evidence in estimating such value in terms of actual dollars and cents. The general methods used and the evidence to be considered should correspond by and large to the methods used

[29] This is the conclusion reached in BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). See discussion in chapters V and VI of Book I and chapters VII and VIII of Book II.

[30] This standard of valuation is suggested by Professor Bonbright. See 2 BONBRIGHT, VALUATION OF PROPERTY 834 (1937).

by investment bankers and securities brokers in evaluating stocks. Where there is a market quotation on a national exchange, such price would ordinarily constitute a starting point. It would then be in order to consider the underlying elements of this price to determine whether or not it has been influenced to any substantial degree by undesirable factors. Clearly, the corporate earnings history will be important and in most cases there will be a heavy reliance on capitalization of earnings and capitalization of dividends figures. More evidentiary problems will arise in the case of a small, closed corporation with unlisted securities, but the same general standard of valuation should be helpful in such a situation as a guide through the maze of evidentiary detail.

Some states have indicated a tendency to adopt this proposed approach to the appraisal problem.[31] Statutes calling for "fair market value" seem to indicate an acceptance of this type of analysis. However, the decisions under such statutes do not give express recognition to this general standard.[32]

Conclusion

It is submitted that hypothetical market value as a standard for appraisal of a dissenter's stock in a merger or consolidation transaction will make the statutory remedy a more meaningful one. While it does not purport to be a precise formula for measuring value, it does provide a general guide for determining the relevancy of possible considerations. This, it is hoped, will give more direction to these valuation proceedings to the end that actual litigation on the question will be somewhat more efficient and less burdensome. Moreover, it should serve as a valuable aid to extrajudicial negotiation and settlement without undue coercion on either party. In this way, perhaps, the general purposes of the appraisal statutes, i.e., a fair compromise between conflicting intracorporate interests, will be more fully realized.

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[31] In a comment in 17 FORDHAM L. REV. 259 (1948), the writer analyzes a group of decisions under §21 of the New York Stock Corporation Act and concludes at p. 267 that in New York the rule running through the cases is that "the value of the stock to be appraised is what the stock will sell for in a normal market."

[32] A number of cases decided under such statutes actually apply a net asset value approach.