THE DELAWARE APPARISAL STATUTE

BY J. KIRKLAND GRANT *

At common law, the shareholder had the power of vetoing an action to prevent almost any kind of corporate change.[1] This was based on the theory that he had invested in one type of going concern and that the majority shareholders and the management should not be allowed to change the basic characteristics of that concern without unanimous shareholder approval and acquiescence.[2] Without this, an investment could be subjected to unreasonable risk after the initial capital commitment.[3]

This strict policy obviously hindered otherwise legitimate corporate activities, and modern corporation statutes have taken away this veto right from the individual shareholders.[4] In 1931, Ballantine[5] noted that because these statutes were experimental they left a number of questions unanswered. Based on our discussion thus far, and probably for the remainder of the day, we still find that the appraisal statutes, even fifty years later, still appear to be experimental and still leave a number of questions unanswered.

Appraisal can be expensive for the corporation because the costs of the appraisal process normally are assessed against the corporation, in the absence of any bad faith on the part of the shareholder-dissenter.

The major question in appraisal is the valuation of the shares. The secondary question is the procedure which must be followed to perfect a shareholder's right to appraisal. There are two other questions: Is appraisal, as it occurs under the Delaware statute,[6] really

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1. *See, e.g.,* Voeller v. Neilston Co., 311 U.S. 531, 535 n.6 (1941); Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 595-96 (1921); Levy, *Rights of Dissenting Shareholders to Appraisal and Payment,* 15 CORNELL L.Q. 420 (1930); Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes,* 45 HARV. L. REV. 233, 234 (1931).

2. *See* Chicago Corp. v. Munds, 20 Del. Ch. 142, 172 A. 452 (1934).

3. *Id.*

4. *See, e.g.,* DEL. CODE ANN. tit. 8, § 262 (Supp. 1981); N.J. STAT. ANN. §§ 14A:11-1, :11-3 (West Supp. 1981), :11-4, :11-5 (West 1969), :11-6 (West Supp. 1981), :11-7 to :11-11 (West 1969); N.Y. BUS. CORP. LAW § 623 (McKinney Supp. 1980); PA. STAT. ANN. tit. 15, § 1515 (Purdon) (Supp. 1981).

5. Ballantine, *Questions of Policy in Drafting a Modern Corporation Law,* 19 CALIF. L. REV. 465 (1931).

6. DEL. CODE ANN. tit. 8, § 262 (Supp. 1981).

equivalent to the "fair value" of the shares? Is the intrinsic value equivalent to the "fair value"?

Additionally, are shareholders really investors these days, or do we have the institutional investors and perhaps even the normal investor voting by their feet? In other words, instead of being concerned with the impact on the company of a particular fundamental corporate change, will that investor merely unload his stock holdings? Do we have the traditional long-term investor concept in a publicly-held corporation any more?

There are other considerations as well, such as proper purpose and fairness. However, I do not propose to discuss these. I would just like to point out that fairness is not a federal question under SEC rule 10b-5,[7] as we are aware.

Delaware has never recognized the appraisal right in anything other than a merger or consolidation situation,[8] but the corporate charter can provide for other instances where appraisal might be provided for shareholders of a given company.

Normal statutory appraisal rights would have been denied in: (1) a sale of assets for a consideration other than cash; (2) a charter amendment; or (3) a merger or a consolidation.[9] Remember that these three instances will only apply if there is an appropriate charter provision.

Finally, in Delaware, the terms of the merger or consolidation itself can provide appraisal as a matter of contract right, not statutory right.

There are situations where appraisal is not permitted in Delaware. The two major items, of course, concern stock listed on a national securities exchange or where there are more than 2,000 shareholders of record.[10]

The remedy is exclusively statutory. The shareholder must comply, and must neither vote in favor of nor consent to the merger. This does not require the shareholder to cast a vote; it just requires that the shareholder not vote in favor of or consent to the particular merger.

The items relating to the right of appraisal are fairly well-stated. The definition of stockholder is clearly stated in the statute as are the statutory formalities.

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7. 17 C.F.R. § 240.10b-5 (Supp. 1981).

8. DEL. CODE ANN. tit. 8, § 262 (Supp. 1981).

9. Some states allow appraisal in these situations. *See, e.g.*, CAL. CORP. CODE ANN. §§ 181, 1300 (1977); GA. CODE ANN. § 22-1201 (1977); CAL. CORP. CODE ANN. §§ 151, 1300 (1977); 33 S.C. CODE § 33-13-270 (1981).

10. DEL. CODE ANN. tit. 8, § 262(b)(1) (Supp. 1981).

The reason for these clear definitions and the statutory formalities is to provide the corporation with certainty and also to indicate that the right of appraisal cannot be purchased. A share which has not previously dissented cannot be purchased with the hope of joining in the class of shares which are in the dissenting shareholder-petitioner situation.

The procedure is made much clearer and more readable in the amendments to the statute which are now being proposed.[11] They accomplish this by stating the appraisal right as an affirmative right. When and how appraisal is permitted is stated affirmatively rather than negatively.

The stockholder is entitled to a copy of the statute at the time notice of the transaction is approved [12] or has been approved if a short-form merger.[13] Additionally, the stockholder is entitled to specific notification of his rights of appraisal. A mere summary of the appraisal right statute cannot be used; rather, a copy of the statute must be provided. But a question remains: How many investors in the small investor, widow, or orphan class can really understand what they are supposed to do upon reading the present Delaware statute?

The shareholder is then required to make a written demand. Unlike some states, Delaware has no real requirement other than that the demand reasonably inform the corporation that the shareholder intends to dissent. A letter is sufficient. Even a rather nebulous letter, as in the *Bell v. Kirby Lumber* [14] case, is sufficient.

It is interesting to note that, in Delaware, a shareholder is not required to include all his shares for appraisal.[15] I suppose this is the result of the broker/street-name phenomenon,[16] but it could also be a problem in a situation where the corporation is attempting through merger and the exercise of appraisal rights to freeze-out a large or particularly obstreperous minority shareholder. When he or she is allowed to participate in appraisal for only a portion of the shares, perhaps this is just a thaw-out instead of a freeze-out.

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11. *See* DEL. CODE ANN. tit. 8, § 262 (1981). (These amendments have now been enacted—*editor's note.*)

12. This would include consent of stockholders in lieu of a meeting. DEL. CODE ANN. tit. 8, § 228 (1974).

13. DEL. CODE ANN. tit. 8, § 253 (1976).

14. Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. Ch. 1978). The shareholders' letter was nebulous in that it explicitly rejected the offer, but only impliedly requested appraisal.

15. Colonial Realty Corp. v. Reynolds Metals Co., 185 A.2d 754 (Del. Ch. 1962), *aff'd*, 41 Del. Ch. 183, 190 A.2d 752 (1963).

16. This is the situation where shares are held in the broker's account and in the broker's name ("street name") rather than the customer-investor's name.

MR. FENTON: Does *Colonial Realty*[17] deal only with a broker's holdings or does it specifically say that an individual can have it both ways?

DEAN GRANT: It is quite clear that since the remedy is exclusively statutory—and the statute makes no reference to dissenting to all of one's shares—one can split the shares. The *Colonial Realty* case is a broker street-name case.

MR. FENTON: Some Delaware lawyers take the position that an individual would have to go one way or the other.

DEAN GRANT: I would not opine on it. In any event, the burden is on the shareholder to establish his right to appraisal. The question is whether or not he is again a shareholder under the statute.

The withdrawal of demand is also interesting. Once the demand is made, and once the corporation or the dissenting shareholder has gone to the court of chancery, there is no corporate consent required within the first sixty days in order for the shareholder to withdraw his demand. This is unlike some statutes which provide that once a demand has been sent in by the shareholder and he has voted against the particular transaction he cannot withdraw his dissent without corporate consent.

The amendments which are proposed remove any doubt about the jurisdiction of the court of chancery to determine appraisal rights. They specifically provide that the court of chancery is the proper court of first hearing.[18]

The corporation must file a verified list of all dissenting shareholders within ten days—twenty days under the new provisions.[19] There are some additional language changes proposed. The major change is the reinstatment of a provision that existed in Delaware prior to 1976: The corporation must pay for the notice to the shareholders and for the publication notice. The publication notice does not have to appear only in a Wilmington newspaper, but can appear anywhere in Delaware.[20]

Also, the court of chancery has discretion as to whether or not to require the delivery of the certificates for a notation that these shares are subject to dissent. This is a problem, especially if the

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17. Colonial Realty Corp. v. Reynolds Metals Co., 185 A.2d 754 (Del. Ch. 1962), *aff'd*, 41 Del. Ch. 183, 190 A.2d 752 (1963).

18. DEL. CODE ANN. tit. 8, § 262(a) (Supp. 1981).

19. DEL. CODE ANN. tit. 8, § 262(f) (Supp. 1981).

20. *Id.*

shares are transferred to a bona fide purchaser without being subject to this notation.

Then we come to the language with which we are really concerned for the balance of today's discussion: "The Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger." [21] Another wrinkle in Delaware is that each dissenting shareholder can participate in the proceedings. Question: Might that not be burdensome? Might the appraisal litigation not be unmanageable?

The Chancellor appoints the appraiser. In fact, if the Chancellor appoints a master to hear the particular appraisal argument, under Chancellor Seitz's opinion in *Adams v. R.C. Williams Co.*,[22] then the appraiser must even have the court's approval to hire expert witnesses to assist him in appraisal.

Value is judged on a number of factors. The basic premises that Delaware adopts are the traditional "going concern" and "entire fairness" concepts. When entire fairness is discussed, we are only discussing the entire fairness of the appraisal process itself, not the entire fairness of the transaction. As the appraisal determination is reviewed, the question is fairness in the evaluation process, not the transaction.

Bell v. Kirby[23] maintains that the basic concept of value under the appraisal statute is what the shareholder is entitled to be paid for what has been taken from him—his proportionate interest in a going concern. By "value of the stockholder's proportionate interest in a corporate enterprise" is meant the true or intrinsic value of his stock which has been taken away as a result of the merger or consolidation. In determining what this figure represents, the appraiser and the court must take into consideration all factors and elements which reasonably might enter into the fixing of a value.

Thus, the standard includes the elements of market value, asset value, dividends, and earnings prospects—the future prospects, not of the merged enterprise, but of the business before the combination. In addition, any other facts which are known or could be ascertained as of the date of the merger and which throw any light on any future prospects of the uncombined business are not only pertinent to the inquiry, but must be considered in determining the appraised value.

Consequently, appraisal case review is normally a question of what constitutes the process in determining the value. The process is

21. DEL. CODE ANN. tit. 8, § 262(h) (Supp. 1981).

22. Adams v. R.C. Williams, 38 Del. Ch. 346, 152 A.2d 112 (1959).

23. Bell v. Kirby Lumber Corp., 395 A.2d 730 (Del. Ch. 1978), *aff'd in part rev'd in part*, 413 A.2d 137 (Del. 1980).

really one of isolating the factors which will be used in the particular appraisal. Each factor must first be valued: the weighted average of each factor then must be taken in order to determine the statutory requirement of an intrinsic or fair value. In essence, what we are really doing is determining a number of different measures of value.

First, we can have the earnings value. Typically the earnings value is historical, an average over a period of time. One year has been held to be too short.[24] Five years is usually good, as illustrated by the *Francis I. duPont*[25] and *City Specialty Stores*[26] cases.

The dividend value is also reflective of a value and can be considered in appraisal.

Market value usually relates to stock market transactions on the date of the merger. In order to use market value, there must be sufficient activity to justify the existence of a market price. The market price obviously must not be created by the bidders in a takeover situation.

A hypothetical market value can also be created by approximating the earnings of the company, determining its earnings value, and approximating the status of the company with other companies, in order to determine a multiplier; then, by using comparable companies and their price earnings ratios and this multiplier on the day of the merger, we can determine a reconstructed market value or hypothetical market value.

The problem here is whether or not the risk factor has been taken into account. How does the risk in this company compare to those comparable companies, and how should it affect their price earnings multiples as applied to this particular enterprise? All the enterprises obviously have different capital structures and different kinds of organization, and so forth.

The cases and the writers indicate that the probable way of accomplishing an earnings and market value figure to determine this hypothetical market value is to compare typical industries. The Dewing approach in *The Financial Policy of Corporations*[27] is still being used in today's cases, the distinction being the cyclical versus the stable industry.

Asset value is normally a willing buyer and a willing seller.[28] The actual transaction is, of course, the best example. A physical

24. Sporborg v. City Specialty Stores, Inc., 35 Del. Ch. 560, 123 A.2d 121 (1956).

25. Universal City Studios, Inc. v. Francis I. duPont & Co., 312 A.2d 344 (Del. Ch. 1973), *aff'd*, 334 A.2d 216 (Del. 1975).

26. Sporborg v. City Specialty Stores, Inc., 35 Del. Ch. 560, 123 A.2d 121 (1956).

27. DEWING, THE FINANCIAL POLICY OF CORPORATIONS (3d ed. 1934).

28. Bell v. Kirby Lumber Corp., 395 A.2d 730 (Del. Ch. 1978).

appraisal is probably the next best example. It is unusual, the cases indicate, not to have one.[29]

Book value, reproduction value, book value less depreciation, can all be used. The question is whether liquidation value can be used, and that is clearly answered. Liquidation value can be used only if there is a present plan to liquidate. The appraisal statute is very clear. The enterprise is to be valued as a going concern.

Insurance value may also be used if that has any relevance.

As to the intangibles, Wendell, I think you are an expert on this one. Can the value of a lawsuit that you may or may not recover on be used?

MR. FENTON: No.

DEAN GRANT: That is supported by *Tannetics v. A.J. Industries.*[30]

The question of synergistic effect of a merger is normally not considered. Mr. Klein [31] has indicated that it is difficult to determine the synergistic effect. I really question whether he is correct because hasn't the market already taken into account the synergistic effect in the value of the stock on the day of the merger? In any event, synergism is not an appropriate factor according to the case law, especially the *Tanzer* [32] case, because it is not part of the statute. Additionally, *Tanzer* stated, in dicta, that because there was a premium over the market price offered to the shareholder, this may have adequately compensated the minority shareholders for whatever synergistic effect there was.

If market price is truly reflective of future earnings potential, then it seems inconsistent that a premium over market price would not be in excess of Delaware's definition of intrinsic value. I cannot reconcile these concepts. The *Adams v. R.C. Williams* [33] case also concurs on this point.

Finally, there is the question of what kind of interest and costs should be assessable against the corporation in an appraisal matter. Interest is a purely statutory right, recoverable only if it is in the

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29. Adams v. R.C. Williams Co., 38 Del. Ch. 346, 152 A.2d 112 (1959).

30. Tannetics v. A.J. Indus., No. 5306 (Del. Ch. July 17, 1979), *reprinted in* 5 DEL. J. CORP. L. 337 (1980) (discussing the valuation of intangibles).

31. *See* p. 583 *supra.*

32. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).

33. Adams v. R.C. Williams & Co., 38 Del. Ch. 346, 152 A.2d 112 (1959).

statute. The commentators indicate that interest is a matter of simple justice, and all appraisal statutes call for it.[34]

Lattin[35] stated that the shareholder should retain all rights as a shareholder. If his status is lost, then he should be paid the highest legal interest rate. His rights must be secured so that, if he loses his status as a shareholder or if the deal does not go through, he will receive the same benefits as the majority shareholders.

Some states take the position that shareholder rights are reserved during the period of appraisal, thinking that the particular transaction might not go through. Of course, that is not really the case, because at the time the petition has been filed the transaction normally has already been consummated.

Most states terminate shareholder rights after a filing of dissent. The proposed revisions to the Delaware statute indicate that after the shareholder has filed his demand he will then become a type of creditor of the corporation instead of continuing to be a shareholder. The problem here is a conceptual one. Once you file for dissent and perfect that dissenting right status, if the corporation is then entitled to treat you as a non-shareholder for the purposes of voting, for the purposes of dividends and other distributions, and for other purposes, how can you be said to be a shareholder? But, then, what is the nature of your capital remaining in the enterprise? Are you a creditor? Not according to most statutes. Since the appraisal remedy is exclusively statutory, the cases indicate that appraisal is the process by which the right of compensation to a shareholder is determined; consequently, the shareholder is not a creditor. What about the interest award? Is the shareholder entitled to interest or not?

Interest should be required. The question then is what rate, and here there is some Delaware language relating to the type of calculation that must be entered into in order to determine the rate of interest.[36]

What about the compounding of interest? It is not covered in the statutes. What about the interest period? Normally the period

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34. Grant, *Appraisal Rights; Allowance for Prejudgment Interest*, 17 B.C. INDUS. & COM. L. REV. 1 (1975).

35. LATTIN, THE LAW OF CORPORATIONS § 12-13 (1959).

36. The court shall determine interest, if any, and equitable taxation of costs and expenses of stockholders, including attorney's fees and expert's fees and expenses. The matter of allowing interest is left to the court's discretion. Felder v. Anderson, Clayton & Co., 39 Del. Ch. 76, 159 A.2d 278 (1960); Sporborg v. City Specialty Stores, Inc., 35 Del. Ch. 560, 123 A.2d 121 (1956). Payment of award by decree may or may not include payment of interest for prejudgment period. *See* Grant, *Appraisal Rights; Allowance for Prejudgment Interest*, 17 B.C. INDUS. & COM. L. REV. 1 (1975).

during which interest accrues is the period during appraisal, after demand, after the corporate action took place.

MR. FENTON: Excuse me. Is interest incurred from the effective date of the merger until the date of the judgment?

DEAN GRANT: Yes, from the effective date of the merger until the date of the judgment, and then the interest accrues at the judgment rate.

The costs are normally against the corporation. They are normally prohibitive in terms of the individual shareholder, especially the small shareholder, bringing these actions, unless he can find somebody who will bring them on a contingent fee basis for him.

MR. FENTON: Prior to the '76 amendment,[37] the one stockholder that brought the appraisal action was responsible for all of the costs. The '76 amendment now permits the costs of the action, including the legal fees, to be spread out over the whole class of dissenting stockholders, which gives a little more incentive to the plaintiff's lawyer.

DEAN GRANT: And more incentive to create it as a class action than otherwise.

The interest, according to Chancellor Marvel,[38] is calculated this way: The average return of short-, medium-, and long-term United States Treasury bills, savings deposits in mutual savings banks, Moody's Triple-A corporate bond averages, and Standard & Poor industrial averages. This is the rate of the prudent investor under the Delaware statute.

Is this an appropriate measure if the standard of what the corporation would have to pay is used, or if the standard of what a corporation in this industry would have to pay, because again the question of risk is being discussed?

MR. FENTON: A couple of other comments. Prior to 1976, the statute called for the appointment of an appraiser by the judge, but that appraiser did not do what one might think an appraiser would do. He acted as a judge himself. He sat back and listened to the evidence and came up with a judgment. He was usually a lawyer, a Delaware lawyer.

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37. DEL. CODE ANN. tit. 8, § 262 (1976), *as amended by* DEL. CODE ANN. tit. 8, § 262 (Supp. 1981).

38. Lebman v. National Union Elec. Corp., 414 A.2d 824 (Del. Ch. 1980); Gibbons v. Schenley Indus., Inc., 339 A.2d 460 (Del. Ch. 1975).

Since the judge did that again when he reviewed the appraiser's decision to enter the judgment, the 1976 amendment abolished the appraiser. It is true that the judge, of course, still had the power under the general rules of court to appoint a master who would fulfill the same function as the abolished appraiser? I do not believe that our chancellors have appointed any masters to carry out the functions of the appraiser since the '76 amendment. They have done it themselves, de novo.

CHAIRMAN MORRIS: Are not all appraisal proceedings, as a practical matter, automatically class actions? Once the action is filed, notice has to go to every stockholder.

MR. FENTON: Every dissenting stockholder.

CHAIRMAN MORRIS: Correct, but that is the only stockholder we are still talking about.

DEAN GRANT: It is only every *remaining dissenting stockholder,* because, during the interim, if there has been a corporate settlement offer which some of the dissenters have accepted, then they are not included in the list which the corporation must file with the court, and for which the court requires notification in Wilmington newspapers and also by registered and certified mail.

Interestingly, it is only this notice which has any requirements of registered or certified mail in the statute.

CHAIRMAN MORRIS: But, after the action is filed, the dissenting stockholder who has initiated it cannot leave the scene by making a settlement on his or her own. Notice has to be given. In the one experience I have had, we followed the same procedure as we would have followed had we had a settlement of representatives.

DEAN GRANT: That is right. The court of chancery has to approve the withdrawal of any dissenting shareholder after the action has been filed according to the present statute.

MR. KLEIN: Dean Grant, I have a problem with your evaluation of market value and synergistic value. In most of the cases, the freeze-out merger is not something that happens instantly. The freeze-out merger is a case of attrition normally over a year or more, which means that the number of shares on the market is being reduced rather continually. For some period of time—in my experience maybe a year or two or more—the market is so thin that it is unlikely to represent anything.

DEAN GRANT: You are talking, of course, about the freeze-out merger. If you are talking about a non-freeze-out merger, the synergistic effect should be reflected.

MR. KLEIN: No, it need not be. It won't necessarily be.

MR. FENTON: I think we ought to move on, though I hate to cut you off. Thank you very much.

CHAIRMAN MORRIS: Before you cut the Dean off, I want to make one comment about the revisions to title 8, section 262. The Senate Judiciary Committee considered those at a meeting on Wednesday, and I am pleased to report that we were told by Senator Sharp, Chairman of the Committee, that the Committee will report those out favorably. These amendments have already passed the House and the Governor has already evidenced his support.[39]

MR. FENTON: Is my understanding correct that they may be effective July 1?

CHAIRMAN MORRIS: That is correct.

DEAN GRANT: If I may again stress that the most significant part of these amendments, from a theoretical and instructional point of view, is defining the dissenting shareholder as a creditor after the dissent has been filed and perfected.

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39. These amendments have now been enacted—*editor's note.*