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Delaware's Appraisal Statute: The Courts' Artificial Ceiling on Asset Valuation Weighting

Prices have increased dramatically during the past decade. This is particularly true for natural resource prices. Companies owning such resources have seen these assets become an increasingly significant indicia of their intrinsic worth.¹ Consequently, the general business community views natural resource corporations differently than it views other types of corporations.² Businesses will frequently make an investment, acquisition, or merger decision by valuing such a corporation's assets with little or no regard to the corporation's other attributes.³

Although the Delaware courts⁴ have recognized the importance of asset holdings in natural resource corporations, they have only reluctantly emphasized asset value when valuing dissenting shareholders' stock under Delaware's appraisal statute.⁵ This reluctance stems from a judicially-imposed limitation on the amount of weight which may be given to a corporation's assets when valuing the stock.⁶ Until recently, this limitation posed no problem since asset value rarely comprised the bulk of a corporation's total value. The tremendous rise in natural resource prices, however, has recently made the limitation a barrier to a more realistic appraisal.

This note analyzes the courts' limitation on asset weighting. Part I discusses Delaware's appraisal statute and the system of valuation developed by Delaware courts; Part II examines weighting of the asset valuation; and Part III suggests a more practical approach to valuing natural resource corporations.

1 See Part III A. *infra*.

2 See notes 85-86 *infra* and accompanying text.

3 See notes 87-89 *infra* and accompanying text.

4 The Delaware appraisal approach has been chosen for its position as a model for other states, the large number of national corporations incorporated in Delaware, the many decisions in that jurisdiction which deal with the appraisal statute, and the relatively standardized approach the Delaware courts have for valuing a corporation. See Comment, *Short-Form Merger in Missouri: Potential Problems for Minority Shareholders*, 46 MO. L. REV. 195, 196 (1981). See also Banks, *Measuring the Value of Corporate Stock*, 11 CAL. W.L. REV. 1, 26, 34 (1974). Thus, while discussion here specifically addresses Delaware's appraisal schemes, Delaware's pervasive influence in the area of corporate law makes the discussion applicable to all jurisdictions with a similar appraisal statute.

5 DEL. CODE ANN. tit. 8, §262 (1974 & Supp. 1980). See notes 69-71 *infra* and accompanying text.

6 See Part II *infra*.

I. The Delaware Appraisal Statute

A. *Erosion of Minority Shareholder Veto Rights*

Under general common law a corporation could not make a fundamental change without unanimous shareholder approval.⁷ Thus a dissenting shareholder⁸ owning a single share could essentially veto the corporation's sale or merger. As the demands and complexities of modern business increased, this veto power debilitated corporate management.⁹ Legislatures responded by enacting merger statutes that denied dissenting minority shareholders this common law power.¹⁰

Although these statutory provisions satisfied the corporation's desire to effect a merger without unanimous consent, they left the shareholder with a difficult decision. Deprived of his veto power, a dissenting shareholder had to either become a shareholder in the new corporation or sell his stock.¹¹ Neither choice was necessarily palatable to the shareholder. If he became a shareholder in the new corporation he was investing in an entity which refused to follow his preferred policies. If he sold his stock he had to accept either the market price or any price the corporation offered. In many cases, an active market did not exist or the market price did not reflect the stock's true value.¹²

Delaware and other states have adopted appraisal statutes in response to this inequity.¹³ These statutes authorize a dissenting minority shareholder to request an appraisal of his stock. Under the Delaware statute, the court determines the stock's "fair value" and directs the surviving or resulting corporation to pay this value to the dissenting shareholders.¹⁴ Unfortunately, the statute fails to explain how to determine a share's "fair value" other than to say that it does

7 See Note, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453 (1966).

8 As used in this note, a dissenting shareholder is one who objects to a corporate merger or consolidation "and has not voted in favor of or consented to the merger or consolidation." DEL. CODE ANN. tit. 8, §262(b) (Supp. 1980).

9 See Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023, 1027 (1976).

10 *Id.* at 1028.

11 See Comment, *Bell v. Kirby Lumber Corp.: Ascertaining "Fair Value" Under the Delaware Appraisal Statute*, 81 COLUM. L. REV. 426, 427 (1981).

12 See notes 52-54 *infra* and accompanying text.

13 See DEL. CODE ANN. tit. 8, §262 (1974 & Supp. 1980). All states enable dissenting minority shareholders to demand the appraised value of their stock. See Note, *supra* note 7, at 1453.

14 See DEL. CODE ANN. tit. 8, §262(f), (g) (Supp. 1980).

not include any value associated with the merger.¹⁵ Thus, the judiciary developed valuation methods to satisfy the statute's purpose.

B. *Valuation Methods: The Judiciary's Flexible Approach*

When a merger or consolidation occurs, a dissenting shareholder often decides to relinquish his stock in the corporation.¹⁶ In the early case of *Chicago Corp. v. Munds*,¹⁷ a Delaware court explained that the appraisal remedy existed in order to give the minority shareholder "what he has been deprived of," the value of a shareholder's stock.¹⁸ To determine the "intrinsic value" of that stock,¹⁹ Delaware courts have adopted a relatively flexible valuation method. Based on the premises that all corporations are unique and that every relevant factor should be considered,²⁰ a court will normally determine three separate valuations—a market valuation, an investment valuation, and an asset valuation.²¹

Market valuation is determined by calculating the price at which a willing seller would transfer a share of stock to a willing buyer.²² If the stock is actively traded, this calculation is relatively simple. The applicable quotation for that stock will provide the necessary information. If the stock is not actively traded, however, the calculation becomes more complicated. The court must attempt to find a "hypothetical market value" for such stock.²³ In determining this value, the court will normally look to similar companies that have an active market for their stock.²⁴ It may also refer to the cor-

15 See DEL. CODE ANN. tit. 8, §262(f) (Supp. 1980).

16 See text accompanying note 11 *supra*.

17 20 Del. Ch. 142, 172 A. 452 (1934).

18 See *id.* at 150, 172 A. at 455.

19 The term "intrinsic value" is repeatedly referred to by the courts as the amount that a dissenting shareholder should receive from the appraisal. See *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216, 218 (Del. 1975); *In re Delaware Racing Ass'n*, 42 Del. Ch. 406, 415, 213 A.2d 203, 209 (Sup. Ct. 1965); *Tri-Continental Corp. v. Battye*, 31 Del. Ch. 523, 526, 74 A.2d 71, 72 (Sup. Ct. 1950).

20 See 31 Del. Ch. at 526, 74 A.2d at 72 (Sup. Ct. 1950). See generally Note, *The Dissenting Shareholder's Appraisal Remedy*, 30 OKLA. L. REV. 629 (1977) (concluding that each case must be viewed in context of its own unique facts).

21 See Note, *supra* note 7, at 1457. Dividend value occasionally has been calculated, but most cases rely exclusively on the investment, market, and asset valuations, apparently feeling dividend considerations are adequately reflected in those calculations. But see *In re Delaware Racing Ass'n*, 42 Del. Ch. 406, 213 A.2d 203 (Sup. Ct. 1965) (dividend value weighted at 10%); *Heller v. Munsingwear, Inc.*, 33 Del. Ch. 593, 98 A.2d 774 (Ch. 1953) (dividend value weighted at 25%).

22 See Note, *supra* note 7, at 1463.

23 *Id.*

24 *Id.*

poration's earnings prospects. Finally, the court will arrive at an appropriate figure—the price at which a hypothetical seller would transfer a share of stock to a hypothetical buyer.²⁵

Investment valuation is determined by a two-step process: 1) calculation of the corporation's annual earnings; and 2) selection of a multiplier.²⁶ Courts usually calculate a corporation's annual earnings by taking its average earnings over the past five years.²⁷ Selection of a multiplier depends upon the soundness and predictability of the earnings.²⁸ The product of the multiplier and the earnings calculation results in the corporation's investment valuation.²⁹

Asset valuation is determined by calculating the corporation's theoretical liquidation value. The corporation is viewed as if it were being dissolved and its assets distributed to its shareholders or sold to third parties. The assets' hypothetical liquidation values are totalled to reach the asset valuation figure.³⁰

After calculating these valuations, the court assigns a specific weight to each.³¹ Delaware courts use two significant factors in determining the weight given to each particular valuation: the type of company being appraised and the reliability of the valuation.³² In considering the first factor, Delaware courts apply different degrees of weight to a particular valuation depending on its relative impor-

25 *Id.*

26 *Id.* at 1464.

27 *Id.*

28 *Id.* at 1464, 1467.

29 *Id.* For example, if a stock had per share average earnings of \$2.00 and a selected multiplier of 10, the earnings times the multiplier would result in an investment valuation of \$20.00.

30 Prior to the decision in *Poole v. N. V. Deli Maatschappij*, 243 A.2d 67 (Del. 1968), there was confusion among the Delaware courts whether the asset valuation should be calculated on a liquidation or potential earnings basis. The court in *Poole* rejected the potential earnings approach for asset valuation and held that the asset valuation is to be determined by the fair market value of the corporation. *Id.* at 72. The court thus rejected earnings considerations for asset valuation, stating, "[a]ny allowance for earning power of the assets or value of the business, deemed necessary under the circumstances of a given case, is best left to the court's consideration of earnings as an independent element of stock value and to the court's exercise of its weighting function." *Id.* See Comment, *supra* note 11, at 429 n.26.

31 For example, in *Lebman v. National Union Electric*, 414 A.2d 824 (Del. Ch. 1980), an electronics manufacturing firm was assigned a market value weight of 40%, an investment value weight of 35%, and an asset value weight of 25%. *Id.* at 828. In *Lebman*, the weights were typical for a manufacturing firm's valuation. Such a company normally relies much more heavily on earnings than on liquidation value for intrinsic worth. Consequently, the investment and market valuations, which largely depend upon the company's earnings for their calculation, received more weight than the asset valuation. *Id.* See notes 65-66 *infra* and accompanying text.

32 See Note, *supra* note 7, at 1468-71; Note, *supra* note 20, at 640-43.

tance to the corporation's intrinsic value.³³ The second factor reflects the court's confidence in a particular valuation. A valuation relying on conjecture and unpredictable estimates normally receives less weight. Conversely, a particularly reliable valuation based on fairly predictable events normally receives more weight.³⁴

Weighting the three separate valuations ensures that no single valuation is exclusively determinative, thus minimizing the inherent defects in calculating those figures.³⁵ Weighting also allows the court to emphasize a specific valuation if that valuation is more indicative of the corporation's true worth.³⁶ Finally, weighting provides the court with a flexible method to mold its valuation around the corporation's particular attributes.³⁷

Generally, the Delaware valuation process provides a workable solution to the problem of valuing a dissenting shareholder's stock.³⁸ It uses empirical facts to formulate reasonable values from different viewpoints and provides the flexibility necessary to emphasize those facts as each case warrants.

C. *Recent Refinements*

While the Delaware courts' valuation method is laudable, there remain at least two drawbacks to the appraisal remedy itself. First,

33 See, e.g., *Universal Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216 (Del. 1975) (motion picture studio depended heavily on earnings, not assets for its value); *In re Olivetti Underwood Corp.*, 246 A.2d 800 (Del. Ch. 1968) (investment and market value received most weight for typewriter manufacturer); *Jacques Coe & Co. v. Minneapolis-Moline Co.*, 31 Del. Ch. 368, 75 A.2d 244 (Ch. 1950) (market value emphasized because corporation had an active market for its stock); *In re General Realty & Utils. Corp.*, 29 Del. Ch. 480, 52 A.2d 6 (Ch. 1947) (assets weighted more heavily because the corporation depended more on value of real estate and securities than on good management).

34 See, e.g., *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 123 A.2d 121 (Ch. 1956) (market value disregarded because it was artificially sustained); *Heller v. Munsingwear, Inc.*, 33 Del. Ch. 593, 98 A.2d 774 (Ch. 1953) (asset valuation deemphasized because that value was so dissimilar to other values).

35 Note, *supra* note 20, at 640 (1977).

36 *Id.* at 640-43.

37 *Id.* See also Note, *supra* note 7, at 1468-71. Confronted with a highly leveraged corporation, for example, the court may wish to minimize extremely high earnings. It could accomplish this by decreasing the weight given to the earnings valuation. Similarly, the court could increase the asset valuation's weight when confronted with a corporation relying extensively on its assets, such as a natural resource company. See Part III *infra*.

38 For other suggested appraisal methods, see generally Brudney and Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (appraisal should include value of gains generated by merger); Birk, *Shareholder's Appraisal Process: Need for Reform*, 51 N.Y. ST. B.J. 274 (1979) (appraisal should be analogous to eminent domain proceedings); Note, *The Valuation of a Close Corporation: Glimpses of Objectivity in an Inflationary Period* 13 LOY. U. CHI. L.J. 107 (1981) (valuation should be based on book value as adjusted for inflation).

the shareholder is virtually forced to sell his stock,³⁹ and second, certain shareholders are not protected by the appraisal statute.⁴⁰

When a shareholder sells his stock, he often incurs a tax liability.⁴¹ This liability would not exist or at least could be deferred if the dissenting shareholder was not forced to sell his stock. Thus, after adjustment for tax liabilities, the appraisal remedy normally gives the shareholder less value than the stock had to him before its sale.⁴² Such a result fails to accomplish the appraisal statute's purpose of giving the dissenting shareholder "what he is deprived of."

The Delaware courts have lessened, although not eliminated, the negative effect of the appraisal statute's forced sale feature by allowing a minority shareholder to block a merger under certain circumstances. In a line of cases beginning with *Singer v. Magnavox Co.*⁴³ the courts have held that the transaction must meet the standard of "entire fairness."⁴⁴ If the sole reason for effecting a merger is to "freeze-out"⁴⁵ minority shareholders, the court will disallow the merger.⁴⁶ The courts require that the transaction be entirely fair and that the merger have a legitimate business purpose.⁴⁷ Thus, if a dissenting shareholder can establish that a merger is not entirely fair, he will also avoid the forced sale aspect of the appraisal statute.

The appraisal statute's second disadvantage is that it fails to afford the appraisal right to shareholders whose stock was "either (1) listed on a national securities exchange or (2) held of record by more than 2000 stockholders."⁴⁸ Proponents of this "stock market exception" claim that a minority shareholder purchases stock in a widely-held corporation with a mind only toward profits from a future sale.⁴⁹ They argue that such a shareholder has no interest in the nature of the business and that the market price is the value the appraisal procedure is supposed to find anyway.⁵⁰

39 See text accompanying note 11-14 *supra*.

40 See note 48 *infra* and accompanying text.

41 A shareholder's tax liability is determined by the gain, if any, he recognizes upon the sale or disposition of his stock. See I.R.C. §1001 (1976).

42 See Comment, *Shareholder's Rights in Short-Form Mergers: The New Delaware Formula*, 64 MARQ. L. REV. 687, 699 (1981).

43 380 A.2d 969 (Del. 1977).

44 *Id.* at 976.

45 A "freeze-out" refers to any transaction designed to eliminate minority interests in a corporation. See Comment, *supra* note 11 at 427 n.15.

46 380 A.2d 969, 980.

47 *Id.* at 975.

48 DEL. CODE ANN. tit. 8, §262(k) (Supp. 1980).

49 See Note, *supra* note 9, at 1029.

50 *Id.* at 1030.

Commentators severely criticize these arguments.⁵¹ A stock's price frequently reflects factors other than the corporation's intrinsic value. A general market upturn may carry the stock with it although the reason for the upturn may affect the corporation less than the price rise indicates.⁵² Tax selling may occasionally depress a stock's value.⁵³ Finally, a majority shareholder can often manipulate even a large corporation's stock price.⁵⁴ Delaware courts have recognized the unreliability of a stock's market price. Notwithstanding the appraisal statute's edict, they often have valued a corporation's stock in the traditional weighting manner even though an active market for the stock has existed.⁵⁵

Both the courts' refusal to strictly follow the stock market exception and the dissenting shareholders' ability to invoke the entire fairness theory when objecting to a merger have greatly reduced the drawbacks associated with the appraisal remedy. A shareholder may insist that the merger be "fair" to minority shareholders. If unsatisfied with a "fair" merger, the shareholder may ask for an appraisal. This appraisal, if the court takes full advantage of the innovative method of weighting the three valuations, can provide a realistic approximation of the stock's intrinsic value.

II. Asset Valuation Weighting

Delaware courts have devised a commendable method of valuing a dissenting shareholder's stock.⁵⁶ The method's strongest attribute is the flexibility it provides by weighting a particular valuation in a manner reflective of the corporation's specific circumstances. Courts, however, have been reluctant to fully use this flexibility when weighting a corporation's asset valuation.⁵⁷

51 See Brudney and Chirelstein, *supra* note 38, at 306; Comment, *supra* note 42, at 700-01. See generally Brudney, *Efficient Markets and Fair Mergers in Parent Subsidiary Mergers* 4 J. CORP. L. 63 (1978); Note, *supra* note 9.

52 See Schilt, *Pitfalls in the Valuation of Closely Held Companies*, TR. & EST., June 1980, at 44.

53 Tax selling refers to the investment practice of selling stocks toward the end of the year in order to minimize taxes by recognizing capital losses in the stocks that have declined in price. This concentrated selling often depresses a stock's price for a short period. See generally Y. HIRSCH, *THE 1980 STOCK TRADER'S ALMANAC* 109 (1979) (referring to relatively lower prices in December of each year as tax selling occurs).

54 See Note, *supra* note 9, at 1052-54.

55 *Id.* at 1054-60. See, e.g., *Gibbons v. Schenley Indus.*, 339 A.2d 460 (Del. Ch. 1975) (market price given only a 55% weighting); *Greene v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971) (other factors could, in certain circumstances, be considered).

56 See notes 19-38 *supra* and accompanying text.

57 Most decisions center their weighting discussion on the amount of emphasis to be given to the company's asset valuation. See, e.g., *Bell v. Kirby Lumber Corp.*, 413 A.2d 137

This reluctance apparently stems from a misinterpretation of the Delaware courts' "going concern" appraisal standard. This standard causes the courts to view the corporation as an on-going rather than dissolving business.⁵⁸ The court in *Tri-Continental Corp. v. Battye*⁵⁹ said this standard meant that the courts must consider "all factors and elements which reasonably might enter into the fixing of value," including market value, earnings value, and asset value.⁶⁰ This statement conforms to the rationale behind the traditional valuation method.⁶¹ Another of the court's statements, however, apparently generated the judiciary's subsequent reluctance to appropriately emphasize asset valuation. The court said that "since value is to be fixed on a going-concern basis, the liquidating value of the stock may not be accepted as the sole measure."⁶² Courts in subsequent cases have interpreted this as an edict to deemphasize the asset valuation factor, rather than simply a direction to consider factors in addition to asset value. Later cases, therefore, began minimizing asset valuation, consistently citing *Tri-Continental* as support.⁶³

While minimizing the importance of asset valuation, Delaware courts have been willing to give it significant, yet arguably insufficient,⁶⁴ weight when valuing a real estate, investment, or natural resource company. The Delaware courts have correctly recognized that such corporations are different from their manufacturing counterparts. A manufacturing company relies very little on the value of its assets, such as plants and factories, to carry on its business. Rather, these assets have value to the corporation only to the extent that they produce goods that generate earnings.⁶⁵ Consequently, earnings are the most important valuation component to a manufac-

(Del. 1980); *In re Delaware Racing Ass'n*, 42 Del. Ch. 406, 213 A.2d 203 (Sup. Ct. 1965); *Swanton v. State Guar. Corp.*, 42 Del. Ch. 477, 215 A.2d 242 (Ch. 1965); *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 123 A.2d 121 (Ch. 1956); *Jacques Coe & Co. v. Minneapolis-Moline Co.*, 31 Del. Ch. 368, 75 A.2d 244 (Ch. 1950); *In re General Realty & Utils. Corp.*, 29 Del. Ch. 480, 52 A.2d 6 (Ch. 1947).

58 *See, e.g.*, *Tri-Continental Corp. v. Battye*, 31 Del. Ch. 523, 74 A.2d 71 (Sup. Ct. 1950).

59 31 Del. Ch. 523, 74 A.2d 71 (Sup. Ct. 1950).

60 *Id.* at 526, 74 A.2d at 72.

61 *See* notes 19-21 *supra* and accompanying text.

62 31 Del. Ch. at 526, 74 A.2d at 72.

63 *See, e.g.*, *In re Delaware Racing Ass'n*, 42 Del. Ch. 406, 213 A.2d 203 (Sup. Ct. 1965) (assets weighted at 25%); *Levin v. Midland Ross Corp.*, 41 Del. Ch. 276, 194 A.2d 50 (Ch. 1963) (assets weighted at 50%); *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 123 A.2d 121 (Ch. 1956) (assets weighted at 40%); *Heller v. Munsingwear, Inc.*, 33 Del. Ch. 593, 98 A.2d 774 (Ch. 1953) (assets weighted at 20%).

64 *See* Part III *infra*.

65 *See* Comment, *supra* note 11, at 433.

turing enterprise and courts will tend to give very little weight to the value of such a firm's assets.⁶⁶ Investment and natural resource companies, on the other hand, depend primarily on their assets to generate direct earnings, either from return on investment or from appreciation and sale of the assets themselves.⁶⁷ Delaware courts have accordingly weighted such companies' asset valuations more heavily.⁶⁸

Although the courts admit the primacy of asset value in some companies, particularly natural resource companies, their decisions have shown a reluctance to weight assets above 50%, even in cases where the court indicates that assets comprise most of the corporation's value.⁶⁹ The court in *Swanton v. State Guaranty Co.*⁷⁰ considered this 50% limit and concluded that the limit had little, if any, basis. Disregarding the 50% ceiling, the *Swanton* court assigned a 60% weight to a real estate corporation's asset valuation.⁷¹ Subsequent

66 See *Gibbons v. Schenley Indus., Inc.*, 339 A.2d 460 (Del. Ch. 1975) (manufacturing plant assets given 0% weighting since they had value only to the extent they produced income).

67 The court in *Swanton v. State Guar. Corp.*, 42 Del. Ch. 477, 215 A.2d 242 (Ch. 1965), stated:

The capital appreciation investment policy of Guaranty, presumably motivated in part by tax considerations, suggests that placing undue weight in this appraisal proceeding on the normally important earnings factor would give a false picture of the intrinsic value of Guaranty's stock. . . . Also, to the extent the "market" apparently valued this stock on the basis of earnings and dividends it clearly did not give full recognition to its going concern value.

Id. at 482, 215 A.2d at 245 (emphasis added).

68 See, e.g., *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980) (timber products company's assets given 40% weight); *Swanton v. State Guar. Corp.*, 42 Del. Ch. 477, 215 A.2d 242 (Ch. 1965) (investment and real estate company's asset valuation given 60% weight); *In re General Realty & Utils. Corp.*, 29 Del. Ch. 480, 52 A.2d 6 (Ch. 1947) (real estate holding company's asset valuation given 50% weight). See generally *Lynch v. Vickers Energy Corp.*, 402 A.2d 5 (Del. Ch. 1979) (petroleum company's assets given 40% weight).

69 The court in *Levin v. Midland-Ross Corp.*, 41 Del. Ch. 276, 194 A.2d 50 (Ch. 1963), reduced an admittedly important asset valuation weight from 60% to 50%. Conforming to the judiciary's 50% ceiling, the court stated:

[T]he principal factor in the value of the stock was undoubtedly the exceptionally strong asset position of the corporation. I conclude therefore that the appraiser's high weighting of asset value was basically correct. It will, however, principally because of Delaware precedents on this subject be reduced from 60% to 50%.

Id. at 289, 194 A.2d at 58 (emphasis added).

70 42 Del. Ch. 477, 215 A.2d 242 (Ch. 1965).

71 The court in *Swanton* seemed to dismiss the logic of the 50% ceiling by stating:

Defendants emphasize that no reported Delaware case has weighted asset value at more than 50%. Like Professor Dewing's capitalization chart, such a fact is not the "be-all and end-all" here. The court's apparent deference to the 50% figure in *Levin v. Midland-Ross Corp.*,—Del. Ch.—, 194 A.2d 50, is not and indeed, considering the subject matter, could not be considered a rule of law.

cases have not taken *Swanton*'s lead, however, and continue to adhere to an apparent 50% ceiling for asset valuation.⁷²

This limitation has little foundation. Theoretically, a corporation's appraisal should reflect its intrinsic value.⁷³ When a company's assets comprise most of this value, the weighting should emphasize assets to the proper extent. The courts have advanced no jurisprudential reason justifying adherence to a 50% ceiling. The *Tri-Continental* court emphasized that all elements should be considered when appraising a corporation.⁷⁴ It did not say that the asset valuation is unimportant, merely that it is not to be the only factor considered.⁷⁵ The *Tri-Continental* approach is totally consistent with the rationale behind the valuation method. None of the three factors should be solely determinative of a company's value.⁷⁶ The Delaware valuation method provides an inherent flexibility which ensures that the final valuation will be a composite of all the factors, with each factor weighted according to its importance to the corporation's intrinsic value.⁷⁷ The courts apparently have no prohibition against weighting the other valuations above 50%. Investment value has been weighted as high as 87.5%.⁷⁸ The Delaware judiciary should therefore find little difficulty giving the appropriate weight to asset value, even if it does exceed 50%.

Thus, if an appraisal clearly shows that the asset value comprises the bulk of a corporation's intrinsic worth, no apparent reason exists

Id. at 484, 215 A.2d at 246 (emphasis added).

72 The only case since *Swanton* to exceed the 50% ceiling was *In re Creole Petroleum Corp.*, 3 DEL. J. CORP. L. 606 (Del. Ch. 1978). The court in *Creole* held that a 100% asset value weighting was appropriate, distinguishing that case from other appraisal cases because *Creole*'s assets were to be nationalized. Thus, the court did not treat *Creole* as a typical appraisal situation. The corporation was, in essence, valued on a liquidating, not going-concern, basis. The court also tempered the precedential impact of its move above the 50% ceiling by admitting that in other Delaware cases "a maximum weight of 50 percent is preferred." *Id.* at 614. While *Creole* apparently authorizes a higher asset value weighting only upon imminent liquidation, the case still has value to future courts as an example of the 50% ceiling being exceeded.

73 See text accompanying notes 19-21 *supra*.

74 See text accompanying notes 59-61 *supra*.

75 See text accompanying note 62 *supra*.

76 A possible exception exists where the company being appraised faces imminent liquidation. See *In re Creole Petroleum Corp.*, 3 DEL. J. CORP. L. 606 (Del. Ch. 1978) and note 72 *supra*.

77 See notes 19-21, 31-38 *supra* and accompanying text.

78 See *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216 (Del. 1975). Market valuation also has no apparent 50% ceiling as indicated by the appraisal statute's adoption of the stock market exception, see notes 48-55 *supra* and accompanying text, and the 55% weight given market valuation in *Gibbons v. Schenley Industries*, 339 A.2d 460 (Del. Ch. 1975).

for not weighting that value accordingly.⁷⁹ The rationale behind the courts' self-imposed ceiling of 50% remains unexplained.

III. Asset Valuation and Natural Resource Companies

A. *Nonrenewable Natural Resource Companies: A Unique Situation*

Spiraling inflation throughout the past decade has transformed the nature of nonrenewable natural resource companies. The tremendous appreciation of their assets' value often has made that factor the most important element to the corporation's intrinsic value.⁸⁰ The asset valuation of such a company could conceivably comprise over 50% of its worth.⁸¹ Strict adherence to the court's 50% ceiling, however, would deny this fact from being fully reflected in the corporation's appraisal.

Nonrenewable natural resource companies differ from other enterprises. Their income depends on a continual liquidation of their assets. These assets, unlike renewable natural resources, do not replenish themselves.⁸² Thus, any distinction between a corporation's liquidation value and its going-concern value becomes increasingly insignificant when a court appraises a nonrenewable natural resource company.⁸³

Nonrenewable natural resources normally comprise an overwhelming percentage of an oil, gas, or coal company's assets. Such enterprises typically drill, dig, or mine their assets for direct sale to a refiner or other third party. Thus, the corporation's continued existence depends almost exclusively on the value of those resources. If the resources' value decreases, the corporation's value also decreases. If the resources' value increases, the corporation's value increases. The stock price movements of major oil companies are representative

79 Certain commentators observe that investment value often receives a higher weighting because that element traditionally comprises most of a corporation's fair value. *See* Note, *supra* note 20, at 637. This observation, however, fails to address the situation where a court finds that most of a company's value derives from its assets.

80 *See* *Lynch v. Vickers Energy Corp.*, 402 A.2d 5 (Del. Ch. 1979) (asset weighting of 40% was as high or higher than other two weightings). Certain investment services specifically calculate a petroleum company's proven oil reserve value, indicating that such a calculation is often considered an inherent measure of value. *See* 37 THE VALUE LINE INVESTMENT SURVEY RATINGS & REPORTS 1824 (June 18, 1982).

81 The court actually weighted asset valuation at 100% in *In re Creole Petroleum*, 3 DEL. J. CORP. L. 606 (Del. Ch. 1978), although the situation in that case was unique. *See* note 72 *supra*.

82 *See generally* *Bell v. Kirby Lumber Corp.*, 413 A.2d 137 (Del. 1980) (timber was harvested in manner that caused continual replenishment of company's timber assets).

83 *See* notes 58-63 *supra* and accompanying text.

of this relationship.⁸⁴

Both renewable and nonrenewable natural resource companies rely on their assets for intrinsic value when selling either a portion or all of their holdings to another party. The purchasing party and the selling corporation look to the value and appreciation potential of the natural resources when formulating a transaction price.⁸⁵ This process shows a unique attribute of natural resource companies: the corporation's assets are relatively marketable, making asset valuation realistic. Thus, liquidation value uniquely reflects a natural resource company's intrinsic value.⁸⁶

The recent surge of tender offers for natural resource companies⁸⁷ also exemplifies that asset value provides a significant indicia of a natural resource corporation's intrinsic worth. These tender offers consistently include a substantial premium over the stock's original market price.⁸⁸ This premium may reflect synergistic and other attractions to the acquiring corporation. When a natural resource company is the object of the tender offer, however, the major consid-

84 During the 1980 "oil crisis," oil companies' stock prices increased dramatically, far outdistancing any general market increase. During the recent "oil glut," on the other hand, stock prices of the major oil companies fell greatly in excess of any general market decrease. These dramatic increases and decreases in stock prices coincided almost exactly with the price movements in the world oil markets. While the increased stock price undoubtedly reflected prospects for increased earnings as well as an increase in the value of the companies' oil assets, those increased earnings were a direct consequence of oil's appreciation in value; there could have been no increased earnings if the value of the companies' assets had not increased first. This strongly suggests that oil companies rely almost exclusively on the value of their oil for the degree of earnings derived from its sale. See 37 THE VALUE LINE INVESTMENT SURVEY RATINGS & REPORTS 1826 (Sept. 17, 1982) (graph showing stock prices of petroleum companies diverged from general stock prices during 1980 oil crisis and 1981-82 oil glut).

85 This was explained in *Bell v. Kirby Lumber Corp.*, 395 A.2d 730 (Del. Ch. 1978), *aff'd*, 413 A.2d 137 (Del. 1980), where minority shareholders argued that recent sales of lumber companies indicated that asset value, not earnings value, was the primary consideration in setting the sales price. The shareholders explained that the prices offered for these companies represented only a 2% return on investment if calculated solely on an earnings basis. *Id.* at 734. Only when the unrealized appreciation of these assets is considered do the offered prices seem realistic. See Comment, *supra* note 11, at 437.

86 This characteristic fails to hold true for the asset valuation of a typical manufacturing firm where assets are normally unmarketable or must be sold at desperation prices. For example, the court in *Kirby* indicated that a manufacturing company's assets had no independent liquidation value, but had value only to the extent that they generate earnings "because essentially this is the only way such a corporation can generate a return on investment." 395 A.2d at 734.

87 In 1979 there were as many as 114 tender offers, many dealing with natural resource companies. See Note, *Tender Offer Developments in 1980*, 38 WASH. & LEE L. REV. 999 (1981).

88 For example, in a recent tender for Conoco, Mobil Oil Corporation offered to pay \$120.00 per share for Conoco's stock, which was nearly \$70.00 above the \$50.00 pre-tender price. See *Du Pont's Victory*, NEWSWEEK, Aug. 17, 1981, at 49; *The New Urge to Merge*, NEWSWEEK, July 27, 1981, at 50; *Conoco Under Siege*, NEWSWEEK, July 6, 1981.

eration normally concerns the value of the company's assets and their potential price appreciation.⁸⁹

Finally, the appreciation in raw material prices has radically transformed companies owning natural resources. In the early 1970's, such a company's intrinsic worth could have been as much dependent on its management and other business concerns as it was on the value of its assets; now the tremendous rise in the value of its natural resources often causes that factor to be the primary determinant of the corporation's value.⁹⁰

The foregoing factors demonstrate the uniqueness of natural resource corporations. They rely heavily on their asset value for their intrinsic worth. This is particularly true for nonrenewable natural resource companies which constantly liquidate their assets. Such companies provide the clearest example where a court's adherence to an arbitrary limitation would result in an unrealistic valuation.

B. *Bell v. Kirby Lumber Corp.*

The leading Delaware Supreme Court case dealing with the natural resource company issue is *Bell v. Kirby Lumber Corp.*⁹¹ In *Kirby*, the court adopted the "going concern" standard for natural resource company appraisals and upheld a 40% asset valuation weighting for a timber and paper products corporation.⁹² Kirby Lumber had vast timberland holdings which it harvested on a "sustained yield" basis.⁹³ Santa Fe Industries acquired about 95% of Kirby Lumber's stock and consummated a merger under Delaware's short-form

89 In duPont's tender for Conoco, analysts emphasized the value of Conoco's assets stating that by buying the stock of such a company, the offeror receives oil assets at bargain prices, often as low as \$4.00 to \$6.00 per barrel. See *Conoco Under Siege*, *supra* note 88, at 57. Acquisition-minded companies have quickly realized that a resource-rich corporation such as Conoco presents a bargain in terms of natural resources—while Conoco's asset value was estimated at over \$140.00 per share, the company's pre-tender stock price was in the mid 50's. See *The New Urge to Merge*, *supra* note 88, at 50-51. The present bargain stock prices and the general conviction that nonrenewable natural resource prices will continue upward are clearly the major consideration when making a tender offer for a company such as Conoco. *Id.*

90 The increased importance of asset value to nonrenewable natural resource corporations is demonstrated by the past decade's rise in oil prices. Prior to 1973 oil sold on the general market for about \$4.00 per barrel. As recently as 1979 a barrel of oil sold for about \$12.00. Currently, a barrel of oil will command a price of around \$30.00. See THE VALUE LINE INVESTMENT SURVEY RATINGS & REPORTS 1824 (June 18, 1982). Thus, the asset value, in degree of importance to an oil company's intrinsic value, has increased more than seven-fold during the past decade.

91 413 A.2d 137 (Del. 1980), *aff'd*, 395 A.2d 730 (Del. Ch. 1978).

92 *Id.* at 142, 146.

93 Sustained yield, according to the chancery court, "means that [Kirby] harvests and

merger statute. Certain minority shareholders rejected Santa Fe's \$150.00 per share offer as inadequate and asked for appraisal under the Delaware statute. A court-appointed appraiser used the traditional method of valuing and gave the asset valuation a 40% weighting.⁹⁴

The minority shareholders raised two arguments: they objected both to the use of the traditional appraisal method and to the amount of weight attributed the asset valuation. The shareholders first argued that a third party arm's length appraisal method should replace the traditional going-concern approach for natural resource companies.⁹⁵ The shareholders contended that since such companies are normally sold with asset value as the determinative element, "entire fairness" required that asset value should control Kirby's appraisal.⁹⁶ The court rejected this argument by defending the going-concern approach.⁹⁷ The opinion adopted the language of *Tri-Continental Corp. v. Battye* in holding the traditional valuation method adequate for natural resource company appraisals.⁹⁸ Although the decision has been criticized,⁹⁹ the court appears to have come to the right conclusion.

The minority shareholders wanted Kirby's asset value to control the appraisal. The court could have accomplished this simply by weighting asset valuation more heavily.¹⁰⁰ There was no need to adopt a new appraisal method. Kirby's minority shareholders apparently attacked the going-concern standard because they thought it limited the amount of weight the court would give asset valuation. Actually, any limitation on weighting asset valuation derives from the arbitrary 50% ceiling, not the going-concern standard.¹⁰¹

processes its trees at approximately the same rate at which its timber base grows, thus maintaining a constant source of timber reserves." 395 A.2d at 733.

94 The Delaware appraisal statute currently provides that "the Court shall appraise the shares." DEL. CODE ANN. tit. 8 §262(f) (Supp. 1980). Prior to a 1976 revision, however, the appraisal statute provided that "the Court . . . shall appoint an appraiser to determine such value." DEL. CODE ANN. tit. 8 §262(e) (1974). The minority shareholder's request for an appraisal in *Kirby* occurred prior to the appraisal statute's 1976 revision. Therefore, a court-appointed appraiser, rather than the court itself, made the initial appraisal.

95 413 A.2d at 140.

96 *Id.* The minority shareholders argued that Singer's "entire fairness" standard should be extended to appraisal proceedings. This contention was discussed extensively by one commentator. See notes 111-112 *infra* and accompanying text.

97 *Id.* at 141-42.

98 See *Id.*

99 See text accompanying notes 110-112 *infra*.

100 See text accompanying note 120 *infra*; see also note 37 *supra*.

101 See Part II *supra*.

The shareholders also contended that, even under the traditional appraisal method, asset value constituted an overwhelming degree of Kirby's intrinsic worth¹⁰² and should therefore be weighted at 90% rather than at 40% as the appraiser had done.¹⁰³ Kirby's assets were so substantial, the shareholders contended, that they constituted the corporation's true value.¹⁰⁴ The supreme court agreed that no rule of thumb is applicable to weighting and that assets should be weighted more heavily as they become more important to the corporation.¹⁰⁵ The court admitted that with a natural resource company such as Kirby, asset valuation should receive substantial weight.¹⁰⁶

The supreme court nonetheless refused to weight asset valuation above 40%. Even though this decision conforms to the judiciary's 50% ceiling for asset valuation,¹⁰⁷ the result appears justified. The court apparently limited the asset valuation because of Kirby Lumber's manufacturing characteristics and timber's status as a renewable natural resource, not because of the 50% ceiling. While the corporation may have relied on price appreciation of its timber to a certain extent, the corporation depended on its manufacturing capabilities for its income.¹⁰⁸ Thus, the court found investment value extremely important and assigned it a 60% weighting.

The court also considered Kirby's sustained yield harvesting method to be an important factor. Unlike oil or natural gas, Kirby's timber was not a wasting asset. Kirby owned the timber to provide a continuous supply of material for its manufacturing operations, not as a finite asset to be systematically liquidated.¹⁰⁹ Thus, Kirby substantially resembled a manufacturing company and was valued accordingly.

The *Kirby* holding has been criticized by at least one commentator.¹¹⁰ The author argued that *Singer's* entire fairness standard

102 See 413 A.2d at 142.

103 See *id.* at 141.

104 This contention and the discussion concerning Kirby's vast timberland holdings are most clearly presented in the lower court's opinion. See 395 A.2d at 733.

105 See 413 A.2d at 143, 146.

106 *Id.* at 146.

107 See notes 69-72 *supra* and accompanying text.

108 The chancery court said, "while Kirby's lands and forests continue to appreciate in value here, the distinction is that such assets were not acquired and held solely to appreciate in value, but rather to provide the materials for its manufacturing operations from which substantial earnings are being realized." 395 A.2d at 740.

109 The supreme court emphasized Kirby's sustained yield policy saying, "Kirby's resources are essential to the manufacturing operations on a sustained basis from which earnings are generated and dividends paid." 413 A.2d at 145.

110 See Comment, *supra* note 11.

should be extended to appraisal proceedings.¹¹¹ This standard would require a court to value a natural resource company essentially as if the transaction were an acquisition of assets.¹¹²

Such changes, however, are unnecessary. The traditional valuation method is adequate for valuing natural resource companies.¹¹³ The court, while not specifically citing *Singer*, held that the rule for valuation was one of "entire fairness."¹¹⁴ Using this standard, *Kirby's* facts did not warrant a higher asset valuation. Reviewing Kirby's manufacturing characteristics, the court held that a 40% weighting of the asset valuation was appropriate—a justifiable conclusion.¹¹⁵

C. *Natural Resource Companies: A Practical Approach to Valuation*

While the *Kirby* court valued Kirby Lumber primarily as a manufacturing corporation and failed to address the issue of nonrenewable natural resources, the holding was nevertheless significant. First, the court recognized that asset valuation is entitled to substantial weight in certain circumstances and implied that natural resource companies are peculiarly suited to such increased weighting.¹¹⁶ Second, it stated that the standard for weighting is "one of entire fairness and sound reasoning in the application of [the] traditional standard and settled Delaware law to the particular facts of each case."¹¹⁷

These judicial observations serve as stepping stones to a more equitable valuation of natural resource companies. The Delaware courts have firmly embraced their traditional approach to valuation. This approach, when used to its full potential, provides an accurate and flexible method of appraisal.¹¹⁸ By agreeing that natural re-

111 *Id.* at 434-37.

112 *Id.* at 438.

113 See text accompanying notes 16-38 *supra*.

114 413 A.2d at 143.

115 Although the *Kirby* court appeared satisfied with the appraiser's valuation and said it did not constitute reversible error, by stating that it only "fairly capture[d] the situation," the court seemed to indicate that under the new appraisal procedure, with the court as the initial appraisal forum, see note 94 *supra*, a greater weighting may have resulted. 413 A.2d at 146. See also *id.* at 150-51 (Quillen, J., concurring).

116 The *Kirby* court stated:

Kirby's assets at the time of the merger were appreciating in value, appeared to be saleable on the open market although no sale or liquidation was contemplated, and the forest utilization on a sustained-yield basis was readily available to generate an anticipated increase in earnings. Therefore, as in *Swanton*, asset value is entitled to substantial weight.

Id. at 146.

117 *Id.* at 143.

118 See text accompanying notes 16-38 *supra*.

source companies are unique and that their assets should be weighted more heavily, the courts have the opportunity to ensure that the valuation of natural resource companies meets the standard of "entire fairness and sound reasoning."

The courts, however, must abandon their self-imposed asset weighting limitation of 50% to ensure this fair valuation. The 50% ceiling is particularly illogical in view of the concurring opinion in *Kirby*.¹¹⁹ Justice Quillen invited the courts to be less restrictive in weighting asset valuation. Emphasizing the flexibility implicit in the traditional standard, he stated that in *Kirby*, "if asset value had been given even greater weight, the ultimate valuation would have been closer to a liquidating valuation. . . . Thus, it is important to bear in mind that the traditional standard is open to a broad range of evidentiary possibilities."¹²⁰

When discussing Delaware's change in appraisal forum, Justice Quillen also showed his apparent dissatisfaction with past valuations. In a statement particularly applicable to the new problem of valuing nonrenewable natural resource companies, he observed that "if, in the past, the process has been burdened by too strict an adherence to precedent from different factual contexts than a case at hand, relief has been supplied by a change of the initial forum."¹²¹ Thus, if a corporation derives 75% of its intrinsic worth from nonrenewable natural resources, Justice Quillen undoubtedly would weight asset valuation at that figure. An asset valuation of only 50% would be illogical.

The *Kirby* court did not value Kirby Lumber as a true natural resource corporation.¹²² No other reported Delaware case exists where a natural resource company was valued under the appraisal statute.¹²³ Thus, a court could use Justice Quillen's reasoning to apply a heavier weight to the asset valuation of natural resource companies without overturning significant precedent.

Although no post-*Kirby* court has appraised a nonrenewable natural resource company under the appraisal statute, the court in *Lynch v. Vickers Energy Corp.*¹²⁴ valued stock of a natural resource company

119 413 A.2d at 150-51.

120 *Id.* at 151.

121 *Id.*

122 See notes 107-109 *supra* and accompanying text.

123 An unreported case dealing with the appraisal of a natural resource company exists, but the situation there was unique. See *In re Creole Petroleum Corp.*, 3 DEL. J. CORP. L. 606 (Del. Ch. 1978); see also note 72 *supra*.

124 402 A.2d 5 (Del. Ch. 1979).

in a manner similar to the method used for appraisal proceedings.¹²⁵ In *Lynch*, minority shareholders attempted to block Vickers Energy Corporation's planned merger with Trans-Ocean Oil Inc., a petroleum and natural gas company. The shareholders argued that the stock value should be calculated solely on the basis of asset valuation.¹²⁶ The court instead used the traditional method of appraisal by weighting the asset, market, and investment valuations. In assigning a weight to the asset value, the court noted that the value of the corporation's assets is an important element to be considered in fixing the intrinsic value of stock, particularly of a wasting asset corporation.¹²⁷ Nevertheless, the court adhered to the 50% ceiling on asset valuations, and weighted that value at only 40%.¹²⁸ *Lynch* was not brought under the appraisal statute and thus could be distinguished from prior decisions. The holding suggests, however, that courts would adhere to the 50% limitation even for nonrenewable natural resource companies. Such a suggestion should not be followed. When the facts warrant, courts should abandon the 50% ceiling and use the flexibility of the traditional method to give a realistic reflection of a corporation's true value.¹²⁹

IV. Conclusion

The unique attributes of nonrenewable natural resource corporations should prompt a reevaluation of the Delaware courts' 50% asset valuation ceiling. Both business and the judiciary have recognized that such a corporation's intrinsic value substantially depends on the value of its assets. The Delaware appraisal statute requires

125 The minority shareholders in *Lynch* asked for "damages arising as a consequence of an alleged unfair offer of a parent corporation to buy the stock of its subsidiary's minority stockholders." *Id.* at 11.

126 The minority shareholders contended that the merger terms were unfair because the asset valuation was \$17.50 and they had been offered only \$12.00. *Id.*

127 *Id.*

128 *Id.*

129 Allowing the asset valuation to determine the bulk of a nonrenewable natural resource company's fair value will undoubtedly make an appraisal more reflective of intrinsic worth. The importance of other factors, however, should be noticed as well. Few, if any, natural resource companies rely exclusively on their raw materials. Investment and market value considerations will normally comprise some portion of a corporation's intrinsic value. These considerations can easily be made part of the appraisal, however, by weighting them as each case merits. The investment and market values would have been totally ignored under the shareholders' theory in *Lynch*, which advocated consideration of the company's asset value only. Such an approach would result in replacing an over-emphasis on investment and market values with an over-emphasis on asset value. The flexible approach retained by the Delaware courts is preferable.

that a dissenting minority shareholder be paid a fair price for his stock. A more realistic price is also a more fair price. To arrive at a more realistic price for nonrenewable natural resource corporations, the courts must abandon their arbitrary 50% asset valuation ceiling.

By refusing to adhere to the 50% ceiling, the courts can fully utilize the inherent flexibility of the traditional valuation method. Such a refusal will allow future courts to fully reflect asset value not only for nonrenewable natural resource companies, but for any company where assets comprise the majority of its intrinsic worth.

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