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# THE UNCERTAIN CASE FOR APPRAISAL ARBITRAGE

*Jay B. Kesten*[*]

INTRODUCTION

A new form of merger arbitrage has fundamentally changed the high-stakes arena of takeover litigation. Traditional arbitrageurs purchase stock in a target company immediately after the announcement of an acquisition to capture the premium associated with the risk of deal failure.[1] By acquiring shares (often a substantial number) and then voting them in favor of the deal, arbitrageurs aim to improve the likelihood of a successful closing, thus increasing their expected returns.[2] Recently, a new strategy has emerged. Arbitrageurs purchase large blocks of shares with a much different plan: they do not vote in favor of the merger and instead challenge the adequacy of the deal price through appraisal litigation.

The appraisal remedy provides shareholders who dissent from certain fundamental transactions, such as mergers, with the statutory right to petition the court for a judicial determination of the fair value of their shares.[3] Long dismissed as a "sleepy corporate backwater"—rarely employed and economically insignificant—appraisal has been profoundly transformed by this new arbitrage strategy.[4] Hedge funds specializing in appraisal arbitrage have raised billions of dollars in recent years.[5] And, unsurprisingly,

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1. Wei Jiang et al., *Influencing Control: Jawboning in Risk Arbitrage* 2–3 (Columbia Bus. Sch., Working Paper No. 15-41, 2016), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2587925. Target company stock prices generally rise in the aftermath of a deal announcement but remain below the final purchase price due to the possibility that the deal may fail. *Id.* at 3.

2. *Id.* ("The passive arbitrageur then votes his shares in favor of the merger and hopes to profit from the full price convergence at deal consummation.").

3. Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551, 1558 (2015).

4. *Id.* at 1553 (arguing that appraisal arbitrage has utterly transformed appraisal).

5. Trevor S. Norwitz, *Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses*, CLS BLUE SKY BLOG (Feb. 10, 2015),

appraisal claims have surged in both number and economic significance.[6]

Appraisal arbitrage has only recently begun to attract significant academic attention.[7] An emerging literature makes the case that a robust appraisal arbitrage market serves as a useful mechanism of corporate governance.[8] Sophisticated financial actors with the ability to take large positions in target firms can overcome collective action and free-rider problems that rendered the "old appraisal" uneconomic for most shareholders.[9] A more vibrant appraisal remedy could thus act as an effective deterrent or back-end constraint on underpriced mergers and opportunistic behavior by corporate managers or controlling shareholders in cash-out transactions.[10] And if minority shareholders have fewer concerns about the possibility of expropriation in those deals, then they should be willing to pay more for their shares at the outset, which would lower the cost of equity capital.[11]

This Article presents a more skeptical, though not entirely dismissive, view of appraisal arbitrage based on both empirical evidence and economic theory. A series of recent cases is illustrative. Between 2013 and 2016, the Delaware Chancery Court decided six strikingly similar cases in which appraisal arbitrageurs challenged seemingly unobjectionable mergers.[12] In each, the challenged

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http://clsbluesky.law.columbia.edu/2015/02/10/delaware-legislature-should-act-to-curb-appraisal-arbitrage-abuses/.

6. *See infra* Part II.

7. Korsmo & Myers, *supra* note 3, at 1553 (noting the "lack of prior work" and "dismissive attitudes towards" modern appraisal litigation). By contrast, appraisal arbitrage has been a major topic of public debate among the corporate bench and bar. *See, e.g.*, Peter E. Kazanoff & Paul C. Gluckow, *Appraisal Arbitrageur's Standing Reaffirmed by Chancery Court*, DEL. BUS. CT. INSIDER, Feb. 3, 2015 (reporting that investment advisors are "waging an escalating battle" and forecasting that "the fight is likely to continue to be played out before the Delaware Chancery and Supreme courts and in the General Assembly").

8. *See* Korsmo & Myers, *supra* note 3, at 1598–1600, 1604 (discussing economic theory and recent case law to demonstrate the role of appraisal arbitrage in corporate governance).

9. *Id.* at 1599.

10. *Id.* at 1598.

11. *See, e.g.*, George S. Geis, *An Appraisal Puzzle*, 105 NW. U. L. REV. 1635, 1657 (2011) ("[A]n overly permissive freezeout regime will theoretically reduce the market value of firms that have controlling shareholders. Potential investors are haunted by the constant fear of an abusive freezeout. That risk should, in turn, depress the upfront price that investors are willing to pay for stock.").

12. Vice Chancellor Glasscock described this trend in one of the cases at issue. Merion Capital LP v. BMC Software, Inc., C.A. No. 8900–VCG, 2015 WL 6164771, at *1 (Del. Ch. Oct. 21, 2015) ("This case presents what has become a common scenario in this Court: a robust marketing effort for a corporate entity results in an arm's length sale where the stockholders are cashed out, which sale is recommended by an independent board of directors and adopted by a substantial majority of the stockholders themselves. On the heels of the sale,

transaction involved an arm's length deal untainted by procedural irregularities or breaches of fiduciary duty. In each, the target actively solicited multiple potential purchasers and conducted robust negotiations, auctions, or both.[13] In each, the merger consideration represented a significant premium over the pretransaction trading price of the company's stock and was duly approved by an independent board and a majority of the firm's independent shareholders. And in each, the court ultimately concluded—after years of costly litigation—that the merger price was indeed fair.[14] Ultimately, while the arbitrageurs "lost" these cases, they nevertheless received the merger price for their shares plus a significant award of statutory interest (the Federal Reserve discount rate plus 5%, compounded quarterly from the effective date of the merger), all paid by the surviving corporate entity.[15] This outcome is both the median and the mode of trials in the appraisal arbitrage

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dissenters (here, actually, arbitrageurs who bought, not into an ongoing concern, but instead into this lawsuit) seek statutory appraisal of their shares.").

13. Merion Capital L.P. v. Lender Processing Servs., Inc., C.A. No. 9320–VCL, 2016 WL 7324170, at *2–11 (Del. Ch. Dec. 16, 2016) (finding that "the [target] Board conducted a sale process that involved a reasonable number of participants and created credible competition among heterogeneous bidders during the pre-signing phase"); Longpath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094–VCP, 2015 WL 4540443, at *1, 21–24 (Del. Ch. June 30, 2015) (finding that the target conducted a "thorough" sale process in response to an unsolicited bid, "actively solicited every buyer it believed could be interested in a transaction," and extracted five separate price increases from the unsolicited bidder); Merlin Partners LP v. AutoInfo, Inc., C.A. No. 8509–VCN, 2015 WL 2069417, at *14 (Del. Ch. Apr. 30, 2015) (holding that "the sales process was generally strong and can be expected to have led to a Merger price indicative of fair value"); *In re* Appraisal of Ancestry.com, Inc., C.A. No. 8173–VCG, 2015 WL 399726, at *16 (Del. Ch. Jan. 30, 2015) (finding that the sales process "represent[ed] an auction of the Company that is unlikely to have left significant stockholder value unaccounted for"); Merion Capital LP v. BMC Software, Inc., C.A. No. 8900–VCG, 2015 WL 67586, at *6–8 (Del. Ch. Jan. 5, 2015) (finding that the target engaged in "a thorough and vigorous sales process" involving both financial and strategic buyers); Huff Fund Inv. P'ship v. CKx, Inc., C.A. No. 6844–VCG, 2013 WL 5878807, at *1 (Del. Ch. Nov. 1, 2013) (finding that "[t]he company was sold after a full market canvas and auction" and the sale was "free of fiduciary and process irregularities"), *aff'd* 2015 WL 631586 (Del. Feb. 12, 2015).

14. In five of these cases, the Court of Chancery held that the exact merger price reflected fair value. *See Lender Processing Servs.*, 2016 WL 7324170, at *1; *Merlin*, 2015 WL 2069417, at *18; *Ancestry.com*, 2015 WL 399726, at *16; *BMC*, 2015 WL 67586, at *18; *Huff*, 2013 WL 5878807, at *1. In the sixth case, the Court of Chancery similarly found that the merger price reflected fair value, but made a very small (0.97%) downward adjustment to account for deal synergies. *LongPath*, 2015 WL 4540443, at *1.

15. Owen v. Cannon, C.A. No. 8860–CB, 2015 WL 3819204, at *32 (Del. Ch. June 17, 2015). Subpart III.B.1, *infra*, evaluates the impact, if any, of the statutory interest rate both in the abstract and in view of recent amendments to the Delaware General Corporate Law.

era.[16] And this trend seems likely to continue—over 93% of appraisal petitions filed against public companies during 2015 and 2016 challenged arm's length transactions.[17]

This trend raises both efficiency and distributional concerns about the merit of appraisal arbitrage. First, these cases, alongside other contemporary data points, cast doubt on whether appraisal arbitrageurs systematically target underpriced deals. If appraisal litigation is increasingly an exercise in rent seeking or interest rate arbitrage, it threatens to impose an inefficient transaction tax on certain mergers and may deter some worthwhile transactions altogether. Second, appraisal arbitrage can distort the market for corporate control more broadly. Rational acquirers that anticipate appraisal proceedings, even in marginal cases, will self-insure against appraisal outlays by offering less for their acquisitions, thereby transferring value from target shareholders as a class to the minority who dissent. This dynamic is particularly pernicious because auction theory predicts that these wealth transfers will occur most prominently in arm's length, multibidder transactions—the deals least likely to be characterized by the type of self-dealing or other managerial misconduct that would cast into doubt the effectiveness of the sales process.[18] Empirical evidence suggests that these wealth transfers can also occur in single-bidder transactions and controlled freeze-outs.[19]

A recent amendment to the Delaware appraisal statute seeks to deter questionable appraisal claims by curbing any distortionary influence of statutory interest awards.[20] Pursuant to this change, target companies are given an option to prepay petitioners an amount of their choosing (e.g., the merger price), after which interest accrues only on the difference, if any, between the amount prepaid and the fair value determined by the court.[21] It is too early to know for sure whether this amendment will have the intended effect, but there are several reasons to question its efficacy.

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16. The cases described above comprise six of the nine appraisal arbitrage decisions rendered by the Delaware Chancery Court during this period. In two of the others, the appraisal petitioners had more success, though both are currently on appeal to the Delaware Supreme Court. *See In re* Appraisal of DFC Glob. Corp., C.A. No. 10107–CB, 2016 WL 3753123, at *1 (Del. Ch. July 8, 2016) (awarding petitioners a 7.5% premium above the merger price); *In re* Appraisal of Dell, Inc., C.A. No. 9322–VCL, 2016 WL 3186538, at *1 (Del. Ch. May 31, 2016) (awarding petitioners a 28% premium above the merger price). In the remaining case, the petitioners were awarded a small (3.5%) premium above the merger price. Merion Capital, L.P. v. 3M Cogent, Inc., C.A. No. 6247–VCP, 2013 WL 3793896, at *1 (Del. Ch. July 8, 2013). Part III, *infra*, analyzes the outcome of these decisions and other appraisal cases more systematically.

17. *See infra* Figure 6.

18. *See infra* Subpart III.B.2.

19. *See id.*

20. DEL. CODE ANN. tit. 8, § 262(h) (2016).

21. *Id.*

More generally, the increase in appraisal litigation casts into sharp relief a latent pathology of the appraisal process. Nearly a century after its appearance in corporate statutes, the purpose of appraisal remains unclear.[22] At least in theory, appraisal serves two remedial objectives: to provide shareholders with liquidity, in the event that they might be forced to accept an illiquid instrument in exchange for their shares; and to ensure that shareholders are not forced against their wishes to accept less than fair value for their shares. Appraisal arbitrage fits uncomfortably with these remedial objectives, since arbitrageurs need neither protection. In public companies, appraisal is only available in cash-out mergers—liquidity is thus not an issue. Moreover, arbitrageurs are never forced to accept anything against their wishes; they purchase stock after the announcement of transactions exclusively for the purpose of bringing the appraisal litigation. As noted above, some scholars suggest an alternative normative goal: that the threat of appraisal serves as an ex ante deterrent against underpriced transactions.[23] Here, appraisal arbitrage plausibly serves a salutary function, though the magnitude of this effect is open to question and any benefits may well be offset by the costs described above.

Based on the foregoing, the core claim presented in this Article is that we are presently at a point of epistemic uncertainty about the merits of the "new appraisal." More time and observation are needed to accurately evaluate its costs and benefits, but there are important reasons to believe the current process is suboptimal. Due to this uncertainty, this Article proposes a modest but potentially impactful modification to the appraisal process. Given the potential mismatch between the statutory purpose of appraisal and the real-world effect of the growing arbitrage market, there is a principled basis for subjecting arbitrageurs (and other postannouncement purchasers) to a modified process.[24] Specifically, target companies should have the option to opt out of the American Rule and elect cost shifting in

22. Commentators have long offered various explanations, justifications, and critiques of the appraisal remedy in light of its odd statutory structure. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 145 (1991) (exploring the ex ante effect of appraisal); Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 437–45 (1985) (proposing three plausible objectives for appraisal: inframarginality, reckoning, and discovery); Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121, 1123 (1998) (proposing a "preference reconciliation" theory of appraisal). *See generally* Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962) (critiquing the appraisal remedy).

23. *See, e.g.*, EASTERBROOK & FISCHEL, *supra* note 22, at 145; Geis, *supra* note 11, at 1657; Korsmo & Myers, *supra* note 3, at 1598.

24. Prior work often incorrectly assumes that all appraisal petitioners should be treated equally. *See, e.g.*, Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, 71 BUS. LAW. 427, 432 (2016).

exchange for a heightened burden of proof; if they carry the burden of demonstrating that the merger price was fair, the petitioners are obliged to pay their costs and vice versa. This modification builds on the literature analyzing the benefits of privately ordering litigation procedures and parallels the optionality built into the most recent amendment to the appraisal statute. Acquirers are most likely to exercise this option when they are confident in the fairness of the merger price (e.g., in arm's length deals resulting from a robust sales process). This reform would provide a measure of targeted deterrence against rent seeking, and thereby mitigate the second-order wealth transfer effects associated with an increase in appraisal activity.

The remainder of the Article is organized as follows. Part I provides a brief overview of the statutory appraisal remedy. Part II describes in detail the emerging appraisal arbitrage market and identifies several other recent developments that are likely to increase the importance of appraisal in the future. Part III illustrates how the growing importance of appraisal claims highlights the potential mismatch between the corporate law aims of the appraisal remedy and its real-world impact. It also presents empirical evidence and economic theory that calls into question the salutary impact of appraisal arbitrage. Part IV describes and defends the cost-shifting procedure proposed herein.

## I. ANATOMY OF THE APPRAISAL REMEDY

The appraisal remedy is a century-old feature of every domestic corporate law statute.[25] It provides shareholders who dissent from certain fundamental transactions, such as mergers and acquisitions, with the statutory right to petition the court for a judicial appraisal of the fair value of their shares.[26] Appraisal is one of the few exceptions to the equity lock-in rule. Ordinarily, shareholders have no right to require the firm to repurchase their shares; dissatisfied shareholders can exit only via transactions in a secondary market at whatever price that market is willing to bear.[27] The appraisal remedy thus provides unhappy minority shareholders with an ostensibly valuable put option—a statutory liquidity event with a built-in minimum value.[28]

The process for exercising that statutory right is, however, notoriously byzantine and cumbersome.[29] First, not all fundamental

25. WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 481 (4th ed. 2012).

26. ARTHUR FLEISCHER, JR. ET AL., TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS § 14.10 (2016); Korsmo & Myers, *supra* note 3, at 1553.

27. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37–38 (Del. Ch. 2013) ("Equity capital, by default, is permanent capital.").

28. ALLEN ET AL., *supra* note 25, at 481–85.

29. FLEISCHER ET AL., *supra* note 26, § 14.10 at [A]–[B]; Korsmo & Myers, *supra* note 3, at 1559–61.

transactions trigger appraisal rights. Delaware limits mandatory appraisal rights to mergers alone, while other jurisdictions provide appraisal rights for a wider array of transactional forms (such as amendments to the corporate charter and sales of all or substantially all of the firm's assets).[30] For public companies, which are the focus of this Article, appraisal rights are further limited by the form of consideration: cash, debt, and mixed-consideration transactions trigger appraisal, but stock-for-stock mergers do not.[31] For many transactions, appraisal rights are coextensive with the ability to sue for breach of fiduciary duty.[32] Indeed, these claims are often pursued contemporaneously.[33] But, appraisal is the exclusive avenue of relief for dissatisfied shareholders in so-called "short-form" mergers, where no shareholder vote is required and the controller is under no fiduciary obligation to offer a fair price.[34]

Second, the appraisal remedy is rather unusual in that a shareholder must perfect her rights by "opting in" through a series of procedural steps prior to filing suit.[35] She must send the corporation a written demand, notifying it of her intention to seek appraisal, in advance of the shareholder meeting at which the vote on the transaction will be held.[36] She must refrain from voting her shares in favor of the merger, though she can vote no or abstain as she sees fit.[37] And she must continuously hold her shares between the date of demand through the effective date of the merger.[38] Then, within 120 days of the transaction closing, she must commence her appraisal claim in the Court of Chancery.[39] Figure 1, below, illustrates the

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30. *Compare* DEL. CODE ANN. tit. 8, § 262 (2011 & Supp. 2014), *with* MODEL BUS. CORP. ACT § 13.02 (2008).

31. DEL. CODE ANN. tit. 8, § 262(b)(1)–(2).

32. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1105–06, 1108 (Del. 1985).

33. *See, e.g.*, *In re* Dole Food Co., Inc. Stockholder Litig., C.A. No. 9079–VCL, 2015 WL 5052214, at *25 (Del. Ch. Aug. 27, 2015) (noting that the case was "another progeny of one of our law's hybrid varietals: the combined appraisal and entire fairness action"); *In re* Emerging Commc'ns, Inc. S'holders Litig., No. Civ.A. 16415, 2004 WL 1305745, at *1 (Del. Ch. June 4, 2004) (describing consolidation of appraisal and fiduciary duty claims).

34. Glassman v. Unocal Expl. Corp., 777 A.2d 242, 243 (Del. 2001). An acquirer can conduct a short-form merger if it owns 90% or more of the stock of the target company. DEL. CODE ANN. tit. 8, § 253 (2011).

35. Ala. By-Prods. Corp. v. Cede & Co., 657 A.2d 254, 260 n.10 (Del. 1995) ("[S]hareholders seeking appraisal 'opt in' to a class, invariably before suit is even filed, rather than 'opt out.'").

36. DEL. CODE ANN. tit. 8, § 262(d)(1) (2016). For short-form mergers where no vote is required, an appraisal petitioner must make such demand within twenty days of receiving notice of that transaction, which the company is statutorily required to provide. *Id.* § 262(d)(2).

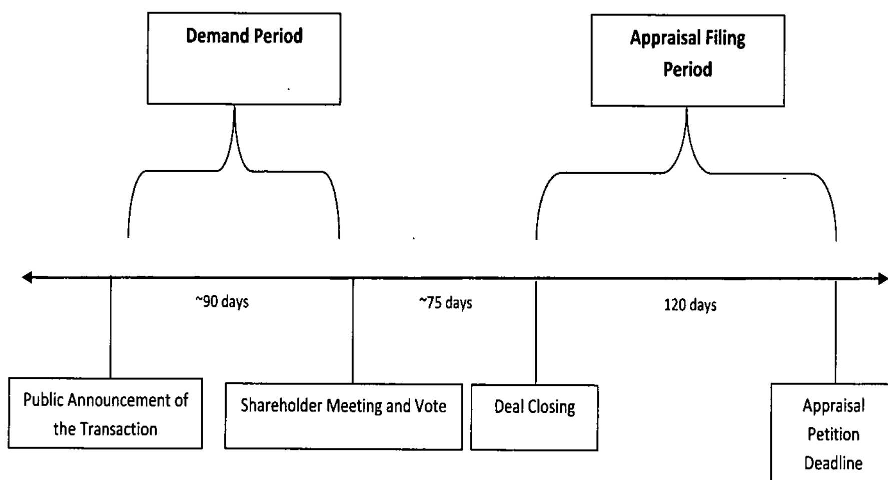
37. *Id.* § 262(a), (d)(1).

38. *Id.* § 262(a), (e).

39. *Id.* § 262(e). If at least one appraisal petition is filed, all shareholders with perfected appraisal rights will be entitled to receive whatever the court

appraisal procedure along with a representative timeline of events and dates.

Figure 1: A Typical Appraisal Process[40]




Finally, and perhaps most importantly, an appraisal petitioner must forego the merger consideration.[41] This is not a trivial matter economically; recovery can be delayed substantially if the case goes to trial. Recent data suggest that judicially-decided appraisal claims take approximately two years at a minimum, and, on average, something approaching three years to resolve.[42] Of course, many of these claims settle in a shorter time period.[43]

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determines to be fair value. Mannix v. PlasmaNet, Inc., C.A. No. 10502–CB, 2015 WL 4455032, at *3 (Del. Ch. July 21, 2015). Thus, appraisal is often termed an "opt-in" version of the class action. *Id.*

40. Approximate durations for timeline events are derived from a 2010 to 2014 sample of nonhostile cash-out mergers in which the acquirer was not a majority pretransaction shareholder. *See* Jetley & Ji, *supra* note 24, at 435–36.

41. Turner v. Bernstein, 776 A.2d 530, 547–48 (Del. Ch. 2000) ("Most significant, of course, is the fact that a stockholder who seeks appraisal must forego all of the transactional consideration and essentially place his investment in limbo until the appraisal action is resolved.").

42. Jetley & Ji, *supra* note 24, at 452 n.86 (reporting a post-2010 minimum of 1.9 years and an average of 3.6 years). Jetley and Ji note that removing one outlier case from the sample, which took over 12 years to resolve, results in an average of 2.9 years from filing to resolution. *Id.* Some appraisal cases are even longer-lived; the now infamous *Technicolor* appraisal action was litigated for more than twenty years. *See* ROBERT THOMPSON, MERGERS AND ACQUISITIONS: LAW AND FINANCE 362 (2d ed. 2014) (describing the history of the *Technicolor* litigation).

43. *See, e.g.*, Charles Korsmo & Minor Myers, *Reforming Modern Appraisal Litigation* 19 (Brooklyn Law Sch. Legal Studies Research Paper No. 431, 2016), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2712088 (reporting that

Once a perfected appraisal claim is filed, the court must "determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."[44] In practice, this means determining the going-concern value of the target company immediately prior to the transaction, including nonspeculative elements of future value.[45] But such value cannot include synergies derived exclusively from the merger itself.[46] As such, strategic mergers (mergers between two operating companies in complementary industries) are ostensibly dangerous targets for appraisal petitioners; the merger premium likely reflects, in large part, excludable synergistic benefits of the combination.[47] And, consistent with this intuition, strategic acquirers are often willing to pay higher premiums.[48] By contrast, financial buyers (such as private equity funds) typically bring fewer synergies to the table.[49] Instead, they create value by selling off parts of acquired firms, deriving the benefits of the target's cash flows, remedying managerial or operations defects, and then reselling the

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from 2004 to 2013, 81% of counseled appraisal claims against public companies settled).

44. DEL. CODE ANN. tit. 8, § 262(h) (2016).

45. Golden Telecom, Inc. v. Glob. GT LP, 11 A.3d 214, 217 (Del. 2010) (stating that the court must determine "the value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction"); Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) ("We take [the exclusion of speculative elements] to be a very narrow exception to the appraisal process, designed to eliminate use of *pro forma* data and projections of a speculative variety relating to the completion of a merger. But elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation, may be considered.").

46. Merion Capital, L.P. v. 3M Cogent, Inc., C.A. No. 6247–VCP, 2013 WL 3793896, at *3 (Del. Ch. July 8, 2013) (stating that "any synergistic value . . . should be excluded from a fair value calculation on the date of the merger").

47. *See* Jay B Kesten, *Adjudicating Corporate Auctions*, 32 YALE J. ON REG. 45, 54 (2015) (explaining how strategic acquisitions include substantial elements of synergistic private value).

48. Alexander S. Gorbenko & Andrey Malenko, *Strategic and Financial Bidders in Takeover Auctions*, 69 J. FIN. 2513, 2514, 2516 (2014) (finding that strategic bidders have higher average valuations across all targets). But this result is not invariably true. Financial bidders are often willing to offer higher premiums for distressed targets. *Id.* at 2515–16. Some commentators suggest that this result occurs because financial buyers are repeat players in the takeover markets and thus are more experienced at monitoring underperforming companies and better able, due to their ability to diversify capital structures across their deals, to take advantage of factors such as putatively overpriced debt. *See* Marc Martos-Vila et al., *Financial vs. Strategic Buyers* 4–6 (Harvard Bus. Sch., Working Paper No. 12-098, 2014), http://www.hbs.edu/faculty/Publication%20Files/12-098_dc44025a-785b-45c5-9d31-60e02f091b7d.pdf.

49. Mark E. Thompson & Michael O'Brien, *Who Has the Advantage: Strategic Buyers or Private Equity Funds?*, FINANCIER WORLDWIDE (Nov. 2005), http://www.kslaw.com/library/publication/ThompsonOBrien.pdf.

firm or taking it public.[50] In certain cases, the value from these operational plans may be included in the court's determination.[51] But overall, excludable synergies—which may be difficult for potential dissenting shareholders to quantify ex ante—are much less of a confounding factor in financial transactions.[52] Finally, going-private transactions in which a controlling shareholder freezes out the minority shareholders are particularly vulnerable to opportunistic behavior and underpricing.[53]

Appraisal is also an odd creature with respect to proof at trial. The petitioning shareholder need not prove fraud, breach of fiduciary duty, or any other inequitable conduct to prevail.[54] Valuation is the single triable issue.[55] However, both sides technically bear the burden of proof.[56] If neither side carries its burden, the court must make its own determination.[57] Put differently, if the court is not convinced by either party's evidence, it must use its own independent business judgment to determine fair value.[58] To make this determination, the statute merely notes that the court must consider "all relevant factors."[59] Delaware courts regularly employ a combination of three sophisticated valuation techniques: discounted cash-flow analysis ("DCF"), comparable transactions analysis, and

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50. Kesten, *supra* note 47, at 53–54 (describing the characteristics of financial acquirers).

51. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 297, 300 (Del. 1996) (finding that financial buyer's plans, which had been implemented in the period between its initial investment and the freeze-out merger, were appropriately included in the determination of fair value).

52. Gorbenko & Malenko, *supra* note 48, at 2515–16.

53. *See, e.g.*, *In re* Emerging Commc'ns, Inc. S'holder Litig., No. Civ.A. 16415, 2004 WL 1305745, at *32 (Del. Ch. June 4, 2004) ("Our courts have recognized that a freeze-out merger of the minority proposed by the majority stockholder is inherently coercive. Where, as here, the freeze-out merger is initiated by the majority stockholder, that fact, even though not dispositive, is evidence of unfair dealing." (internal citation omitted)).

54. Andra v. Blount, 772 A.2d 183, 192 n.22 (Del. Ch. 2000) (noting that a stockholder seeking appraisal "is entitled, without having to prove wrongdoing or liability on anyone's part, to a determination of the fair value of his investment").

55. Bomarko, Inc. v. Int'l Telecharge, Inc., C.A. No. 13052, 1994 WL 198726, at *3 (Del. Ch. May 16, 1994) (noting that "allegations attacking the manner in which the merger was effectuated . . . should be stricken [from an appraisal petition] pursuant to Chancery Court Rule 12(f)").

56. M.G. Bancorporation, Inc. v. Le Beau, 737 A.2d 513, 520 (Del. 1999) ("In a statutory appraisal proceeding, both sides have the burden of proving their respective valuation positions by a preponderance of evidence.").

57. Reis v. Hazelett Strip–Casting Corp., 28 A.3d 442, 456 (Del. Ch. 2011).

58. Longpath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094–VCP, 2015 WL 4540443, at *9 (Del. Ch. June 30, 2015) (quoting Gholl v. eMachines, Inc., C.A. No. 19444–NC, 2004 WL 2847865, at *5 (Del. Ch. Nov. 24, 2004)).

59. DEL. CODE ANN. tit. 8, § 262(h) (2016).

comparable companies analysis.[60] But a survey of recent Delaware opinions displays a strong preference for DCF in appraisal cases due to the difficulties in finding appropriate comparables.[61]

After trial, petitioners are entitled to receive the fair value of their shares as determined by the court.[62] Regardless of the outcome—whether the fair value is above, below, or precisely the merger price—petitioners also receive interest on that award at the Federal Reserve discount rate plus 5%, compounded quarterly from the effective date of the underlying transaction to the time the appraised value is actually paid.[63] Both fair value and interest thereon are paid to the petitioner by the combined entity surviving the merger.[64]

## II. THE NEW APPRAISAL: ARBITRAGE MARKETS AND OTHER RECENT DEVELOPMENTS

Notwithstanding the potential value of this statutory put right, virtually all commentators agree that, until very recently, appraisal was largely a dead letter.[65] According to this literature, most shareholders are unlikely to seek appraisal in most transactions, especially in public corporations, due to several factors that render the remedy uneconomic for all but the largest blockholders. First, in contrast to fiduciary duty litigation, no class action mechanism (and attendant cost sharing) is available in appraisal claims.[66] Whereas shareholders need not take any action to be represented in a class of fiduciary complainants, as described in Part I, *supra*, they must opt in to an appraisal proceeding by individually filing their petitions and bearing the cost thereof.[67] This problem is exacerbated because

60. S. Muoio & Co. v. Hallmark Entm't Invs. Co., No. C.A. 4729–CC, 2011 WL 863007, at *20 (Del. Ch. Mar. 9, 2011) ("[I]t is preferable to take a more robust approach involving multiple techniques—such as a DCF analysis, a comparable transactions analysis (looking at precedent transaction comparables), and a comparable companies analysis (looking at trading comparables/multiples)—to triangulate a value range, as all three methodologies individually have their own limitations.").

61. Jetley & Ji, *supra* note 24, at 442 (collecting cases).

62. DEL. CODE ANN. tit. 8, § 262(h).

63. Owen v. Cannon, No. C.A. 8860–CB, 2015 WL 3819204, at *32 (Del. Ch. June 17, 2015).

64. DEL. CODE ANN. tit. 8, § 262(i).

65. *See, e.g.*, Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 242–43 (1999) (finding no evidence that the availability of appraisal leads to greater merger premiums for target shareholders).

66. *Id.* at 241.

67. *See, e.g.*, Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 546 (2003) ("Most problematic is that in contrast to the class action model where fees and costs incurred by successful shareholders can be shifted to the class or the corporation, the statutory regime

dissenters forego the merger consideration and thus cannot finance their litigation with those proceeds. Consequently, it is often cost prohibitive for small shareholders to pursue this remedy.[68] Second, the complex procedural requirements and short deadlines of the appraisal process may deter small or unsophisticated shareholders from bringing an appraisal action.[69] Finally, even sophisticated shareholders face a game-theoretical dilemma. Only dissenting shareholders can seek appraisal, thus a shareholder must decide in advance to vote no (or abstain) on the transaction, which increases the likelihood that the deal fails to garner the requisite approval, and thus any premium associated with the deal is lost altogether.[70]

In sum, both judicial and academic commentators have concluded in the past that shareholders dissatisfied with a fundamental transaction will rarely choose appraisal (despite the lower burden of proof) over a claim for breach of fiduciary duty.[71] That conclusion is

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for appraisal rights requires individual shareholders to foot these costly expenses on their own." (internal citation omitted)); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 30 (2005) ("[U]nlike plaintiff shareholders in a class action claim for entire fairness, plaintiffs in an appraisal proceeding must bear their own costs, including legal fees and the costs of expert witnesses.").

68. *See, e.g.*, JAMES D. COX ET AL., CORPORATIONS 595–96 (1997) ("[Appraisal] is rarely the remedy of other than the 'wine and cheese' crowd, for seldom is appraisal sought by investors whose holdings are less than $100,000.").

69. ROBERT CHARLES CLARK, CORPORATE LAW 508 (1986) ("[A]ppraisal is often a cumbersome remedy."); Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1004 (2006) (noting that "[a]ppraisal litigation is complicated and expensive" and "many shareholders find it difficult to meet the complicated procedural requirements and deadlines of the appraisal remedy"). A shareholder who holds stock prior to a merger announcement has, on average, ninety days to decide whether or not to seek appraisal. That number may overstate the true decision-making period. Many shareholders do not become aware of the transaction contemporaneously with its public announcement. And, even if a shareholder is generally aware of the transaction at an early stage, new information about the transaction is typically provided in the target's definitive proxy statement, which is made public on average a month before the shareholder meeting. *See supra* Figure 1; *see also* Jetley & Ji, *supra* note 24, at 436 ("[T]he definitive proxy statement provides detailed information regarding the background of the transaction, deal process, valuation, and opinions of the target's financial advisors, as well as the company's financial forecasts. While much of this information may have already been disclosed to the public in the target's preliminary proxy filings, the definitive proxy statement sometimes contains new information not available prior to the notice date, and this can help an investor better assess the target's value relative to the contemplated offer price.").

70. Jetley & Ji, *supra* note 24, at 432.

71. *See, e.g.*, Turner v. Bernstein, 776 A.2d 530, 548 (Del. Ch. 2000) (noting that the appraisal process "creates an incentive for plaintiffs to reject the technically easier option of an appraisal action for the more onerous burden of proving a fiduciary breach"); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 623 n.52 (1998) ("There are numerous economic incentives for shareholders to challenge

largely borne out by empirical evidence. From 2004 to 2010, with some year-to-year variance attributable largely to the overall volume of merger activity, approximately 5% of all eligible Delaware transactions attracted at least one appraisal petition.[72] By way of comparison, in 2004, 36% of transactions eligible for appraisal triggered at least one claim for breach of fiduciary duty.[73] By 2010, more than 80% of transactions eligible for appraisal were the subject of fiduciary duty litigation.[74]

Since 2010, however, the landscape is drastically different; appraisal litigation has sky-rocketed, as measured both by litigation volume and the amounts at stake. Appraisal proceedings, as a percentage of eligible transactions, have increased steadily.[75] On average, twenty-two petitions were filed annually between 2011 and 2014, compared with an average of nine per year from 2004 to 2010.[76] In 2015, fifty-one appraisal petitions were filed, and 2016 appraisal claimants filed seventy-seven petitions challenging, inter alia, thirty-six public company mergers—the highest level of appraisal activity to date.[77] It is likely that these figures understate the total amount of appraisal activity; appraisal demands, typically provided to the target firm several months before the deal closes, regularly settle prior to the filing of an appraisal petition.[78] Moreover, the aggregate size of these cases has also increased over time.[79] This Part documents several recent developments that have amplified appraisal's economic relevance and explains why appraisal is likely to become even more important going forward.

### A. *Appraisal Arbitrage and the Market for Appraisal Rights*

The growth of appraisal litigation described above does not coincide with a cyclical increase in merger activity.[80] Rather, the surge in appraisal appears driven primarily by the emergence of a new market for appraisal arbitrage. Appraisal arbitrage is an

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acquisition transactions in class action lawsuits alleging breach of fiduciary duty, rather than in appraisal proceedings.").

72. Korsmo & Myers, *supra* note 3, at 1569.

73. *Id.* at 1581.

74. *Id.*

75. *Id.* at 1569 (presenting data on appraisal petitions filed from 2004 to 2014).

76. *Id.* at 1568.

77. Data on 2015 and 2016 appraisal petitions was hand-collected from the Delaware Chancery Court docket. This information was then cross-referenced with public records to determine the type of acquirer and target, the relationship between the acquirer and the target, and transaction structure.

78. Korsmo & Myers, *supra* note 43, at 19.

79. Korsmo & Myers, *supra* note 3, at 1571 (noting that petitioning shareholders forewent nearly $1.5 billion in merger consideration to seek appraisal during 2013).

80. *Id.* at 1571–72.

investment strategy whereby an investor—typically a sophisticated financial entity such as a hedge fund or private equity fund—acquires a large equity position in a company that is the target of a transaction that triggers appraisal rights.[81] Whereas traditional merger arbitrageurs buy with the intent of influencing the vote on the transaction (typically by voting yes), appraisal arbitrageurs purchase their shares specifically for the purposes of filing an appraisal action challenging the fair value of the merger consideration.[82]

In the landmark decision *In re Appraisal of Transkaryotic Therapies, Inc.*,[83] the Delaware Court of Chancery greatly facilitated the growth of the market for appraisal rights. That case held that appraisal plaintiffs need not have been shareholders on the record date of the vote to approve the transaction.[84] Instead, shareholders who acquired their shares *after* such date but before the effective date of the merger have standing to seek appraisal so long as the record holder did not vote their shares in favor of the transaction.[85] The practical importance of this ruling is that the record date almost always precedes circulation of the company's proxy statement soliciting votes for the merger, which contains critical information about the mergers and acquisitions process and the valuation metrics underlying any investment bankers' fairness opinions.[86] Thus, practitioners assumed that an outside investor considering appraisal arbitrage would have to acquire shares without the benefit of those disclosures.[87]

Post-*Transkaryotic*, however, arbitrageurs have the luxury of waiting until at least the date of the shareholder vote to acquire shares;[88] they can fully assess the economics of appraisal based on the company's disclosures and canvas institutional investors' sentiment to determine if there is likely to be a large no-vote before purchasing the shares.[89] In certain cases, arbitrageurs may be able to purchase

81. Merion Capital LP v. BMC Software, Inc., C.A. No. 8900–VCG, 2015 WL 67586, at *1 (Del. Ch. Jan. 5, 2015).

82. *Id.*

83. No. Civ.A. 1554–CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

84. *Id.* at *3.

85. *Id.* at *4.

86. Latham & Watkins LLP, *Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?* (2007), https://corpgov.law.harvard.edu/wp-content/uploads/2007/05/20070525%20Appraisal%20Arbitrage--A%20New%20Hedge%20Fund%20Strategy.pdf.

87. *Id.*

88. Jetley & Ji, *supra* note 24, at 430 (arguing that "[a]ll else being equal, an appraisal arbitrageur is likely to wait for as long as possible prior to buying the target stock in order to reduce the risk (primarily the risk of the deal failing) and thereby to maximize the return").

89. *Id.* at 437 ("[B]y waiting, the arbitrageur can take into consideration any developments or new information when assessing the value of the target company relative to the transaction price.").

the bulk of their stock even after the shareholder vote.[90] While demand is necessary to perfect appraisal rights, the notice sent need not specify the precise number of shares for which appraisal will be sought.[91] Accordingly, an arbitrageur could—at least in theory—purchase a relatively small number of shares prior to the shareholder meeting, make a demand, and then decide whether to make the full arbitrage investment.[92] Figure 2, below, illustrates a typical chronology of events along with associated arbitrage windows.

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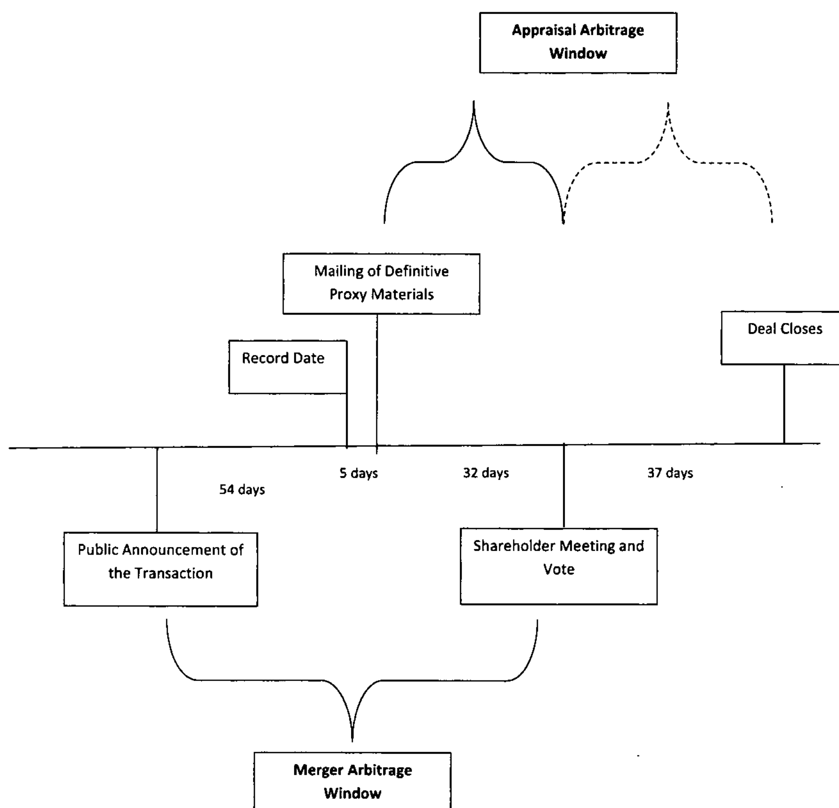
90. Maurice M. Lefkort, *Hedge Funds Can Still Manipulate Corporate Law*, WHARTON MAG.: WHARTON BLOG NETWORK (Feb. 12, 2015), http://whartonmagazine.com/blogs/hedge-funds-can-still-manipulate-stock-market-rule ("The Appraisal Arbitrageur waits until a deal is almost closed, which is often after the stockholder vote, and then buys stock on the market at what is likely less than the deal price, becoming the beneficial owner, but not the record owner.").

91. Jetley & Ji, *supra* note 24, at 435 ("In practice, however, the extant interpretation of the statute is that the written demand for appraisal that needs to be delivered to the target company prior to the shareholder meeting can simply be a generic one, without specifying the number of shares for which appraisal will be sought. Thus, an appraisal arbitrageur could make a demand before the shareholder vote without having established any significant position in the target's stock, thereby preserving the flexibility to acquire a larger portion of target shares at any time before the deal closing.").

92. Note, however, that record holders such as Cede & Co. are unlikely to issue an appraisal demand for an indefinite number of shares. So, at least at present, institutional arbitrageurs' holdings will likely be fixed as of the date of the shareholder vote.

Figure 2: Representative Deal Timeline (With Arbitrage Windows)[93]




Since *Transkaryotic*, a vibrant market for appraisal rights has emerged.[94] Numerous hedge funds, private equity funds, and even

93. Average duration of timeline events is reported by Jetley and Ji from a 2010 to 2014 sample of nonhostile cash-out mergers in which the acquirers were not majority pretransaction shareholders. *See* Jetley & Ji, *supra* note 24, at 435–36.

94. *See* Korsmo & Myers, *supra* note 3, at 1578–83 (considering but rejecting several causal stories); Tom Hals, *Update 1–Hedge Funds Lose Court Bid Over Ancestry.com Deal Price*, REUTERS (Jan. 30, 2015), http://www.reuters.com/article/ancestrycom-ruling-idUSL1N0V92SX20150130 (asserting that appraisal arbitrage is "an increasingly popular hedge fund strategy"). This Article takes no position in the ongoing debate about whether *Transkaryotic*, or some other factor or combination of factors, is the main causal driver of appraisal arbitrage. *See, e.g.*, Liz Hoffman, *M&A Price Bump Lawsuit Backfires, Sounding Note of Caution*, WALL ST. J.: MONEYBEAT (July 1, 2015, 6:16 PM), http://blogs.wsj.com/moneybeat/2015/07/01/ma-price-bump-lawsuit-backfires-sounding-note-of-caution/ ("[A] strategy known as 'appraisal arbitrage' . . . has gained favor among hedge funds mining the merger boom for profits.").

mutual funds have filed large appraisal petitions in recent years.[95] Multiple investment funds have been raised primarily to pursue appraisal arbitrage strategies. As of 2013, for example, Merion Capital had over $700 million invested in appraisal claims alone.[96] Another group, the Shareholder Forum, has considered creating asset-backed securities tied to appraisal rights.[97]

These institutional arbitrageurs are largely responsible for the increase in appraisal to date. As Charles Korsmo and Minor Myers report, every appraisal case filed in 2013 involved at least one repeat petitioner.[98] More generally, since 2011, over 80% of appraisal proceedings involve at least one repeat petitioner.[99] While defendants have challenged the legality of this arbitrage in several subsequent cases, Delaware courts have yet to show a desire to proscribe or limit the practice in any material way.[100]

### B. *Other Developments: The Future Importance of Appraisal*

Aside from the emergence of appraisal arbitrage, several other recent developments suggest that appraisal is likely to increase in importance over time. First, in 2013, the Delaware General Assembly amended its corporate statute to provide a new, so-called "medium-form" merger procedure.[101] Under that structure, assuming certain statutory requirements are met, acquirers can consummate the back-end merger of a two-step takeover without holding a shareholder vote.[102] A parallel amendment to the statute provides that appraisal rights are available in all medium-form mergers, regardless of the

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95. Hoffman, *supra* note 94 ("[T]he promise of outsize returns has drawn billions of dollars into appraisal-arbitrage cases over the past two years. Funds including Fortress Investment Group LLC, Third Point LLC and Brigade Capital Management LP have recently challenged buyouts of AOL, retailer PetSmart and fruit grower Dole Food.").

96. Korsmo & Myers, *supra* note 3, at 1574.

97. Miles Weiss, *Dell Value Dispute Spotlights Rise in Appraisal Arbitrage*, BLOOMBERG TECH. (Oct. 3, 2013, 12:00 AM), http://www.bloomberg.com/news/articles/2013-10-03/dell-value-dispute-spotlights-rise-in-appraisal-arbitrage.

98. Korsmo & Myers, *supra* note 3, at 1573.

99. *Id.* at 1572.

100. *See, e.g.*, *In re* Appraisal of Dole Food Co. Stockholder Litig., Nos. 8703–VCL, 9079–VCL, 2015 WL 298295, at *1 (Del. Ch. Jan. 21, 2015) (citing *In re* Ancestry.Com, Inc., C.A. No. 8173-VCG, 2015 WL 66825, at *9 (Del. Ch. Jan. 5, 2015)) (rejecting Dole's argument that beneficial owners may not exercise appraisal rights on shares acquired after the record date of the transaction); Merion Capital LP v. BMC Software, Inc., C.A. No. 8900–VCG, 2015 WL 67586, at *7 (Del. Ch. Jan. 5, 2015) (rejecting a challenge to appraisal arbitrage and suggesting that reforms, if any, must come from the Delaware legislature).

101. *See* Allison L. Land, *Amendments to Delaware General Corporate Law to Facilitate Short-Form Mergers in Two-Step Transactions*, SKADDEN: INSIGHTS (July 26, 2013), http://www.skadden.com/insights/amendments-delaware-general-corporation-law-facilitate-short-form-mergers-two-step-transact.

102. DEL. CODE ANN. tit. 8, § 251(h) (Supp. 2014).

type of consideration—even in stock-for-stock transactions.[103] Appraisal petitioners have already begun to challenge these medium-form transactions.[104] Moreover, proponents of the appraisal remedy have long argued that the form of consideration should be irrelevant in any transaction, and proponents have suggested statutory reform along those lines.[105] Accordingly, the universe of transactions that gives rise to appraisal rights has recently been expanded, and may be expanded further going forward.

Second, several recent Delaware Supreme Court decisions broaden the class of transactions for which appraisal is likely the only viable remedy. Traditionally, freeze-out mergers initiated by controlling shareholders are subject to the exacting entire fairness standard if challenged via fiduciary duty litigation.[106] In *Kahn v. M&F Worldwide* ("*MFW*"),[107] however, the court concluded that business judgment review was appropriate if certain procedural safeguards are effectively employed to simulate an arm's length bargain and to ensure an uncoerced shareholder vote. A shift to business judgment review is typically outcome determinative for fiduciary duty claims.[108] Dissatisfied shareholders in "cleansed" controlled freeze-outs are thus left only with an appraisal claim. The recent *In re Appraisal of Dell, Inc.*[109] case illustrates that these claims are potentially viable—the petitioners were awarded a significant premium over the merger price notwithstanding the fact that the transaction satisfied the *MFW* standard.[110] The impact of *MFW* is

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103. DEL. CODE ANN. tit. 8, § 262(b)(3) (Supp. 2014).

104. *See, e.g.*, Verified Petition for Appraisal of Stock at 1–2, JEC II Assocs., LLC v. Meru Networks, Inc., No. 11678–VCMR, 2016 WL 204695 (Del. Ch. Nov. 5, 2015); Meru Networks, Inc., Form 8-K: Current Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934, at 2 (May 27, 2015) (describing terms of two-step 251(h) transaction between Meru Networks and Malbrouck Acquisition Corp., a wholly-owned subsidiary of Fortinet, Inc.).

105. *See* Korsmo & Myers, *supra* note 3, at 1606–07 ("[T]he first reform we suggest is that the form of merger consideration should be irrelevant to eligibility for appraisal.").

106. Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983).

107. 88 A.3d 635, 644 (Del. 2014) ("We hold that business judgment is the standard of review that should govern mergers between a controlling stockholder and its corporate subsidiary, where the merger is conditioned *ab initio* upon both the approval of an independent, adequately-empowered Special Committee that fulfills its duty of care; and the uncoerced, informed vote of a majority of the minority stockholders.").

108. Sullivan & Cromwell LLP, Kahn v. M&F Worldwide Corp.: *Delaware Supreme Court Affirms* In Re MFW *Court of Chancery Ruling that Business Judgment Review Can Apply to Squeeze-Out Mergers Conditioned Up Front on Both Approval by Special Committee and Majority-of-the-Minority Vote*, SULLIVAN & CROMWELL: S&C MEMOS (Mar. 17, 2014), https://www.sullcrom.com/kahn-v-mandf-worldwide-corp-delaware-supreme-court-affirms-in-re-mfw-court-of-chancery-ruling.

109. C.A. No. 9322–VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016).

110. *See id.*, at *1.

amplified by the decisions in *Corwin v. KKR Financial Holdings*[111] and *Singh v. Attenborough*,[112] in which the Delaware Supreme Court emphasized that plaintiffs are unlikely to survive a motion to dismiss on postclosing breach of fiduciary duty claims for damages where the business judgment rule applies and the transaction was approved by a fully informed, uncoerced majority of the disinterested stockholders.

Finally, and perhaps more speculatively, a sea-change in takeover litigation generally may increase the volume of appraisal petitions. Breach of fiduciary duty claims, once ubiquitous, are in steep decline. From 2010 to 2015, more than 85% of all completed fundamental transactions attracted at least one shareholder lawsuit.[113] At the peak in 2014, nearly 95% of all such transactions were challenged in court.[114] The vast majority of these claims ended with so-called "disclosure-only" settlements, in which the target company merely agrees to make available supplementary information about the sale in exchange for a broad release of claims going forward.[115] These settlements were widely criticized as a "deal tax,"[116] and empirical analysis provided strong evidence for that proposition.[117] The additional disclosures typically provided no

111. 125 A.3d 304 (Del. 2015).

112. 137 A.3d 151 (Del. 2016).

113. Matthew D. Cain & Steven Davidoff Solomon, Takeover Litigation in 2015 at 2 (Jan. 14, 2016), (unpublished manuscript) (on file with the Berkeley Center for Law, Business, and the Economy), http://papers.ssrn.com /sol3/papers.cfm?abstract_id=2715890.

114. *Id.*

115. Steven Davidoff Solomon, *Why The Surge in Merger Litigation Fizzled*, N.Y. TIMES: DEALBOOK (Jan. 22, 2016), http://www.nytimes.com/2016/01/23 /business/dealbook/why-the-surge-in-merger-litigation-fizzled.html?_r=0 (reporting that disclosure-only settlements comprise approximately 80% of merger litigation settlements).

116. Browning Jeffries, *The Plaintiffs' Lawyer's Transaction Tax: The New Cost of Doing Business in Public Company Deals*, 11 BERKELEY BUS. L.J. 55, 56–58 (2014); *see also* Joel C. Haims & James J. Beha, II, *Recent Decisions Show Courts Closely Scrutinizing Fee Awards in M&A Litigation Settlements*, MORRISON FOERSTER 1 (2013), http://www.mofo.com/files/Uploads/Images /130418-In-the-courts.pdf [http://perma.cc/9NBW-VL2S] ("[P]ayment of attorneys' fees effectively becomes a tax on M&A transactions.") (in email).

117. Jill E. Fisch et al., *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 TEX. L. REV. 557, 577, 585 (2015) (noting, in a study of essentially all large public company mergers between 2005 and 2012, that disclosure-only settlements had an insignificant effect, if any, on shareholders' support for a merger); *see also* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 137, 198 (2004) (noting, in a 1999 to 2000 study of Delaware Court of Chancery lawsuits, that around 80% of all fiduciary duty claims were class actions objecting to mergers and acquisitions, and that 75% of management buyouts, 85% of third-party acquisitions, and 88% of control shareholder transactions successfully closed despite the class action litigation).

measurable benefit to shareholders[118] but instead served primarily as a vehicle for generating attorney fees and foreclosing potentially meritorious future litigation.[119]

Based in part on this academic commentary, Delaware courts began questioning the validity of these disclosure-only settlements.[120] In September 2015, Vice Chancellor Glasscock warned that the Delaware courts were unlikely to approve of such settlements in the future.[121] Perhaps in view of these warnings, by the end of the year, takeover litigation had fallen to its lowest rate in over a decade—in the fourth quarter of 2015, shareholders brought suit in only 21% of eligible transactions.[122] As one notable commentator declared, "The takeover litigation boom has ended."[123] It is too soon to tell at present, but it is plausible that some of the resources previously invested in fiduciary duty claims (meritorious or otherwise) might be redirected toward appraisal, especially if, as discussed in Subpart III.B.1, that procedure, as currently constituted, leaves the door open for rent seeking.[124]

Collectively, these trends all point toward an increasingly important role for appraisal as a matter of corporate law. The open question, to which we turn next, is whether the "new appraisal" serves corporate law policy.

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118. Fisch et al., *supra* note 117, at 583, 585 (finding that disclosure-only settlements have no measurable effect on shareholder voting, and concluding that "[t]he lack of a significant relationship between disclosure-only settlements and shareholder voting suggests that shareholders may not value the additional information from these disclosures at least in a way that affects their vote").

119. Jeffries, *supra* note 116, at 59.

120. *See, e.g.*, *In re* Trulia Stockholders Litig., 129 A.3d 884, 887, 895 (Del. Ch. 2016) (rejecting a disclosure-only settlement and summarizing the academic critique of such settlements); Phillip R. Sumpter, *Adjusting Attorneys' Fee Awards: The Delaware Court of Chancery's Answer to Incentivizing Meritorious Disclosure-Only Settlements*, 15 U. PA. J. BUS. L. 669, 688–91 (2013) (describing earlier Chancery Court criticism of disclosure-only settlements).

121. *In re* Riverbed Tech. Inc. Stockholders Litig., C.A. No. 10484–VCG, 2015 WL 5458041, at *6 (Del. Ch. Sept. 17, 2015) ("[G]iven the past practice of this Court in examining settlements of this type, the parties in good faith negotiated a remedy—additional disclosures—that has been consummated, with the reasonable expectation that the very broad, but hardly unprecedented, release negotiated in return would be approved by this Court. I note that this factor, while it bears some equitable weight here, will be diminished or eliminated going forward in light of this Memorandum Opinion and other decisions of this Court.").

122. Cain & Solomon, *supra* note 113, at 3.

123. Solomon, *supra* note 115.

124. BLOOMBERG BNA, MAKING SENSE OF THE WORLD OF DELAWARE CORPORATE LITIGATION 22–23 (2014), https://www.dlapiper.com/~/media/Files/Insights/Events/2014/06/2014BloombergBNASeminarMakingSenseoftheWorldofDelawareCorporateLitigation.pdf (noting Merion, the largest appraisal arbitrageur to date, is headed by a successful plaintiff's attorney).

## III. PATHOLOGIES OF THE APPRAISAL PROCESS

This Part presents a skeptical view of the "new appraisal," and especially the merit of appraisal arbitrage. Specifically, it argues that appraisal arbitrage fits uncomfortably with the judicially and academically recognized purposes of that remedy, and thus there is a principled basis for differential treatment between preannouncement stockholders and those who purchased their shares between the announcement and closing. Further, as currently constituted, the appraisal remedy invites overlitigation and associated second-order wealth transfers. The following Subparts develop each of these arguments in turn.

### A. *Statutory Mismatch*

In theory, appraisal serves two remedial purposes. First, it provides shareholders a liquidity put in the event of a merger with which they disagree.[125] Historically, mergers and other business combinations required unanimous shareholder approval.[126] But when corporations modernized at the turn of the twentieth century, this unanimity rule created economically meaningful hold-up problems.[127] Minority shareholders (even those holding trivial amounts of the firm's shares) could unfairly extract value from the firm by threatening to veto otherwise beneficial transactions.[128] In recognition of this problem, corporate statutes were universally amended to provide for majoritarian rule.[129] Appraisal was the quid pro quo for this shift.[130] Unhappy shareholders could no longer hold up majority-approved transactions, but could instead obtain a fair-value exit from the enterprise.[131]

Second, appraisal serves as a compensatory device for minority shareholders in the event of abusive or opportunistic freeze-out mergers.[132] The most problematic situation in this regard involves

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125. *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 3–4 (1995).

126. *Id.* at 3.

127. *Id.* at 12–13.

128. Geis, *supra* note 11, at 1642 ("[A]ny single shareholder could block the deal, and the expansion of shareholder rosters during this time period raised serious holdout problems; for example, gadfly shareholders might demand side payments before granting approval.").

129. *See* Thompson, *supra* note 125, at 3.

130. Ala. By-Prods. Corp. v. Cede & Co., 657 A.2d 254, 258 (Del. 1995) ("[Appraisal] is a limited legislative remedy developed initially as a means to compensate shareholders of Delaware corporations for the loss of their common law right to prevent a merger or consolidation by refusal to consent to such transactions." (citing Schenley Indus., Inc. v. Curtis, 152 A.2d 300, 301 (Del. 1959))).

131. *See* Thompson, *supra* note 125, at 13, 45.

132. *See, e.g.*, Geis, *supra* note 11, at 1661 (describing appraisal as a potential "back-end market check on controller expropriation").

firms with majority or otherwise controlling shareholders. Controllers can cash out minority shareholders at will on the terms and conditions of their choosing.[133] Doing so requires only that the controller create a shell corporation that it controls, and then conduct a stock-for-cash merger between the two firms.[134] Assuming the majority has effective board control over both entities, it can unilaterally secure all of the necessary statutory approvals; both boards will do what it says, and, by definition, it has sufficient votes in the "target" firm to approve the transaction at the shareholder level. Controllers can thus force out the minority against their wishes at a below-market price or at an opportunistic time so as to avoid having to share future profitability.

Numerous cases have recognized this danger inherent in controlled freeze-outs. For example, in its seminal *Weinberger v. UOP, Inc.*[135] decision, the Delaware Supreme Court modernized its approach to appraisal in large part as a response to those transactions.[136] Robert Thompson summarizes the compensatory rationale as follows: "[Appraisal] serves as a check against opportunism by a majority shareholder in mergers and other transactions in which the majority forces minority shareholders out of the business and requires them to accept cash for their shares."[137]

Appraisal arbitrageurs need neither of these remedial protections. As to the liquidity rationale, arbitrageurs invest almost exclusively in public company mergers where cash is the dominant deal consideration.[138] Perhaps more importantly, arbitrageurs are not being forced to accept a transaction because they invariably invest *after* the announcement of a cash-out transaction and often after the record date for voting eligibility.[139] Further, unlike preannouncement investors, they need not actually dissent on the transaction, which increases the risk of nonconsummation; arbitrageurs have a costless call option on appraisal claims for all eligible transactions.[140] Put

133. *Id.* at 1657.

134. Thompson, *supra* note 125, at 10.

135. 457 A.2d 701, 713 (Del. 1983).

136. Geis, *supra* note 11, at 1644 (describing how *Weinberger* reflects a fundamental shift in Delaware courts' approach to appraisal).

137. Thompson, *supra* note 125, at 4; *accord* Geis, *supra* note 11, at 1645 (describing appraisal as "a governance 'trump card' to counter the threat of majority expropriation via freezout").

138. For public company targets, appraisal is generally unavailable in stock-for-stock mergers. *See supra* note 31 and accompanying text; *see also* Thompson, *supra* note 125, at 21–22.

139. *Cf. In re* Appraisal of Dole Food Co., 114 A.3d 541, 548 (Del. Ch. 2014) ("An appraisal is a 'legislative remedy which is intended to provide shareholders, *who dissent from a merger* asserting the inadequacy of the offering price, with an independent judicial determination of the fair value of their shares.'" (emphasis added) (citing Ala. By–Prods. Corp. v. Neal, 588 A.2d 255, 256 (Del. 1991))).

140. *See infra* Subpart III.B.2 (discussing further the economics of this option).

differently, arbitrageurs are not the dispossessed minority who dissent from a transaction—they are voluntary participants in these deals who buy stock with full knowledge of the transaction and its terms. Indeed, they are expressly buying a lawsuit. And arbitrageurs regularly challenge transactions far afield from the traditional opportunistic controlled freeze-out; more and more, they seek appraisal in arm's length deals untainted by conflicts of interest.[141] There is, thus, a significant mismatch between the statute's remedial purposes and its application to appraisal arbitrageurs.

These differences between arbitrageurs and preannouncement shareholders serve as a principled basis for differential treatment. By way of comparison, the standing requirements in derivative litigation explicitly require that the plaintiff be a stockholder at the time of the impugned transactions.[142] The Delaware Supreme Court explained that "[t]he long-recognized policy behind [the standing requirement] is to prevent strike suits whereby an individual purchases stock in a corporation with purely litigious motives, i.e., for the sole purpose of prosecuting a derivative action to attack transactions which occurred prior to the purchase of stock."[143] In an earlier case, the Chancery Court stated that "the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of stock" was "considered to be an evil."[144] While the same standing requirement does not apply in appraisal cases,[145] these pronouncements nevertheless highlight Delaware's discomfort with the notion of purchasing a lawsuit. Regardless, in a series of recent cases, the Delaware courts have confirmed arbitrageurs' standing to bring appraisal claims given that their claims satisfy the technical requirements of the statute.[146] Assuming arbitrage serves at least some useful function, differential treatment provides a sensible middle-ground legislative approach. The precise nature of that differential treatment depends in large part on the utility and risks of appraisal arbitrage.

### *B. Appraisal Arbitrage: Costs and Benefits*

Many commentators claim that, in addition to the judicially recognized remedial functions described above, appraisal serves

141. *See infra* Subpart III.B.2.

142. DEL. CODE ANN. tit. 8, § 327 (2011). ("In any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains or that such stockholder's stock thereafter devolved upon such stockholder by operation of law.").

143. Ala. By–Prods. Corp. v. Cede & Co., 657 A.2d 254, 264 n.12 (Del. 1995).

144. Harff v. Kerkorian, 324 A.2d 215, 218 (Del. Ch. 1974), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

145. *Ala. By–Prods. Corp.*, 657 A.2d at 267.

146. *See supra* note 100 and accompanying text.

another corporate governance aim: deterrence.[147] Specifically, the mere threat of appraisal claims might, at least at the margin, deter opportunistic controlled freeze-outs and push managers toward accepting only fair value in other deals. This prophylactic effect serves not only the interests of any particular shareholder who might need to seek appraisal, but it theoretically increases the welfare of *all* minority shareholders. Frank Easterbrook and Daniel Fischel argue, for example, that "[a]ppraisal's principle effects occur *ex ante* and increase the welfare of all shareholders, not just those who happen to be in the minority *ex post*."[148] In turn, if shareholders have less to fear from undervalued freeze-outs, they should be willing to pay more for their shares at the outset, which reduces the cost of equity capital in the aggregate.[149] But these effects depend heavily on the credibility and magnitude of the appraisal threat.

In theory, appraisal arbitrage can increase both the credibility and magnitude of that threat. As discussed above, many shareholders are unable or unwilling to pursue appraisal even if they are unhappy with the transaction.[150] However, sophisticated activist shareholders with the wherewithal to accumulate large blocks of stock have the necessary financial incentives and expertise to monitor the markets and challenge undervalued transactions.[151] Thus, a robust arbitrage market should be expected to amplify the deterrent effect of appraisal.

While this logic is superficially compelling, there are several important reasons to challenge the merits of appraisal arbitrage. First, the magnitude of deterrence resulting from augmenting appraisal is contestable. If appraisal has a meaningful impact on managerial behavior, we should expect higher takeover premia in transactions eligible for appraisal than in those for which appraisal is unavailable. Paul Mahoney and Mark Weinstein report, however, that no such effect was observed in a large sample of transactions

147. *See supra* note 23 and accompanying text.

148. EASTERBROOK & FISCHEL, *supra* note 22, at 145.

149. *Id.* at 146 ("Appraisal, reducing the probability that the minority's shares will be acquired at a price unilaterally set by the majority, increases the price the minority will pay for the shares to the benefits of both the majority and the minority.").

150. *See supra* notes 65–71 and accompanying text.

151. Geis, *supra* note 11, at 1660–61 ("[R]enewed appraisal claims can serve as a force for good, analogous to the discipline on managers thought to be imposed through the market for corporate control, by allowing activist shareholders to purchase shares and pursue large appraisal claims when a controller engages in an underpriced freezeout." (internal citation omitted)); Jetley & Ji, *supra* note 24, at 440 ("From a public policy perspective, it seems to be a good idea to have a group of professional investors dedicated to identifying and litigating deals done at prices that might not be fair to all shareholders.").

from 1975 to 1991.[152] One might argue that in the "old appraisal" world, there was simply insufficient appraisal activity to generate any noticeable deterrence. However, Mahoney and Weinstein also find that in ostensibly high-risk transactions involving self-interested managers, the availability of appraisal was *negatively* associated with shareholder returns.[153] Several studies also find no effects from earlier expansions of appraisal rights, such as the modernization of the remedy in *Weinberger*.[154]

Second, in many cases (including the most problematic conflicted transactions), appraisal provides—at best—incremental deterrence due to the availability of fiduciary duty claims.[155] Unlike appraisal petitioners, who must wait until a transaction has closed to seek relief, fiduciary plaintiffs can seek injunctive relief from the most obviously egregious transactions.[156] Even ex post, conflicted transactions such as controlled freeze-outs and other insider transactions are reviewed, at least in the first instance, under the exacting entire fairness standard.[157] In arm's length cash-outs, managers are subject to obligations set by *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[158] which require the board to take action reasonably aimed at maximizing the deal price.[159] In either instance, the court must resolve plenary fiduciary duty claims *before* considering appraisal petitions.[160] Korsmo and Myers suggest that

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152. Mahoney & Weinstein, *supra* note 65, at 242–43 ("We find no evidence in the full sample that access to the appraisal remedy has a measurable effect on the gains to shareholders of target firms.").

153. *Id.* at 243. This result suggests that the gains from appraisal are not equally distributed among all shareholders, and foreshadows some of the second-order wealth effects discussed *infra* Subpart III.B.2.

154. *Id.* ("On the whole there is no strong evidence that *Weinberger* affected target shareholder returns."); Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 568 (1987) (conducting event study centered on *Weinberger* and finding no effect).

155. Mahoney & Weinstein, *supra* note 65, at 249 ("[I]n the class of merger to which appraisal is most relevant under the post-*Weinberger* analysis, appraisal is duplicative of the fiduciary duty suit.").

156. *Cf.* Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1038–39 (2007).

157. *See id.* As illustrated by the *Dell* appraisal, the Delaware Supreme Court's decision in *MFW* may create a set of cases for which appraisal is the only viable claim for dissatisfied shareholders. *See supra* notes 107–112 and accompanying text.

158. 506 A.2d 173 (Del. 1986).

159. *See* Kesten, *supra* note 47, at 69–71 (synthesizing fiduciary obligations arising from *Revlon* and its progeny).

160. *In re* Dole Food Co., Stockholder Litig., C.A. No. 8703–VCL, 2015 WL 5052214, at *25 (Del. Ch. Aug. 27, 2015) ("The Delaware Supreme Court has instructed that when a merger gives rise to both a plenary action for breach of fiduciary duty and a statutory appraisal proceeding, the court should rule on the plenary claims first, because a finding of liability and the resultant remedy could

the existence of appraisal plaintiffs might helpfully spur meritorious fiduciary litigation toward trial, rather than an agency-cost-driven early settlement, such as the "disclosure only" agreements described in Part II, *supra*.[161] However, this argument loses at least some of its force given the recent decisions questioning, and ultimately rejecting, such settlements.

Third, market actors are becoming increasingly effective at identifying and challenging undervalued mergers ex ante. Wei Jiang et al. document how merger arbitrageurs have recently adopted substantially more aggressive strategies. Conventional merger arbitrageurs were typically passive; they took positions in target companies and then remained silent other than to vote their shares in favor of the merger.[162] Because passive merger arbitrageurs care only about securing the risk premium (i.e., the difference between the postannouncement stock price and the deal price), they have incentives to vote in favor of the transactions regardless of whether it is undervalued. And several studies suggest that passive arbitrageurs can affect the outcome of these votes.[163] Recently, however, a subset of merger arbitrageurs has taken a much more active approach. Upon purchase, they complain loudly and publicly about the transaction price and threaten to vote against the deal in the hopes that such threatened dissent will trigger renegotiation.[164] These activists have had meaningful success—Jiang et al. report annualized average returns of 16.3% for activist merger arbitrageurs as compared with 7–11% for passive strategies.[165] Those excess returns derive from the activists' ability to extract higher deal prices from acquirers.[166] The success of activist merger arbitrageurs further undermines the incremental deterrence of appraisal. These arbitrageurs monitor deals and intervene ex ante, focusing primarily on the deals most likely to raise concerns about underpricing. And unlike appraisal claims, where only dissenters obtain a remedy, the

moot the appraisal proceeding." (citing Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1189 (Del.1988))).

161. Korsmo & Myers, *supra* note 43, at 19 ("Even in fiduciary class actions that are tried to judgment, it may be the presence of appraisal petitioners that leads to trial, rather than the traditional 'disclosure only' settlement.").

162. Jiang et al., *supra* note 1, at 3.

163. *See, e.g.*, Jim Hsieh & Ralph A. Walkling, *Determinants and Implications of Arbitrage Holdings in Acquisitions*, 77 J. FIN. ECON. 605, 606 (2005) (finding that arbitrage holdings are positively correlated with deal success). *See generally* Francesca Cornelli & David D. Li, *Risk Arbitrage in Takeovers*, 15 REV. FIN. STUD. 837 (2002) (modeling how arbitrageurs' behavior impacts deal success).

164. Jiang et al., *supra* note 1, at 3.

165. *Id.* at 4. The Jiang et al. sample excludes standalone appraisal arbitrage (i.e., appraisal petitions that were not accompanied by pretransaction activist campaigns aimed at increasing deal terms for all shareholders). *Id.* at 8.

166. *Id.* at 5.

higher deal price achieved by ex ante activism is shared equally among all investors.

Finally, appraisal arbitrage might give rise to costs that outweigh any salutary deterrence effects. Economic theory and recent empirical evidence suggest a significant risk of overlitigation and potentially pernicious wealth transfers from nondissenting shareholders to arbitrageurs.

*1. The Risk of Rent Seeking*

A well-calibrated appraisal structure should encourage meritorious claims but discourage nuisance suits, interest rate arbitrage, and other forms of rent seeking. But the current data on appraisal claims suggest several plausible reasons to believe that the current system encourages questionable appraisal filings. First, the statutory interest rate appears to drive at least some appraisal petitions. By default, appraisal petitioners receive the statutory interest rate regardless of the outcome of the case.[167] While the extent to which the statutory interest rate drives appraisal claims is debatable, it likely overcompensates appraisal arbitrageurs. The primary function of a statutory interest rate is to make petitioners indifferent to time concerning recovery.[168] Gaurav Jetley and Xinyu Ji argue that the risk associated with appraisal claims is akin to a corporate bond with a three-year maturity (the average length of an appraisal claim) and a rating of at least "BB" (midrange, noninvestment grade/speculative).[169] Given that appraisal claimants are creditors of the surviving entity, the main nonlitigation risk they confront is the time-value of money and the possibility of nonpayment of the final award. This approach therefore makes some sense. Jetley and Ji demonstrated that between 2010 and 2014, the statutory rate exceeded the yield on such corporate bonds.[170] Thus, at the very least, the statutory interest rate improves the economics for appraisal claimants.

Korsmo and Myers challenge this approach, arguing that: (1) appraisal claimants are equity holders, whose investment has been taken from them by board-initiated operation of law, and (2) appraisal claimants face litigation risk in addition to credit risk.[171] The first

167. Jetley & Ji, *supra* note 24, at 452. Historically, this was true for all petitioners. After the recent amendments to the appraisal statute, the amount on which statutory interest is paid depends on the quantum of prepayment, if any. DEL. CODE ANN. tit. 8, § 262(h) (2016).

168. *See* Korsmo & Myers, *supra* note 43, at 58.

169. Jetley & Ji, *supra* note 24, at 431.

170. *Id.* ("We find that during the five-year period between 2010 and 2014, the statutory interest rate, which is set at the Federal Reserve Discount Rate plus 5%, was higher than the yield on corporate bonds with maturity and credit risk that correspond to risk of appraisal (three-year with credit ratings of BB or higher) . . . .").

171. *See* Korsmo & Myers, *supra* note 43, at 57–58.

concern is easily dismissed as to arbitrageurs. Unlike preannouncement shareholders, nothing has been taken from them; they voluntarily purchase target shares with the understanding that they will not remain as post-transaction shareholders.[172] Their investment is in the appraisal claim itself, rendering them much more akin to creditors than traditional shareholders. The second argument is both a problematic policy choice and a likely overstatement of the concern. The ordinary rule is that parties bear their own costs, even if they are successful in their claims.[173] It is unclear from a corporate law policy perspective why acquirers should systematically subsidize appraisal claimants, and especially unsuccessful suits. In any event, the litigation risk associated with appraisal is rather small. While the court can theoretically conclude that fair value was materially below the merger price, it is exceptionally rare. Since 2010, it has happened only once in a public company appraisal case, and that case is an oddity.[174] Assuming appraisal arbitrageurs avoid highly synergistic deals involving strategic acquirers,[175] the likely worst-case scenario is that the arbitrageur receives the deal price plus a generous interest rate compounded quarterly.[176]

A recent study by Jiang et al. provides empirical support for the conclusion that a favorable interest rate is at least one important determinant of appraisal claims.[177] They analyze appraisal petitions filed between 2000 and 2014 and resolved prior to July 8, 2016 and report several data points pertaining to the statutory interest rate. First, the probability of appraisal filings is highly sensitive to the spread between the yield on the two-year U.S. Treasury Note (which they deem a comparable risk-free investment) and the statutory interest rate for appraisal.[178] And second, among trial decisions, interest awards account for approximately half of the total gains obtained by appraisal plaintiffs.[179] The study concludes that interest

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172. The argument carries more weight with respect to preannouncement shareholders. Part IV, *infra*, addresses this consideration in the context of proposed reforms.

173. *See* Thomas D. Rowe, Jr., *The Legal Theory of Attorney Fee Shifting: A Critical Overview*, 1982 DUKE L.J. 651, 651.

174. Korsmo & Myers, *supra* note 43, at 22 (noting that *In re* Hanover Direct, Inc. Shareholders Litigation, Consol. C.A. No. 1969–CC, 3047–CC, 3291–CC, 2010 WL 3959399 (Del. Ch. Sept. 24, 2010), in which the court found that the common stock of the firm had no value whatsoever, involved a dispute about preferred stock that is unlike other types of appraisal claims).

175. *Cf.* Highfields Capital, Ltd. v. AXA Fin., Inc., 939 A.2d 34, 60 (Del. Ch. 2007) (discounting the merger price to account for substantial synergies).

176. *See, e.g.*, Hoffman, *supra* note 94 ("LongPath will likely still come out ahead, thanks to guaranteed interest on its claims of 5.75% a year.").

177. Wei Jiang et al., *Appraisal: Shareholder Remedy or Litigation Arbitrage?* 4 (Columbia Bus. Sch. Research Paper 16–31, 2016), http://ssrn.com/abstract=2766776.

178. *Id.* at 5–6.

179. *Id.* at 4.

rate arbitrage has been, at least historically, a significant driver of appraisal petitions.

Second, appraisal claims may also act as a hedging strategy in conjunction with other shareholder activism. The active merger arbitrage described above is costlier than passive arbitrage and does not always succeed.[180] Even a questionable appraisal claim might provide a route to improve returns in those cases. If the arbitrageur does not achieve the hoped-for results on the front end, it can seek appraisal to top its return either via settlement or, after trial, payment of statutory interest. Activist hedge funds, too, might employ appraisal as an insurance policy against transactions that do not generate sufficient returns for their own investors.[181] In each of these cases, the statutory rate may improve the economics of these activist strategies and thus encourage more of each at the margin.[182]

Finally, appraisal claims might be driven by settlement value. At present, it is impossible to fully assess the economics of appraisal settlements. Unlike standard shareholder litigation, appraisal settlements are not made public because they do not bind nonsignatories.[183] But given that most appraisal claims settle prior to trial (or even prior to filing a petition),[184] one cannot dismiss entirely the potential financial significance of settlement. Collectively, the dynamics above suggest that we should expect more appraisal claims than the merits alone would suggest.

Litigation outcomes provide some support for the overlitigation hypothesis. Claims that go to trial should, at least in theory, be relatively strong from the perspective of the plaintiff. In their

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180. Jiang et al., *supra* note 1, at 20.

181. *See* Kahan & Rock, *supra* note 156, at 1038 (explaining that "[w]hen hedge funds are dissatisfied with the terms of an acquisition and unable to obtain better terms, they also resort to litigation," including appraisal); Jiang et al., *supra* note 177, at 8 ("An appraisal arbitrage may well represent an activist's "last resort" after he failed to convince the majority of shareholders to improve or to block the deal.").

182. An open question, beyond the scope of this paper, is whether we should encourage these activities with a back-end subsidy. While merger arbitrage seems promising as a check against an undervalued takeover, the merits of hedge fund activism writ large is one of the most hotly contested questions of corporate and securities law policy. *Compare* Martijn Cremers et al., *Hedge Fund Activism and Long-Term Firm Value* (Nov. 19, 2015), http://papers.ssrn.com /sol3/papers.cfm?abstract_id=2693231 (presenting evidence that hedge fund activism decreases long-term firm value relative to nontargeted control firms with similar characteristics), *with* Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1090–91 (2015) (finding no evidence that the short-term gains generated by activist interventions come at the expense of long-term performance).

183. Korsmo & Myers, *supra* note 3, at 1582; Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 84 n.17 (1995) (stating that "[t]here is no way to document the number of appraisal settlements").

184. Jiang et al., *supra* note 177, at 4.

seminal paper on litigant behavior, George Priest and Benjamin Klein model the determinants of settlement versus trial.[185] Assuming rational and risk-neutral parties,[186] they conclude that when there is relative agreement about likely outcomes (i.e., where either side has a "powerful" argument), cases are less likely to proceed to trial.[187] Thus, from the perspective of the plaintiff, both the strongest and weakest cases are expected to settle.[188] What remains for trial are relatively strong claims distributed around the decision standard.[189] From this result, Priest and Klein predict that plaintiffs should win at trial approximately 50% of the time.[190] Of course, this prediction describes the limit; actual trial results will vary, but should converge on that limit over time as parties' error rates decline.[191] Nevertheless, the Priest-Klein model also implies a strong bias toward a 50% win-rate.[192] That is, while actual win-rates often diverge from the limit, observed trial win-rates should be closer to 50% than the aggregate win-rate of all cases within the distribution if every case was tried rather than settled.[193] Thus, the observed trial win-rate can provide meaningful information about the broader universe of claims.[194]

Based on this framework, recent trial outcomes call into question whether appraisal arbitrageurs target the right deals. Figure 3, below, provides details on the public company appraisal cases from the "arbitrage era" (2013–2016).

185. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 1 (1984).

186. *See, e.g.*, Robert J. Rhee, *A Price Theory of Legal Bargaining: An Inquiry Into the Selection of Settlement and Litigation Under Uncertainty*, 56 EMORY L. J. 619, 636–37 (2006) (noting that the standard model assumes risk neutrality and rationality). While these assumptions are subject to critique more generally (see *id.*), they seem unproblematic when applied to appraisal arbitrage. Both arbitrageurs and the defendant corporations are sophisticated financial actors well-versed in the valuation process that constitutes the sole issue in appraisal claims. Moreover, given appraisal arbitrageurs' portfolio investment approach to litigation, it is reasonable to model their behavior as risk-neutral.

187. Priest & Klein, *supra* note 185, at 17 ("Where either the plaintiff or defendant has a 'powerful' case, settlement is more likely because the parties are less likely to disagree about the outcome.").

188. *See* Korsmo & Myers, *supra* note 43, at 62.

189. *See* Priest & Klein, *supra* note 185, at 17–18; Korsmo & Myers, *supra* note 43 at 22 ("Cases selected for litigation by petitioners and the cases where petitioners are further willing to push to trial should be a group of relatively strong cases.").

190. Priest & Klein, *supra* note 185, at 17–20.

191. *Id.* at 18–19.

192. *Id.* at 5.

193. *Id.* at 22.

194. *See generally* Yoon-Ho Alex Lee & Daniel Klerman, *The Priest-Klein Hypotheses: Proofs and Generality*, 48 INT'L REV. L. & ECON. 59 (2016) (presenting rigorous proofs of several hypotheses derived from the Priest-Klein model). The 50% Bias Hypothesis is strictly true if the parties are quite accurate at estimating case outcomes. *Id.* at 69–70. If the parties are less accurate, the 50% Bias Hypothesis holds if certain specified conditions are true. *Id.*

Figure 3: Public Company Appraisal Decisions in the Arbitrage Era (2013-2016)

| Case Name | Year | Premium | Arbitrage | Buyer Status: Arm's Length | Buyer Status: Strategic/ Financial | Sale Process |
|---|---|---|---|---|---|---|
| Am. Commcl. Lines | 2013 | 15.6% | N* | Y | F | Single bidder plus go-shop period |
| Cox Radio | 2013 | 19.8% | N* | N | N/A | Short form merger cash-out after tender offer by controlling SH |
| 3M Cogent | 2013 | 3.5% | Y | Y | S | Two bidder negotiation with significant pre-signing market check |
| CKx | 2013 | 0.0% | Y | Y | F | Auction plus significant pre-signing market check |
| Ancestry. com | 2015 | 0.0% | Y | Y | F | Auction plus significant pre-signing market check |
| AutoInfo | 2015 | 0.0% | Y | Y | F | Multiple bidders arising from exhaustive pre-signing market check |
| Ramtron | 2015 | 1.0% | Y | Y | S | Unsolicited offer plus significant pre-signing market check |
| BMC Software | 2015 | 0.0% | Y | Y | F | Auction plus significant pre-signing market check |

| | | | | | | |
|---|---|---|---|---|---|---|
| Lender Processing | 2016 | 0.0% | Y | Y | S | Auction plus significant pre-signing market check |
| Dell | 2016 | 28.0% | Y | N | F | MBO with little pre-signing competition and limited go-shop; process satisfied *MFW* standard |
| DFC Global | 2016 | 7.5% | Y | Y | F | Two bidder negotiation with significant pre-signing market check |

| | |
|---|---|
| Average | 0.07 |
| Median | 0.0000 |

Assuming that any recovery above the merger price constitutes a win, then arbitrageurs have a 33% win-rate. And even that win-rate might overstate arbitrageurs' actual success. In a subsequent decision, Vice Chancellor Laster called into question the result in *Merion Capital, L.P. v. 3M Cogent, Inc.*,[195] suggesting that a different litigation strategy might have led to a finding that the merger price was fair.[196] In that scenario, the observable win-rate falls to 22%. While the small sample size compels extreme caution when drawing conclusions, these trial results coupled with the Priest-Klein 50% Bias Hypothesis suggest that the expected win-rate of the full universe of appraisal petitions filed by arbitrageurs could be rather low.

Moreover, from 2013 to 2016, the median (mean) premium awarded by the court in all public company appraisal claims was 0%

195. C.A. No. 6247–VCP, 2013 WL 3793896 (Del. Ch. July 8, 2013).

196. Merion Capital L.P. v. Lender Processing Servs., Inc., C.A. No. 9320–VCL, 2016 WL 7324170, at *31 n.34 (Del. Ch. Dec. 16, 2016) ("If the respondent corporation had relied affirmatively on the deal price and made some attempt to deal with synergies, it seems likely that the court would have given the deal price at least some weight. . . . If the respondent had made a different tactical decision, the *3M Cogent* court could well have relied on the deal price.").

(7%).[197] To put this in perspective—and consistent with Jiang et al.'s conclusion concerning the importance of statutory interest—the average premium obtained by litigating these cases through trial is generally a fraction of the statutory interest on that judgment.[198] And these figures may overstate appraisal arbitrageurs' success for several reasons. First, the *IQ Holdings, Inc. v. American Commerical Lines Inc.*[199] and *Towerview LLC v. Cox Radio, Inc.*[200] appraisals do not appear to have involved arbitrageurs, but rather were pursued by preexisting shareholders of those firms. Second, as noted above, the premium awarded in *3M Cogent* might have largely been the result of a flawed litigation strategy by the target company. Finally, both the *Dell* appraisal decision and *In re Appraisal of DFC Global Corp.*[201] are currently on appeal to the Delaware Supreme Court.[202] An adverse ruling for the petitioners in either or both cases would further reduce both aggregate returns and the observed trial win-rate.

Notably, the returns on recent claims are substantially smaller than the long-run returns on appraisal cases. Jiang et al. report that the median (mean) return across their sample beginning in 2000 is 49.9% (108.3%).[203] This, too, suggests that appraisal arbitrageurs might increasingly be challenging, and pursuing to trial, less problematic transactions.

These cases also reflect a broader troubling qualitative trend: arbitrageurs are increasingly targeting and vigorously pursuing comparatively low-risk transactions. Recognizing, of course, that some high-risk transactions might be entirely fair to shareholders and vice versa, one can estimate the risk of unfair deal pricing along a continuum of transaction structures. Figure 4, below, illustrates this taxonomy.

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197. If one extends the sample back to 2010, when the first post-*Transkaryotic* cases were resolved, the median (mean) award is 1.75% (9%). But that extended sample includes two outliers involving relatively rare issues related to the valuation of preferred stock. Korsmo & Myers, *supra* note 43, at 21–22. Excluding those cases generates a median (mean) award of 2% (8%).

198. Jiang et al., *supra* note 177, at 4.

199. C.A. No. 6369–VCL, 2013 WL 4056207 (Del. Ch. Mar. 18, 2013).

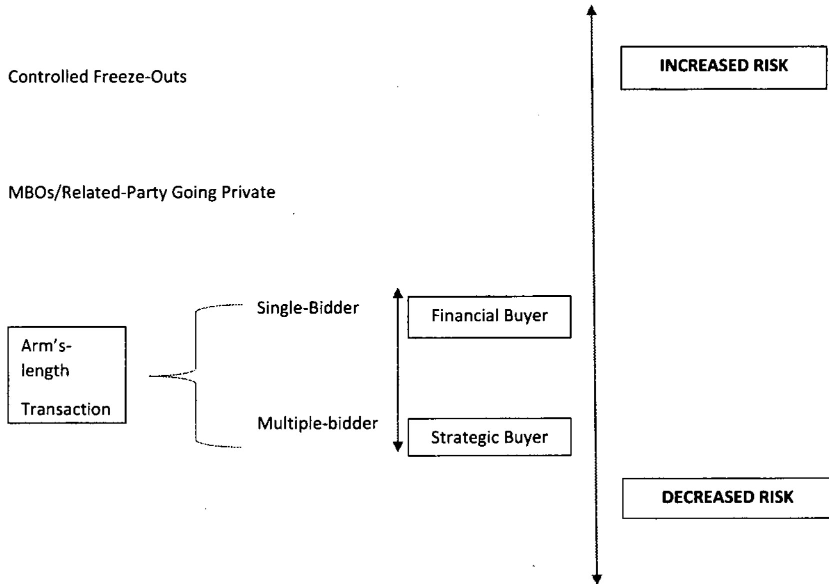
200. C.A. No. 4809–VCP, 2013 WL 3316186 (Del. Ch. June 28, 2013).

201. C.A. No. 10107–CB, 2016 WL 3753123 (Del. Ch. July 8, 2016).

202. *See* Appellant's Opening Brief, Dell, Inc. v. Magnetar Glob. Event Driven Master Fund, Ltd. (Del. Jan. 17, 2017) (No. 565,2016); Appellant's Opening Brief, DFC Glob. Corp. v. Muirfield Value Partners, 2016 WL 7386807 (Del. Dec. 13, 2016) (No. 518,2016).

203. Jiang et al., *supra* note 177, at 55.

Figure 4: Taxonomy of Structural Underpricing Risk




Controlled freeze-outs, in which a majority shareholder forces out the minority, are typically considered most likely to be characterized by unfairness. For example, in *In re Emerging Communications, Inc. Shareholders Litigation*,[204] Justice Jack Jacobs explained that "a freeze-out merger of the minority proposed by the majority stockholder is inherently coercive. Where, as here, the freeze-out merger is initiated by the majority stockholder, that fact, even though not dispositive, is evidence of unfair dealing."[205] Management buyouts ("MBOs") or other related-party going private transactions are similarly problematic.[206] With respect to arm's length deals, those involving only financial buyers, which typically do not enjoy significant synergies with the target, generally pose more risk of underpricing than do strategic acquisitions.[207] Indeed, empirical

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204. No. C.A. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004).
205. *Id.* at *32.
206. *In re* Appraisal of Dell, Inc., C.A. No. 9322–VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016).
207. *See supra* notes 48–52 and accompanying text. The Delaware courts consider deals in which financial sponsors employ leveraged buyout valuation models (which focus on certain return-on-investment hurdles rather than analyzing the intrinsic value of the target) especially problematic. *See Dell*, 2016 WL 3186538, at *29–32 ("The first factor that undermined the persuasiveness of the Original Merger Consideration was the use of an leveraged buyout pricing model.").

evidence strongly suggests that strategic buyers generally pay full value for targets, including the benefits of control and synergistic gains.[208] Within the arm's length subgroup, single-bidder transactions that lack an effective market check pose more risk than sales processes that bring in multiple potential counterparties. Arm's length deals involving a heterogeneous group of potential buyers pose the least structural risk of underpricing.[209]

Yet, as described above, most of the recent appraisal trials were arm's length deals untainted by breaches of fiduciary duty, which involved active solicitations of multiple purchasers and included vigorous negotiations and/or auctions.[210] In one case, the court somewhat incredulously noted that:

> LongPath [the arbitrageur petitioner] asks this Court to adopt its [valuation] and conclude that the market left an amount on the table exceeding Ramtron's unaffected market capitalization. This would be a significant market failure, especially in the context of a well-publicized hostile bid and a target actively seeking a white knight.[211]

Moreover, notwithstanding the divergent structural risks illustrated above, Korsmo and Myers report that buyer type (i.e., financial versus strategic) has no statistically significant impact on the likelihood of appraisal claims.[212] This trend continued in 2015 and 2016—more appraisal petitions were filed in strategic transactions than in those involving financial acquirers. Figure 5,

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208. Merion Capital L.P. v. Lender Processing Servs., Inc., C.A. No. 9320–VCL, 2016 WL 7324170, at *17 (Del. Ch. Dec. 16, 2016) (citing Gorbenko & Malenko, *supra* note 48, at 2537 (reporting that "average returns to [strategic] acquirers are close to zero or even negative")).

209. *Id.* at *19 (Del. Ch. Dec. 16, 2016) ("[B]ecause the Company contacted a reasonable number of heterogeneous bidders during the pre-signing phase, its argument for reliance on the deal price (all else equal) is more persuasive.").

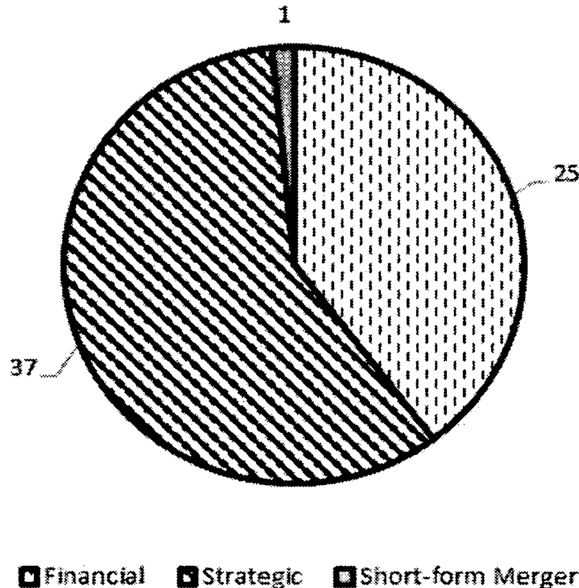
210. LongPath Capital, LLC v. Ramtron Int'l Corp., C.A. No. 8094–VCP, 2015 WL 4540443, at *6–8, *21–24 (Del. Ch. June 30, 2015) (describing the target's active attempts to find other potential buyers in the face of a hostile bid, and the actions taken that caused the acquirer to increase its offer five times even in the absence of a second bidder); Merlin Partners LP v. AutoInfo, Inc., No. 8509–VCN, 2015 WL 2069417, at *3, *17 (Del. Ch. Apr. 30, 2015) (noting that the target had contacted 164 potential bidders, and then conducted "a competitive and fair auction"); Huff Fund Inv. P'ship v. CKx, Inc., C.A. No. 6844–VCG, 2013 WL 5878807, at *13 (Del. Ch. Nov. 1, 2013), *aff'd* 2015 WL 631586 (Del. Feb. 12, 2015) ("The record and the trial testimony support a conclusion that the process by which CKx was marketed to potential buyers was thorough, effective, and free from any specter of self-interest or disloyalty.").

211. *LongPath Capital*, 2015 WL 4540443, at *9.

212. Korsmo & Myers, *supra* note 3, at 1614; Korsmo & Myers, *supra* note 43, at 10–11.

below, presents the breakdown of transactions challenged by buyer type.[213]

Figure 5: Public Company Appraisal Petitions By Buyer Type (2015–2016)

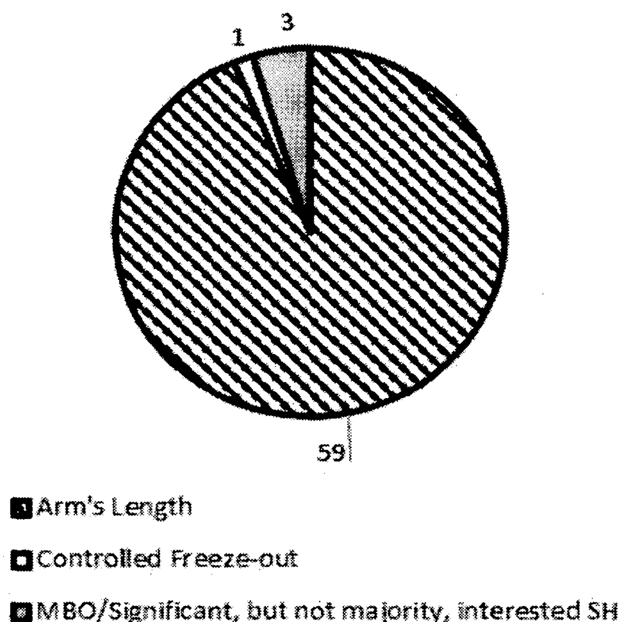



Finally, while freeze-outs and related party transactions are statistically more likely to attract an appraisal claim, these deals account for a tiny fraction of petitions filed (largely because they also constitute a small fraction of all transactions).[214] Figure 6, below, presents appraisal petition data for 2015 to 2016 by type of transaction.

213. Data on 2015 and 2016 appraisal claims were hand-collected. Descriptive data on the petitions themselves was gathered from the Delaware Court of Chancery docket. This information was then cross-referenced with public records to determine the type of acquirer and target; the relationship between the acquirer and the target; and transaction structure.

214. For example, based on deal volume data obtained from SDC Platinum, controlled freeze-outs, MBOs, and related-party transactions comprised approximately 4% of appraisal-eligible deals during the sample period.

Figure 6: Public Company Appraisal Petitions By Relationship Between Buyer/Target




Throughout 2015 and 2016, appraisal petitioners challenged sixty-three public company transactions.[215] More than 93% of the deals challenged involved arm's length transactions, many of which carried important indicia of propriety such as significant presigning market checks and go-shop periods. And, as noted above, more than half of the challenged deals involved strategic buyers. In sum, notwithstanding a series of recent losses at trial, arbitrageurs are increasingly targeting transactions that have a low probability of being meaningfully undervalued.

Korsmo and Myers challenge the overlitigation hypothesis, arguing that, on balance, appraisal petitioners target the right transactions.[216] In several recent articles, they provide extensive, well-researched data on appraisal petitions from 2004 to 2014. Their core empirical claims can be summarized as follows: only two variables—the presence of insiders and low residual deal premia—have any statistically significant effect on the likelihood of an

215. Based on deal volume data obtained from SDC Platinum, petitioners challenged over 20% of appraisal-eligible transactions during the sample period.

216. Korsmo & Myers, *supra* note 3, at 1583 ("We hypothesize that the structure of appraisal litigation—which provides strong incentives for stockholders but not their attorneys—ought to lead to litigation that bears markers of litigation merit. In our empirical analysis, we find strong evidence in favor of this hypothesis.").

appraisal claim.[217] While they concede that their results "do not prove that appraisal arbitrage is a positive development," they argue that "it does at least suggest that appraisal is not simply a new frontier of nuisance litigation."[218] The strength of this conclusion, however, is open to question.

As noted above, insider transactions account for only a tiny portion of the deals challenged. A nontrivial and increasing number of seemingly unproblematic arm's length deals have been challenged, and pursued unsuccessfully, to trial. Relatedly, low residual deal premia are—at best—an imperfect proxy for the merits of a claim. A residual deal premium is the difference between the actual deal premium and an "expected" premium calculated by analyzing putatively similar deals, involving similar companies, during a similar time frame.[219] Korsmo and Myers employ three variables in their calculation: target size, year of transaction, and target industry.[220] While this analysis may provide a rough estimate of comparable transactions, it entirely ignores numerous, potentially critical firm-specific and macroeconomic factors that might influence the fairness of any particular deal price.

For many companies, there may not be sufficiently similar comparables. For industries in which a large number of similar entities operate in a competitive environment, the comparables approach might provide meaningful valuation information.[221] For many firms, however—including several that have been the target of recent appraisal claims—there are insufficient comparable companies or deals.[222] Recognizing these difficulties, Delaware courts in appraisal cases often eschew a comparables analysis in favor of the

217. *Id.* at 1591–97 (presenting data from 2004 to 2013); Korsmo & Myers, *supra* note 43, at 15 (presenting data from 2011 to 2014). They also note that appraisal petitioners sue at a substantially lower rate than do fiduciary plaintiffs. Korsmo & Myers, *supra* note 3, at 1589–90. While it is too early yet to know for certain, the crackdown on disclosure-only settlements seems to have bridged the majority of this gap.

218. Korsmo & Myers, *supra* note 3, at 1597.

219. *Id.* at 1594.

220. *Id.*

221. *In re* Appraisal of Orchard Enters., Inc., C.A. No. 5713–CS, 2012 WL 2923305, at *9 (Del. Ch. July 18, 2012) ("[T]he utility of a market-based method depends on actually having companies that are sufficiently comparable that their trading multiples provide a relevant insight into the subject company's own growth prospects. When there are a number of corporations competing in a similar industry, the method is easiest to deploy reliably.").

222. *Id.* at *9–10.

DCF approach.[223] The *In re Appraisal of Ancestry.com, Inc.*[224] decision itself provides an excellent example. There, the court relied exclusively on a DCF analysis, opining that an evaluation of comparables was "irrelevant and unhelpful . . . given Ancestry's unique business and the concomitant difficulty of finding comparable companies or transactions."[225] At least in these cases, the residual merger premium is likely of little value as a proxy for merit.

Ultimately, there are several possible interpretations of the data presented herein. These outcomes could reflect rational action coupled with high error rates concerning likely trial outcomes, uncertainty about the decision rules employed by the court, or merely irrational exuberance concerning the expected value of appraisal claims. While these possibilities are rather benign, none provide much comfort that appraisal arbitrageurs target the "right" transactions. Or, this trend might suggest that appraisal arbitrageurs are engaged in a combination of interest rate arbitrage and rent seeking, coupled with a portfolio approach to litigation in which a small number of big "wins" generate sufficient return on investment to support a larger number of losses. While the small sample size prevents drawing any strong statistical conclusions, the evidence to date is rather suggestive that appraisal arbitrage leads to overlitigation, and may continue to do so going forward.

#### 2. *The Redistribution of Shareholder Value*

In addition to (and at least in part as a result of) the potential for overlitigation, appraisal arbitrage perniciously redistributes value from acquirers and ordinary shareholders to the arbitrageurs. First, some value is transferred directly from the acquirer even if the appraisal claim is ultimately unmeritorious.[226] Acquirers who purchase targets for fair value and refuse to settle claims face the prospect of a sizeable payout as a result of the statutory interest

223. *Id.* at *9 ("Reliance on a comparable companies or comparable transactions approach is improper where the purported 'comparables' involve significantly different products or services than the company whose appraisal is at issue, or vastly different multiples. 'At some point, the differences become so large that the use of the comparable company method becomes meaningless for valuation purposes.'" (citing *In re* Radiology Assocs., Litig., 611 A.2d 485, 490 (Del. Ch. 1991))).

224. C.A. No. 8173–VCG, 2015 WL 399726 (Del. Ch. Jan. 30, 2015).

225. *Id.* at *8.

226. *See* Jason Mei, *Appraisal Arbitrage: Investment Strategy of Hedge Funds and Shareholder Activists*, 34 REV. BANKING & FIN. L. 83, 89–90 (2014) (discussing how the threat of an appraisal petition creates risk and reduces value for the acquirer at various stages of the transaction); *see also* Jetley & Ji, *supra* note 24, at 452 (noting that "a petitioner is awarded interest, regardless of whether the court appraised fair value is higher or lower than the transaction price").

award.[227] And the aggregate financial impact of unmeritorious appraisal claims also includes settlement costs, since acquirers might settle in advance of trial to avoid that outcome.[228]

More subtly, the current system provides arbitrageurs with a valuable option for which they do not presently have to compensate either the acquirer or the target shareholders.[229] Appraisal rights are akin to a call option written by acquirers. The strike price is the cost of purchasing the target's stock preclosing and the value of the option is the ultimate award granted by the court. Arbitrageurs will exercise the option any time they think that the expected value exceeds the strike price. The ability to delay exercising that option is thus intrinsically valuable. By waiting, the arbitrageur can gather information about the adequacy of the deal price and ascertain the likelihood of deal failure (which would extinguish the option at a loss).[230] More importantly, arbitrageurs can take advantage of postannouncement firm-specific or macroeconomic events that might allow them to more effectively challenge the fairness of the deal price.[231] For example, in a recent case against Safeway, petitioners exploited the fact that grocery stocks rose between signing and closing due to declining oil prices.[232]

Under the current rules, arbitrageurs can wait to exercise their option almost indefinitely.[233] Moreover, because they need not own much stock on the record date,[234] they do not run the risk of endogenously affecting the vote on the transaction. In financial markets, purchasers of such a call option would have to pay. But with appraisal, the arbitrageur need not compensate either the acquirer or the target's shareholders. With respect to the former, clearly no payment is made. To the contrary, the arbitrageur expects to extract value. As to the latter, there is no empirical evidence to date that the target stock price impounds the value of the delay option. Jetley and Ji hypothesize that no such price effect emerges because a sufficient number of sellers (e.g., merger arbitrageurs) are willing to sell at

227. Norwitz, *supra* note 5. Whether this constitutes a value-transfer depends on how the statutory interest rate compares to the target firm's cost of capital.

228. Korsmo & Myers, *supra* note 43, at 62.

229. Jetley & Ji, *supra* note 24, at 430.

230. Norwitz, *supra* note 5.

231. *Id.* ("With such a safety net, arbitrageurs are incentivized to assert appraisal and see what happens: some positive development may allow them to argue that the value of the target has increased before the closing, or, as is often the case, they may convince the purchaser to pay them off (that is, offer them extra consideration not being shared with the rest of the shareholders) to buy certainty.").

232. *Id.*

233. *See* Jetley & Ji, *supra* note 24, at 430.

234. *Id.* at 435.

anything close to the deal price.[235] Unless and until target shareholders can effectively hold out for a higher price, arbitrageurs will get their option for free.[236] This, too, is "a transfer of value from the acquiring company to the arbitrageur."[237]

Perhaps most problematic, appraisal arbitrage may also lead to second-order wealth transfers from target company shareholders. If there is a real threat of appraisal—even in arm's length transactions—acquirers might view the costs of those claims as a form of deal tax and self-insure by lowering their bids.[238] Moreover, given that arbitrageurs have pursued multiple claims to trial absent meaningful indicia of unfairness,[239] acquirers might rationally believe that they cannot necessarily avoid these claims by increasing the deal premium. In other words, in most cases it is likely rational and cost effective to offer a lower price to the majority (or at least not raise one's bid) and set aside an "appraisal reserve" for any potential dissenters.[240] Barring unusual circumstances, it is economically irrational for a winning bidder to pay more than the minimum winning bid if the bidder believes that the transaction will obtain the necessary board and shareholder approvals. An increase in the bid price must be paid to all shareholders; side payments to dissenters or court-ordered appraisal awards need only be paid to the fraction of shareholders who assert those claims, which by definition is—at most—less than half. The *Dell* case is a powerful exemplar. In that case, the 28% premium awarded by the court over the merger price valued the full deal at $6 billion more than the acquirer actually paid.[241] Yet even after losing the appraisal case, the buyers were only

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235. *Id.* at 430 ("We also posit that the stock price of the target subsequent to the announcement of a transaction does not incorporate the value of the delay option. In other words, the arbitrageurs do not pay the targets' shareholders for the option either. We do not think the value of the option is impounded into the target stock price because, for a transaction that market participants like—the ones in which enough shareholders are expected to vote in favor of the transaction—there are potentially enough sellers, such as merger arbitrageurs, who would be happy to exit the deal at a price that is close to the merger price.").

236. Geis, *supra* note 11, at 1656 (observing that appraisal arbitrage "may not help the selling shareholders much, unless the possibility of an amplified appraisal upside is reflected in *their* sale price").

237. Jetley & Ji, *supra* note 24, at 430.

238. *See, e.g.*, Mahoney & Weinstein, *supra* note 65, at 242.

239. *See supra* Subpart III.B.1.

240. Brief of Law and Corporate Finance Professors As *Amici Curiae* In Support of Reversal, at 18, DFC Glob. Corp. v. Muirfield Value Partners, L.P., (Del. Dec. 20, 2016) (No. 518,2016) [hereinafter DFC *Amici* Brief] ("The likelihood of appraisal litigation . . . encourages bidders who do participate to bid less, as they must factor in the tax imposed by litigation after the transaction closes.").

241. Steven Davidoff Solomon, *Ruling on Dell Buyout May Not Be the Precedent That Some Fear*, N.Y. TIMES: DEALBOOK (June 7, 2016), https://www.nytimes.com/2016/06/08/business/dealbook/ruling-on-dell-buyout-may-not-be-precedent-some-fear.html?_r=0.

obliged to pay out an additional $37 million because so few shareholders had perfected their appraisal rights.[242]

This dynamic is most problematic in arm's length transactions involving an auction or similar multibidder sales process. Auction theory teaches that the revenue generated by a standard ascending-bid auction depends on the private valuations of both the highest and second-highest bidders.[243] In this type of auction, the selling firm opens the bidding at a particular level (in the takeover context, that reserve price is typically some premium over the current market price of that company's stock), and then sequentially increases the price until only one bidder remains; that bidder wins and pays the value of its top bid.[244] The dominant strategy for bidders is simple: remain in the bidding until the price reaches your private estimate of the target's value.[245] If the second-highest bidder drops out before you do, you win the auction. Thus, the expected revenue of the auction is the second-highest bidder's private value for the target plus any minimum bid increment that the winning bidder was willing to pay.[246]

If participants in these auctions conclude that there is a legitimate possibility of an appraisal claim challenging the transaction price, they will each rationally discount their all-else-equal private valuation for the target by their estimate of those expected costs. This reduces the private valuation of the second-highest bidder, and thus the expected revenue from the auction. While the magnitude of bidders' discounting might be relatively modest in any single transaction, the aggregate effect is likely economically significant; arm's length, strategic transactions account for the vast majority of public company mergers and acquisitions.[247]

Mahoney and Weinstein present evidence that this concern is not merely hypothetical even in single-bidder cases. In their sample, the availability of appraisal was negatively correlated with deal premia in controlled freeze-outs.[248] They hypothesize that this result occurs because controllers lower their bids in order to pay off potential holdouts.[249]

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242. *Id.*
243. Kesten, *supra* note 47, at 59.
244. *Id.* at 54.
245. *Id.* at 55.
246. *Id.*
247. Craig Doidge et al., *The U.S. Listing Gap* 29 (Fisher C. Bus., Working Paper No. 2015-03-07, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2605000 (reporting that going-private transactions and leveraged buyouts collectively account for less than 20% of public company merger and acquisition activity between 1997 and 2012).
248. Mahoney & Weinstein, *supra* note 65, at 243.
249. *Id.*

Finally, some transactions, such as leveraged acquisitions, are highly sensitive to deal price.[250] If the threat of appraisal is strong enough, even at a plausibly fair valuation, some acquirers may simply refrain from making a bid in the first instance.[251] Thus, at the margins, increased deal cost or uncertainty may deter beneficial transactions outright.

Each of these second-order effects ultimately redounds to the detriment of ordinary shareholders market-wide. The analysis herein does not conclusively answer the empirical question of whether these costs outweigh concomitant benefits from deterrence effects. Indeed, given recent statutory changes to the appraisal process and the still-developing market for appraisal rights, further observation is necessary to properly evaluate the magnitude of these potential wealth transfers. But, at a minimum, there are well-grounded concerns that an unfettered appraisal arbitrage market may not necessarily increase aggregate shareholder value. The next Part turns to the question of how best to structure the appraisal process to maximize its potential benefits while mitigating the potential costs described above.

## IV. REGULATING THE MARKET FOR APPRAISAL RIGHTS

Proposed and enacted reforms to date fall broadly into three categories: (1) limiting the availability of appraisal for shares acquired after transactions have been announced; (2) modulating the impact of the statutory interest rate; and (3) creating a safe harbor for unconflicted transactions. This Part evaluates the leading proposals and reforms—ultimately finding them wanting—and then presents a modest, but impactful alternative that may serve to deter marginal appraisal claims and better calibrate the incentives of the parties in appraisal proceedings.

The first set of proposed reforms seeks to curb appraisal arbitrage by limiting standing to bring those claims. For example, Jetley and Ji argue that appraisal rights should be limited to shares held on the record date.[252] This proposal suffers from two flaws. First, it is likely too restrictive. As described above, the ability to wait substantially

250. Norwitz, *supra* note 5 ("Appraisal arbitrage creates significant risks for buyers, who could find themselves obligated to pay much more for a target company than they had expected to when negotiating the deal. While any buyer needs to know how much it will have to pay to acquire a target, this need is especially acute in leveraged acquisitions where an increase in acquisition costs could easily make the difference between a successful deal and a failure, or even a bankruptcy.").

251. *See* DFC *Amici* Brief, *supra* note 240, at 18 ("The likelihood of appraisal litigation chills some bidders from participating in a sale process . . . .").

252. Jetley & Ji, *supra* note 24, at 432 ("First, from an economic perspective, it seems reasonable to limit a dissenting shareholder's appraisal rights to only the shares held as of the record date.").

increases the value of the arbitrageur's option. Requiring arbitrageurs to exercise that option prior to receipt of definitive proxy materials, the shareholder vote, or other intervening events between the record date and closing might chill their activity entirely by rendering such option uneconomic in most cases. This would, in turn, substantially diminish any deterrent effects. Second, this proposal incorrectly assumes that all shareholders are entitled to equal treatment. However, statutory mismatch justifies differential treatment. In that light, the record date is merely a meaningful dividing line.

The second set of proposed reforms seeks to change the statutory interest rate or otherwise modulate its effect on litigation incentives. Some urge lowering the statutory rate.[253] But applying a lower rate across the board would deter potentially meritorious appraisal claims by institutional investors, who are unlikely to forego the merger consideration for less than a reasonable equity return.[254] And a floating market rate, based on the characteristics of the target, acquirer, or petitioner, would frustrate legislative intent. The current statutory rate was enacted to avoid the need for trials within trials about appropriate prejudgment interest.[255]

In 2016, the Delaware appraisal statute was amended to allow acquirers to pay some or part of the merger consideration up front and thereby avoid prejudgment interest on that amount.[256] This amendment is superficially attractive if interest rate arbitrage is driving a meaningful portion of appraisal claims.[257] It is too soon to evaluate the impact of the amendment conclusively, but there are several plausible reasons to question its ultimate efficacy. First, while the amendment became effective on August 1, 2016, there has not, as yet, been any slowdown in the filing of appraisal petitions. Second, some, such as Korsmo and Myers, suggest that the structure of the current appraisal process might actually benefit some target companies because it grants them a temporary loan below their cost of capital.[258] If that is true, then appraisal defendants may not in fact

253. *See, e.g.*, Norwitz, *supra* note 5.

254. Indeed, the current statutory rate arguably undercompensates these potential claimants.

255. Jetley & Ji, *supra* note 24, at 431 n.14 ("[T]he legislative intent behind setting the Delaware statutory rate at 5% over the Federal Reserve discount rate seems fairly clear: it was enacted as the presumptive rate in appraisal cases in order to eliminate expensive, time-consuming 'trials within trials' over the appropriate pre-judgment interest rate.").

256. DEL. CODE ANN. tit. 8, § 262(h) (2016).

257. Jiang et al., *supra* note 1, at 38 (concluding that the amendment is likely to lead to a significant reduction in appraisal filings).

258. Charles K. Korsmo & Minor Myers, *Interest In Appraisal*, 42 J. CORP. L. 109, 137 (2016) ("If the interest rate is lower than the surviving company's cost of capital, the company would simply refuse to prepay and would face an incentive to prolong the litigation for as long as possible.").

regularly exercise their option to prepay. Finally, if target companies do exercise their option to prepay, that may have the problematic consequence of financing arbitrageurs' other appraisal claims, thus increasing the risk of a proliferation of the type of low-probability appraisal claims that cause the second-order wealth effects described in Part III.[259]

The third proposed reform, which is currently before the Delaware Supreme Court in the *DFC Global* appeal, involves creating a judicial safe harbor for unconflicted, arm's length transactions.[260] The theory is that such a rule would provide deal and price certainty to the parties in the transactions least likely to generate undervalued outcomes. Accordingly, bidders would not need to fear appraisal claims and would thus refrain from discounting their bids to account for the potential costs thereof. A safe harbor would thus, according to its proponents, avoid the type of market distortions and wealth-transfer effects described in Part III. However, a recent paper by Albert Choi and Eric Talley calls into question the economic merit of such a proposal.[261] Employing game theory to model the behavior of market participants, they conclude that such a rule would actually depress both acquisition prices and target shareholders' expected welfare relative to several other alternative rules.[262]

A better approach to the free option and rent-seeking problems (which in turn drive the pernicious wealth-transfer effects) is to force arbitrageurs to pay, via cost shifting, if the defendant corporation convinces a court that the merger price was in fact fair. The theoretical motivation, mechanics, and expected outcome of this proposal require some further explanation.

Pursuant to the American Rule, which is firmly entrenched throughout the domestic civil litigation system, each party is responsible for its own legal fees and costs.[263] This rule is typically

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259. Jetley & Ji, *supra* note 24, at 457 ("[P]aying appraisal claimants a portion of the target's fair value up front [effectively supplies] capital to claimants to pre-fund their appraisal pursuits," which in turn is likely to reduce the cost of bringing an appraisal action).

260. *See* DFC *Amici* Brief, *supra* note 240, at 2 (urging the Delaware Supreme Court to adopt a clear rule deferring to the transaction price obtained by an arm's length auction process untainted by conflicts of interest or concealment of material information).

261. Albert Choi & Eric Talley, *Appraising the "Merger Price" Appraisal Rule* (Va. Law & Econ., Research Paper No. 2017-01), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2888420.

262. *Id.* at 5 ("So long as there exists some plausible alternative appraisal remedy that enhances shareholders' welfare ex ante—even if modestly—the [market price] rule cannot be optimal.").

263. *See* Rowe, *supra* note 173, at 651 (discussing the rationales and consequences of various fee-shifting rules). There are, of course, numerous exceptions to this default fee-bearing rule. *See, e.g.*, *id.* at 651 n.5; John F. Vargo, *The American Rule on Attorney Fee Allocation: The Injured Person's Access to Justice*, 42 AM. U. L. REV. 1567, 1578–90 (1993).

viewed as egalitarian with respect to financial disparities between disputants[264] and is thought to result in a higher level of litigation than various alternatives.[265] However, it enables rent seeking via strike suits.[266] Other legal systems adopt the English Rule, in which the losing party indemnifies the winner.[267] The main justifications for the English rule revolve around the notion that the prevailing party should be made financially whole and that a loser-pays regime deters unmeritorious and low-probability suits.[268] The key arguments against the English Rule are largely the mirror-image of those relating to the American Rule. Notably, the English Rule is especially problematic for risk-averse parties.[269] A full analysis of the merits of each rule is beyond the scope of this Article, but each clearly has costs and benefits. Accordingly, the mandatory imposition of any given fee-allocation regime is likely suboptimal in the aggregate.[270]

In recent work, Robert Rhee proposes a hybrid system with an element of private ordering, which he persuasively argues would move us toward the optimal balance of enforcement and cost. In his proposed regime, the American Rule would apply by default.[271] However, any party willing to take on a heightened burden of proof can unilaterally elect to impose English Rule-style cost-shifting on the parties to the action.[272] If the electing party carries its heightened burden of proof, the losing party must pay its reasonable legal costs; if not, legal costs will be shifted to the electing party.[273] Rhee models the economic incentives of litigants under such a system and finds that parties will make such an election only where (among other variables) they are highly confident in their success on the merits.[274] Rhee thus concludes that such elections will be made rarely in most types of disputes, but that the existence of the option will serve to deter unmeritorious and exceptionally low-probability claims.[275]

The appraisal process is conducive to precisely this sort of procedural private ordering. Currently, neither party in an appraisal case is required to carry its burden of proof; if the court concludes that

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264. Robert J. Rhee, *Towards Procedural Optionality: Private Ordering of Public Adjudication*, 84 N.Y.U. L. REV. 514, 521 (2009).

265. *See* Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 59–60 (1982).

266. *See* Rhee, *supra* note 264, at 526–28.

267. *See* Rowe, *supra* note 173, at 651.

268. *See id.* at 653.

269. *See* Rhee, *supra* note 264, at 520; Thomas D. Rowe Jr., *American Law Institute Study on Paths to a "Better Way": Litigation, Alternatives and Accommodations, Background Paper*, 1989 DUKE L.J. 824, 888.

270. *See* Rhee, *supra* note 264, at 517.

271. *Id.* at 536–37.

272. *Id.*

273. *Id.* at 536–38.

274. *Id.* at 553.

275. *Id.*

neither side's valuation is credible, it must determine the fair value of the petitioner's shares using its own independent judgment.[276] Accordingly, target corporations can readily elect a heightened standard of proof by affirmatively agreeing to take on the burden of persuasion concerning valuation in exchange for English Rule cost-shifting. Presumably, target corporations will only make such an election if they strongly believe that they can defend the fairness of the merger price itself; for instance, where the deal value was set through a high-quality arm's length sales process such as multibidder auctions. In turn, as participants in these unconflicted transactions are less likely to expect a "deal tax" imposed through low-probability appraisal claims, there will be less reason to discount their bids and thereby transfer value away from preannouncement, target company's shareholders.

Privately ordering the fee-allocation rule in this fashion also puts an implicit price on the arbitrageur's option and compensates the acquirer in the event of a meritless appraisal claim. While it is difficult to quantify precisely the magnitude of costs in these cases, most estimates suggest that they are nontrivial compared to appraisal petitioners' net recovery.[277] Accordingly, the possibility of fee shifting should serve as a meaningful deterrent against unmeritorious and low-probability claims, and improve acquirers' settlement leverage if they honestly believe the merger price was fair.

Adding this layer to the appraisal process is unlikely to increase administration costs, and may well reduce the costs of adjudicating these disputes by assisting judges with the difficult task of valuation. A common lament is that because neither party bears the burden of proof, litigants have no incentive to take positions that realistically reflect their true valuations.[278] As the court noted in *Longpath Capital, LLC v. Ramtron International Corp.*,[279] "[m]uch has been said of litigation-driven valuations, none of it favorable."[280] The availability of cost-shifting provides a financial incentive for electing parties to defend reasonable valuation estimates, which in turn can provide the court with better information upon which to determine an

276. *See* DEL. CODE ANN. tit. 8, § 262(h) (2016).

277. *See, e.g.*, Jiang et al., *supra* note 177, at 33 (estimating that average costs to take an appraisal claim to trial range from approximately $3–7 million, which constitutes between 10–20% of the petitioners' net recovery in those cases).

278. *See, e.g.*, Cede & Co. v. Technicolor, Inc., Civ. A. No. No. 7129, 1990 WL 161084, at *8 n.17 (Del. Ch. Oct. 19, 1990) ("[I]f the court will ultimately reject both parties DCF analysis and do its own, the incentive of the contending parties is to arrive at estimates of value that are at the outer margins of plausibility . . . .").

279. C.A. No. 8094–VCP, 2015 WL 4540443 (Del. Ch. June 30, 2015).

280. *Id.* at *9.

accurate fair value.[281] And in cases where the electing party fails to carry its burden, the court does not take on any additional responsibility; it is already obliged by statute to conduct its own independent valuation.[282]

As set forth above, policymakers can differentiate in a principled way between appraisal petitioners who purchased their shares prior to the record date (and are thus obliged to dissent from the transaction, increasing the risk of deal failure) and those who purchased thereafter. Accordingly, these fee-shifting elections should be available only in cases involving postannouncement appraisal petitioners. The inclusion of a privately ordered cost-shifting regime thus provides arbitrageurs with a choice. They can purchase their stock before the record date, engage in passive or active merger arbitrage as they see fit (which plausibly redounds to the benefit of all stockholders), and if they remain unsatisfied, they can bring an appraisal claim on the same terms as any other shareholder. But their option is no longer free—they give up valuable delay and take on the risk of nonconsummation by actually dissenting from the merger. Alternatively, they can wait to exercise their option. However, if they wait, they are incentivized to bring only meritorious claims. If their claim fails, they may be obliged to pay the acquirer's costs. In sum, this differential treatment regime decreases rent seeking while leaving open the possibility of meritorious appraisal claims brought by sophisticated, well-informed petitioners that can overcome the collective action problems facing smaller shareholders.

## CONCLUSION

Appraisal—fueled in large part by a new class of arbitrageurs—is an increasingly important part of the takeover litigation landscape. A vigorous market for appraisal serves a potentially salutary purpose insofar as it deters opportunistic or otherwise undervalued cash-out transactions. This Article demonstrates, however, that the magnitude of that deterrence effect is questionable and that appraisal arbitrage presently generates costs that might outweigh any associated benefit. Resolving this empirical question requires continued observation of several matters about which we currently have insufficient (albeit suggestive) data. We should continue tracking the rate of appraisal arbitrage over time, especially in the aftermath of the recent changes to the appraisal statute aimed at addressing the impact of the statutory interest rate. Moreover, a larger population of litigation outcomes would allow for stronger conclusions to be drawn concerning rent-seeking explanations for

281. *See* Christian J. Henrich, *Game Theory and* Gonsalves*: A Recommendation for Reforming Stockholder Appraisal Actions*, 56 BUS. LAW. 697, 701 (2001).

282. *See* supra notes 56–58 and accompanying text.

appraisal arbitrage. We should also study the economics of the market for appraisal rights and, specifically, whether appraisal arbitrageurs must pay a premium to obtain their shares. If so, this would go some way toward mitigating concerns over value-transfers away from preannouncement shareholders. Similarly, we should attempt to quantify the impact of the "new appraisal" on deal premia in the aggregate.

In light of this epistemic uncertainty, policymakers should opt for a limited intervention in the market for appraisal rights rather than proscribe appraisal arbitrage entirely or leave the market unfettered. Accordingly, this Article proposes a privately ordered cost-shifting regime, which—if elected—would require appraisal arbitrageurs to pay the defendant corporation's legal fees and costs in the event that such defendant carries the burden of proof in demonstrating the fairness of the merger price. This modest reform to the current regime should deter vigorous pursuit of unmeritorious appraisal claims, which in turn can mitigate inefficient wealth transfers from preannouncement shareholders to dissenting arbitrageurs.

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