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Notes

SHORT-FORM MERGERS AFTER *GLASSMAN V. UNOCAL EXPLORATION CORP.*: TIME TO REFORM APPRAISAL

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INTRODUCTION

Reconciling the conflict between the doctrine of entire fairness[1] and the summary process contained in Delaware's short-form merger statute,[2] the Delaware Supreme Court ruled in *Glassman v. Unocal Exploration Corp.*[3] that a majority shareholder need not establish entire fairness in a short-form merger.[4] Instead, majority shareholders can freeze out minority shareholders by simply paying them for the "fair value" of their shares.[5] Under Delaware's new doctrine, a dissatisfied shareholder's only recourse, absent fraud or illegality, is appraisal.[6]

A short-form merger occurs when a parent corporation combines with a 90 percent owned subsidiary.[7] Delaware offers a statutory summary procedure for such mergers. Under Delaware's short-form merger statute, a parent who owns at least 90 percent "of the outstanding shares of each class of [a subsidiary corporation's] stock" may merge the subsidiary corporation into itself, or alternatively, may

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1. Entire fairness is a standard that majority shareholders must satisfy in self-interested transactions, such as merger freeze-outs. Entire fairness involves two components: fair dealing and fair price. Essentially, both the mechanics of the transaction and the buyout price must be fair to minority shareholders. For a complete discussion of entire fairness, see *infra* Part I.B.

2. DEL. CODE ANN. tit. 8, § 253 (2001). A short-form merger is one where the majority shareholder(s) owns at least 90 percent "of the outstanding shares of each class of the [corporation's] stock" and eliminates the minority shareholders using a statutory summary process. *Id.* § 253(a).

3. 777 A.2d 242 (Del. 2000).

4. *Id.* at 248.

5. *Id.*

6. *Id.* at 243.

7. DEL. CODE ANN. tit. 8, § 253(a).

merge both itself and the subsidiary corporation into a third corporation.[8] To effectuate such a merger, a parent's board of directors simply approves a resolution and files the resolution with the Delaware secretary of state.[9] The parent's stockholders, the subsidiary's board, and the subsidiary's stockholders do not play any role in approving the merger or in negotiating the merger price.

In a traditional merger, shareholders of the acquired corporation are entitled to "adequate consideration for their stock."[10] Assuring shareholders adequate consideration are "[t]he traditional legal safeguards": shareholder approval and statutory appraisal.[11] Generally, shareholders must approve mergers.[12] Appraisal then guarantees dissenting shareholders the opportunity to seek a fair price for their shares through a judicial process. Common law fiduciary duties also provide protection.[13]

However, none of these traditional safeguards adequately protect minority shareholders when the majority freezes them out in a short-form merger. First, shareholder approval is ineffective because, by definition, the parent holds sufficient votes to approve the merger without any minority support.[14] Even if a merger's approval required a majority of the minority vote, dissatisfied shareholders would only have "the limited option of rejecting the merger," as minority shareholders rarely participate in merger negotiations.[15] Second,

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8. *Id*.

9. The board resolution shall provide the "terms and conditions of the merger, including the securities, cash, property, or rights to be issued, paid, delivered or granted by the surviving corporation" to the subsidiary. *Id*. Along with the board resolution, the parent must also file a certificate showing 90 percent ownership of the subsidiary. *Id*.

10. Rutheford B. Campbell, Jr., *Fair Value and Fair Price in Corporate Acquisitions*, 78 N.C. L. REV. 101, 102 (1999).

11. Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 299 (1974).

12. DEL. CODE ANN. tit. 8, § 251(c).

13. Campbell, *supra* note 10, at 102; *see* John C. Coffee, Jr., *Transfers of Control and the Quest for Efficiency: Can Delaware Law Encourage Efficient Transactions while Chilling Inefficient Ones?*, 21 DEL. J. CORP. L. 359, 423 (1996) ("[T]he principal purpose of fiduciary duties has long been to constrain opportunism by management and controlling shareholders."). The three common law fiduciary duties are the duty of good faith, the duty of loyalty, and the duty of due care. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995). For a description of the common law fiduciary duties, see *infra* notes 26–30 and accompanying text.

14. Brudney & Chirelstein, *supra* note 11, at 299–300.

15. *Id.* at 300. A majority of the minority vote requires the corporation to obtain a majority of support from the minority shareholders before it can proceed with a transaction. *Id*. However, majority shareholders would likely involve minority shareholders in merger negotiations when the minority shareholders could veto the merger.

researchers label appraisal "a remedy of desperation" and describe it as "technical . . . expensive . . . uncertain . . . and . . . unlikely to produce a better result than could have been obtained on the market."[16] Unsurprisingly, few shareholders seek appraisal even though they might be dissatisfied with the consideration their parent pays them in a freeze-out merger.[17]

Despite appraisal's ineffectiveness, shareholders lack any other means to fight majority overreaching in a short-form merger.[18] Though Delaware "launched the modern movement toward greater reliance on appraisal as a check against majority self-dealing"[19] in *Weinberger v. UOP, Inc.*,[20] it has yet to specify an adequate appraisal remedy for protecting frozen-out shareholders.[21] As such, if Delaware wants appraisal to remain a minority stockholder's exclusive remedy in a short-form merger, it should modify appraisal to protect the minority stockholder.

Instead of merely paying minority shareholders the "fair value" of their shares, appraisal should seek a Pareto optimal outcome and fully compensate minority shareholders while reducing merger transaction costs. In general, a Pareto optimal outcome exists where it is impossible to make any party better off without harming someone else.[22] Applying Pareto concepts to appraisal reform reveals that Delaware can reduce appraisal's transaction costs—benefiting minority shareholders by giving them a realistic remedy and greater compensation—without injuring majority shareholders. Currently, appraisal's high transaction costs harm both minority and majority shareholders. Minority shareholders lack an adequate remedy in a

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16. *Id.* at 304 (quoting Melvin A. Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision Making*, 57 CAL. L. REV. 1, 85 (1969)).

17. Robert B. Thompson & Randall S. Thomas, Shareholder Litigation: Reexamining the Balance Between Litigation Agency Costs and Management Agency Costs, 28 (Sept. 4, 2002) (unpublished manuscript, on file with the *Duke Law Journal*); *see* Coffee, *supra* note 13, at 364 ("[A]ppraisal proceedings are an unwieldy remedy that smaller shareholders infrequently elect . . . .").

18. *See infra* note 36 and accompanying text.

19. Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 43 (1995).

20. 457 A.2d 701 (Del. 1983).

21. *See* Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 616 (1998) ("*Weinberger* apparently was intended to revamp the appraisal remedy so that shareholder challenges to merger transactions would be efficiently resolved in an appraisal proceeding, rather than some other form of legal challenge to the transaction.").

22. ROBERT H. FRANK, MICROECONOMICS AND BEHAVIOR 559 (1997).

freeze-out and, as a result, majority shareholders pay a higher cost of capital through the minority discount.[23] Appraisal reform could lower the parent corporation's cost of capital if minority shareholders feel more secure in their holdings and, through efficient markets, bargain away the traditional minority discount.[24]

Part I of this Note outlines Delaware merger freeze-out law. It first provides a general description of the relevant merger law, before turning to entire fairness and appraisal. Part I gives a detailed account of the procedural and valuation aspects of entire fairness review and appraisal. Next, Part II examines the result of the *Glassman* holding, which leaves appraisal as the exclusive remedy for dissatisfied minority shareholders in a short-form merger. Although appraisal is an adequate remedy substantively because of the similar valuation techniques that appraisal and entire fairness employ, this Note argues that appraisal is procedurally flawed. These procedural flaws reduce shareholder liquidity and render minority shareholders vulnerable to majority opportunism—two harms that appraisal is charged with mitigating. As such, Part III provides a brief discussion of efficient markets to show how minority shareholders discount the purchase price of their shares to reflect the risks of illiquidity and majority overreaching. Applying Pareto concepts, Part IV proposes both procedural and valuation modifications to the appraisal remedy that will provide shareholders with additional liquidity and greater protection against majority overreaching.

I. DELAWARE FREEZE-OUT LAW

A. *Overview of Delaware Merger Law*

Corporations operate as democratic organizations and are generally subject to majority-rule governance.[25] Mitigating the inherent supremacy that majority shareholders have over minority shareholders are the majority's fiduciary obligations to both the parent's minority shareholders and the shareholders of any subsidiary

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23. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 458 (5th ed. 1998) (recognizing that minority shareholders who are vulnerable to a freeze-out merger will demand extra compensation for the risk of their investment).

24. Stock trades in the open market at the minority discount price, which incorporates an offset for the value of holding corporate control. *See infra* Part III.

25. Wertheimer, *supra* note 21, at 613. Many states, however, require supermajority governance when undertaking fundamental corporate acts. F. HODGE O'NEAL, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUTS" IN SMALL ENTERPRISES 5 (1961).

corporation.[26] Regardless of the relative size of each constituency, majority shareholders "owe the same duty of good management" to both the parent and subsidiary.[27] Serving in both capacities does not dilute a parent's fiduciary obligations to its subsidiary.[28]

Three fiduciary obligations police the parent-minority shareholder relationship: the duty of good faith, the duty of loyalty, and the duty of due care.[29] Shareholders may, in their individual capacities, bring derivative suits or class actions against managers alleging breach of one of the triad of fiduciary duties.[30] In a fiduciary claim, the deferential business judgment rule has served historically as both a procedural and substantive guide for litigants, assigning one party the burden of proof and then determining the relevant legal standard.[31] The business judgment rule presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[32] Courts will not second-guess a

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26. *See* Singer v. Magnavox Co., 380 A.2d 969, 976 (Del. 1977) ("Development, as the majority stockholder of Magnavox, owed to the minority stockholders of that corporation, a fiduciary obligation . . . ."), *rev'd on other grounds*, 380 A.2d 969 (1977). Similarly, a majority shareholder who "*exercises control* over the business affairs of the corporation" owes shareholders a fiduciary obligation. Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1113 (Del. 1994) (quoting Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987)) (emphasis added by *Kahn*).

27. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1106 (Del. 1985) (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1981)); *see also* A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. (forthcoming 2004) (manuscript at 4, on file with the *Duke Law Journal*) ("The general rule, long established in Delaware and elsewhere, is that controlling shareholders owe a fiduciary duty to the corporation and minority shareholders.").

28. *Rabkin*, 498 A.2d at 1106 (citing Levien v. Sinclair Oil Corp., 261 A.2d 911, 915 (Del. Ch. 1969)).

29. Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1164 (Del. 1995). Historically, only the duties of loyalty and due care oversaw the parent-minority shareholder relationship. A 1986 amendment to Delaware's General Corporation Law, however, suggested that directors also owe shareholders a duty of good faith. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2001) (prohibiting a corporation from limiting a director's liability in its certificate of incorporation "for acts or omissions not in good faith"). *Cinerama* confirmed that directors owe shareholders all three duties. 663 A.2d at 1164. Even so, directors that violate the duty of good faith are likely also acting disloyal or not exercising due care.

30. Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C. L. REV. 1121, 1157 (1998).

31. *Cinerama*, 663 A.2d at 1162.

32. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Delaware's General Corporation Law expresses the business judgment rule as: "The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ." DEL. CODE ANN. tit. 8, § 141.

board decision unless the plaintiff can rebut one of these business judgment rule presumptions.[33]

In *Weinberger v. UOP, Inc.*, however, the court removed the business judgment rule from consideration when a controlling shareholder stands on both sides of a transaction. Instead, such a transaction is subject to "entire fairness" review.[34] By implementing an entire fairness review of a parent-subsidiary merger, the *Weinberger* court necessarily created a conflict with Delaware's existing short-form merger statute.[35] Specifically, *Weinberger*'s entire fairness requires fair dealing for a freeze-out merger, but Delaware's short-form merger statute does not require *any* dealing whatsoever on the part of the parent. The Delaware Supreme Court resolved this conflict in *Glassman v. Unocal Exploration Corp.* by exempting short-form mergers from entire fairness review. In doing so, the court held that appraisal is the exclusive remedy for dissatisfied stockholders, absent fraud or illegality.[36]

B. Entire Fairness Review

Entire fairness review stems from the duty of loyalty, which applies primarily in situations where one party to a transaction could engage in self-dealing.[37] Although a corporation's board is generally charged with maximizing shareholder wealth, the board might fail to maximize shareholder wealth when the interests of the majority shareholders, who control the board, and the minority shareholders conflict.[38] Consequently, the duty of loyalty and resulting entire fairness review protect minority shareholders from majority

33. 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, 522–23 (2003).

34. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983); *accord* Kahn v. Lynch Communication Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994). In *Weinberger*, the court removed the business judgment rule because the rule did not provide minority shareholders any additional protection given the new entire fairness standard, "the expanded appraisal remedy," and "the broad discretion of the Chancellor to fashion" other relief. 457 A.2d at 715.

35. Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247 (Del. 2000).

36. *Id.* at 248.

37. William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 862 (2001).

38. *See id.* at 875 ("[W]here a majority have personal interests in the transaction that are adverse to the interest of the shareholders, it cannot be presumed that the board will be motivated to achieve the highest transaction price the market will permit.").

shareholders who "could unilaterally implement transactions to the detriment of minority shareholders."[39]

Entire fairness review is Delaware's most rigorous standard of review.[40] It requires majority shareholders to establish that they dealt fairly with the minority shareholders and paid a fair price for the minority shares:

> The concept of fairness has two basic aspects: fair dealing and fair price. . . . [T]he test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness. However, in a non-fraudulent transaction we recognize that price may be the preponderant consideration outweighing other features of the merger.[41]

First, fair dealing "embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[42] Although fair dealing clearly requires a parent to act "free of fraud or misrepresentation," a parent must do more than just avoid deception to achieve fair dealing.[43] The parent must also "disclose[] all information in [its] possession germane to the transaction in issue. . . . such as a reasonable shareholder would consider important in deciding whether to sell or retain stock."[44] For example, in *Weinberger*, the court found important both an internal memorandum discussing merger synergies[45] and a report stating that the freeze-out would be a good investment up to $24 per share

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39. Aronstam et al., *supra* note 33, at 520. Entire fairness also ensures minority shareholders a fair valuation of their shares, given "the difficulty of ascertaining, in non-arms-length transactions, the price at which the deal would have been effected in the market." Allen et al., *supra* note 37, at 876.

40. *See* Aronstam et al., *supra* note 33, at 523 ("The entire fairness test has been consistently referred to as the most exacting standard of review utilized by Delaware courts."); Pritchard, *supra* note 27, at 2 ("[T]he 'entire fairness' standard [is] the most demanding regime in corporate law."); *see also* Mills Acquisition Co. v. MacMillan, Inc., 559 A.2d 1261, 1279 (Del. 1989) (describing entire fairness review as "rigorous judicial scrutiny under . . . exacting standards").

41. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). Note that "where corporate action has been approved by an informed vote of a majority of the minority shareholders . . . the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority." *Id.* at 703.

42. *Id.* at 711.

43. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1104–05 (Del. 1985).

44. *Weinberger*, 457 A.2d at 710.

45. *Id.* at 708.

(instead of the offered $21 per share).[46] As such, the court held that the parent did not satisfy the fair dealing prong of entire fairness.[47]

Second, a transaction must satisfy the fair price element of entire fairness. In *Weinberger*, the court rejected the traditional "Delaware block" method of valuing shares[48] and instead crafted a more flexible approach modeled after valuation in an appraisal proceeding.[49] Under the court's new approach to calculating fair price, a parent must consider "all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[50] Only "speculative elements" can be excluded from the fair price calculation.[51]

The new bifurcated fairness standard established in *Weinberger* set the stage for a conflict between the "fair dealing" component of entire fairness and the summary merger procedure in Delaware's short-form merger statute. Under Delaware's statute, the majority and minority shareholders do not negotiate a merger agreement, minority shareholders receive no advance notice, and shareholders do not vote.[52] The court resolved the conflict in *Glassman*. Looking to the legislative intent behind the short-form merger statute, the court concluded that a standard of entire fairness would thwart the legislature's goal of establishing a quick freeze-out process for parents who hold at least 90 percent of a subsidiary.[53] Therefore, mergers under Delaware's short-form merger statute need not satisfy entire fairness. Instead, a frozen-out shareholder can only check majority overreaching through the state's default appraisal remedy.

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46. *Id.* at 712.

47. *Id*.

48. Under the Delaware block method, a court assigns weights to a company's "net asset value, market price, earnings, and other factors . . . based on the trial court's intuitive judgment." Leo Herzel & Dale E. Colling, *Establishing Procedural Fairness in Squeeze-Out Mergers After* Weinberger v. UOP, 39 BUS. LAW. 1525, 1529 (1984). In *Weinberger*, the court rejected the Delaware block method, which it had used for decades, because the method did not account for "other generally accepted techniques used in the financial community and the courts." 457 A.2d at 712.

49. *Id.* at 712–13.

50. *Id.* at 711.

51. *Id.* at 713.

52. Glassman v. Unocal Exploration Corp., 777 A.2d 242, 247 (Del. 2001).

53. *Id.* at 247–48 ("If . . . [the parent] sets up negotiating committees, hires independent . . . experts, etc., then it . . . [loses] the very benefit provided by the statute—a simple, fast and inexpensive process for accomplishing a merger.").

C. *Appraisal*

Appraisal is a statutory remedy by which shareholders who dissent to a merger can petition Delaware's Court of Chancery for a determination of the "fair value" of their shares.[54] Essentially, appraisal provides dissatisfied shareholders with an option to cash-out without having to demonstrate "illegality, fraud, bad faith or some other breach of fiduciary duty."[55] The concept of appraisal originated in the nineteenth century to provide managers with additional flexibility.[56] At that time, corporate law viewed shareholders as holding vested rights in a corporation, and thus a single shareholder could veto a merger.[57] The growth of American business at the end of the nineteenth century, however, required a more flexible approach to mergers, and appraisal "facilitat[ed] desirable corporate changes [and] provid[ed] liquidity."[58]

Since its introduction, Delaware's appraisal statute has served three main purposes: (1) "facilitating the market for corporate control"; (2) "providing liquidity"; and (3) checking majority shareholder opportunism.[59] Today, appraisal's most important purpose is checking majority shareholder opportunism—a function previously satisfied by both the concept of fiduciary duty and statutes limiting corporate power.[60] To check majority opportunism effectively, appraisal must provide minority shareholders with legitimate access to an adequate price.

1. *Appraisal Procedure.* Appraisal "is a limited statutory remedy"[61] and is available only in certain transactions, one of which is a short-form merger.[62] In Delaware, qualifying dissatisfied

54. DEL. CODE ANN. tit. 8, § 262(a) (2001).

55. *In re* Unocal Exploration Corp. S'holders Litig., 793 A.2d 329, 340 (Del. Ch. 2000).

56. *Id.*; Elliott J. Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of* Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 1, 10 (1983).

57. *Unocal Exploration*, 793 A.2d at 339; Wertheimer, *supra* note 21, at 614–15; *see also In re* Paine v. Saulsbury, 166 N.W. 1036 (1918) (refusing to permit a 99 percent shareholder to dissolve a corporation because the 1 percent minority shareholders did not assent to dissolution).

58. Thompson, *supra* note 19, at 3.

59. Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 16 (2000).

60. Thompson, *supra* note 19, at 4.

61. Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 296 (Del. 1996).

62. DEL. CODE ANN. tit. 8, § 262(b) (2001). Appraisal applies without exception in short-form mergers. *Id.* § 262(b)(3). However, appraisal is not always available within other categories

shareholders must follow a complex set of statutory guidelines to perfect their appraisal rights. Each shareholder seeking appraisal must comply with these guidelines, making appraisal an "opt-in" remedy.[63] In contrast, other shareholder remedies, such as entire fairness, authorize class action litigation—an "opt-out" remedy—where shareholders are included in the class unless they remove themselves from the litigation.[64]

To qualify under Delaware's appraisal statute, a shareholder must first hold the corporation's stock on the date that the shareholder demands appraisal, and then continuously until the effective date of the merger or consolidation.[65] In a short-form merger, the shareholder of record will receive an initial notice about the merger and information about the shareholder's appraisal rights either before the merger's effective date or within ten days thereafter.[66] After the corporation mails the appraisal notice, the dissatisfied stockholder has twenty days to demand appraisal in writing from the continuing corporation.[67] The demand must "reasonably inform[] the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal."[68]

After a shareholder demands appraisal, the continuing corporation must disclose to the shareholder, upon written request, both the number of shareholders demanding appraisal and the collective number of shares they hold. The corporation shall mail

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of mergers. For example, minority shareholders in a long-form merger—a freeze-out merger where the controlling stockholder owns at least 50.1 percent of each class of stock—face a stock market exemption, which denies them appraisal when shares are publicly traded. *Id.* § 262(b)(1).

63. Andra v. Blount, 772 A.2d 183, 194 (Del. Ch. 2000) (stating that one of the "apparent inadequacies of the appraisal remedy [is] that [the shareholder] does not get to represent a class").

64. *See, e.g.*, Herzel & Colling, *supra* note 48, at 1526 (describing the availability of class action litigation in an entire fairness complaint).

65. DEL. CODE ANN. tit. 8, § 262(a).

66. To determine which stockholders receive notice of the merger and their appraisal rights, each constituent corporation can set a record date, not more than ten days before mailing the notice. *Id.* § 262(d)(2). However, if the corporation mails such notice on or after the merger's effective date, the record date will be the effective date. *Id*. Note that the appraisal demand procedure is different for mergers subject to a stockholder vote. In such mergers, the corporation must provide notice to the shareholders at least twenty days before the meeting, and a shareholder must demand appraisal before the vote. *Id.* § 262(d)(1). To retain appraisal rights, the shareholder must not vote for or consent to the merger. *Id.* § 262(a).

67. *Id.* § 262(d)(2).

68. *Id*.

such disclosure within ten days of either receiving the information request or concluding the appraisal demand period.[69] At the same time, either the continuing corporation or a stockholder who complied with the appraisal statute can petition the Delaware Court of Chancery for a "determination of the value of the stock" within 120 days of the merger's effective date.[70] However, a shareholder has sixty days from the effective date to withdraw from an appraisal proceeding and accept the merger terms. Finally, the continuing corporation must provide the Chancery Court with a duly verified list of the names and addresses of stockholders suing for appraisal.[71]

2. *Valuation.* After perfecting the right to appraisal, a shareholder turns to the Court of Chancery for a determination of each share's "fair value."[72] Underlying appraisal is the assumption that dissenting shareholders want to retain their investment in the corporation and would do so absent the freeze-out.[73] As such, an appraisal proceeding must award dissenting stockholders the fair value of what the freeze-out took from them. The appraisal statute does not provide any guidance regarding how to calculate fair value, and thus courts have developed a valuation technique out of necessity.[74] *Weinberger* confirmed that the underlying inquiry in fair value is to determine the stockholder's "proportionate interest in [the] going concern."[75] In valuing the company as a going concern, a court must value the corporation as a whole, rather than merely calculating the value of the minority stock.[76] After establishing the corporation's value, the court then awards a stockholder a sum equal to the stockholder's pro rata share of the corporation.

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69. *Id.* § 262(e).

70. *Id*. The stockholder must also serve notice of the appraisal petition on the continuing corporation. *Id*.

71. *Id.* § 262(f).

72. *Id.* § 262(h).

73. Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 298 (Del. 1996); *see also* Campbell, *supra* note 10, at 118–19 ("Stockholders invest in anticipation of participating in the value that a corporation generates as a going concern.").

74. John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U. PA. L. REV. 1251, 1260 (1999).

75. *Cede*, 684 A.2d at 298; Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

76. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989); *see also Cede*, 684 A.2d at 298 ("The dissenting shareholder's proportionate interest is determined only after the company has been valued as an operating entity on the date of the merger.").

When determining the fair value of the going concern, a court should consider: "all factors and elements which reasonably might enter into the fixing of value. . . . [including] market value, asset value, dividends, earning prospects, the nature of the enterprise, and any other facts."[77] Within this formula, fair value must also consider externalities that might have depressed the current market, cyclical earning cycles, and whether management timed the freeze-out in anticipation of a positive development. Appraisal only excludes "speculative elements of value," but this is "a very narrow exception," and not meant to exclude statistical techniques as a method of proving future value.[78] Nevertheless, fair value does not include any synergy or gain the corporation expects from the merger.[79]

D. Majority Stockholder's Duty to Disclose

Although a parent may conduct a short-form merger without following the procedures that satisfy entire fairness, it must still satisfy the duty of full disclosure.[80] After a parent commences a short-form merger, minority shareholders are left with two options: accept the merger terms and accompanying price for their holdings, or file an appraisal action. To facilitate this decision, the majority shareholder must provide minority shareholders with "all the factual information that is material to that decision."[81] A given fact is material, and thus must be disclosed, if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."[82]

77. *Weinberger*, 457 A.2d at 713 (quoting Tri-Cont'l Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950)).

78. *Id*.

79. DEL. CODE ANN. tit. 8, § 262(h) (2001).

80. Glassman v. Unocal Exploration Corp., 777 A.2d 242, 248 (Del. 2001); Skeen v. Jo-Ann Stores, Inc., 750 A.2d 1170, 1171 (Del. 2000).

81. *Glassman*, 777 A.2d at 248.

82. *Skeen*, 750 A.2d at 1172 (quoting Loudon v. Archer-Daniels-Midland Co., 700 A.2d 135, 142 (Del. 1997)). In disclosing all material information, the majority shareholder must "communicate honestly," and "comply[] with their ever-present duties of due care, good faith and loyalty." *In re* Siliconix Inc., S'holders Litig., No. 18700, 2001 Del. Ch. LEXIS 83, at *36 (June 19, 2001).

For example, a large difference in the merger price and a stock's book price provides new information and is material.[83] However, unless significantly different from previously disclosed information, courts have not required the disclosure of management performance projections, more recent financial statements, or the prices a corporation discussed for its possible sale.[84] Such information might be "helpful" to stockholders, but is not material.[85] Majority shareholders who violate their duty to disclose expose themselves to an action for the breach of their fiduciary duties.[86]

II. AN EXCLUSIVE REMEDY

When *Glassman v. Unocal Exploration Corp.* ended entire fairness review of short-form mergers, it left appraisal as the sole safeguard against majority opportunism.[87] One reason for elevating appraisal was to facilitate the market for corporate control—the first of appraisal's three purposes—in the context of efficient short-form mergers.[88] Nevertheless, because appraisal is now a minority shareholder's sole remedy in a short-form merger, it is critical that appraisal both provides minority shareholders with legitimate access to an adequate price and checks majority opportunism. Without such access and protection, majority shareholders could freeze out minority shareholders for minimal consideration, leaving injured shareholders without a remedy at law.

Generally, entire fairness provides a better remedy for dissatisfied minority shareholders than appraisal. The differences between the two remedies highlight appraisal's inadequacy as a protection against majority opportunism. If appraisal were adequate, courts or the legislature would have extended its exclusivity to other transactions, such as long-form mergers.[89] However, by developing

83. *See* Seagraves v. Urstadt Prop. Co., No. 10307, 1989 Del. Ch. LEXIS 155, at *15 (Dec. 4, 1989) (suggesting that a disparity between the merger price of $12.50 and book value of $25.00 would be material, even though a $3.00 difference would not be).

84. *Skeen*, 750 A.2d at 1173.

85. *Id.* at 1174.

86. *E.g.*, *Seagraves*, 1989 Del. Ch. LEXIS 155, at *13.

87. Neither shareholder approval nor common law fiduciary duties adequately protect minority shareholders. For a discussion of the legal safeguards that protect minority shareholders from majority opportunism, see *supra* notes 11–17 and accompanying text.

88. *See* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 248 (Del. 2001) (recognizing that the short-form merger statute provides "a simple, fast and inexpensive process for accomplishing a merger").

89. Aronstam et al., *supra* note 33, at 551.

two standards of protection—appraisal for short-form mergers and entire fairness review with appraisal for long-form mergers—the Delaware courts and legislature recognize that it is not appropriate to rely solely on appraisal in all situations. This Part first argues that in the context of short-form mergers, appraisal and entire fairness are *substantively* identical. Section B then demonstrates that, despite the *substantive* similarities between the two remedies, their *procedural* differences render appraisal an inadequate protection against majority opportunism.

A. *Appraisal as an Exclusive Remedy in a Short-Form Merger*

Appraisal should be the exclusive remedy for dissatisfied shareholders in a short-form merger because it facilitates the market for corporate control. Because the Delaware legislature created a summary process for short-form mergers—eliminating procedures that a board must follow in other transactions—questions embraced by the fair dealing inquiry of entire fairness are irrelevant. Dissatisfied minority shareholders in a short-form merger only complain about price. As such, appraisal will serve as the *substantive* equivalent of entire fairness review if it provides minority shareholders with the same payout.[90] In other words, fair value in appraisal must equal fair price in entire fairness.

Even though appraisal calculates the "fair value" of minority shares and entire fairness examines "fair price," the two procedures employ similar valuation techniques.[91] Both evaluate the firm as "a going concern," and both utilize a similar laundry list of relevant financial considerations.[92] In addition, Delaware courts often consult

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90. *See In re* Unocal Exploration Corp. S'holders Litig., 793 A.2d 329, 338 (Del. Ch. 2000) ("Put simply, long-form and short-form mergers should be subject to a different set of rules because one form of transaction requires the subsidiary board's participation and assent while the other does not."), *aff'd*, *Glassman*, 777 A.2d 242.

91. Rabkin v. Olin Corp., C.A. No. 7547, 1990 WL 47648, at *12 (Del. Ch. Apr. 17, 1990); Andrew G.T. Moore, *The 'Interested' Director of Officer Transaction*, 4 DEL. J. CORP. L. 674, 676 (1979); Lucian A. Bebchuck & Marcel Kahan, *The "Lemons Effect" in Corporate Freeze-Outs* 3 (Nat'l Bureau of Econ. Research, Working Paper No. 6938, 1999). *But see* Campbell, *supra* note 10, at 111 ("Courts generally have determined that the measure of fair price is different from the measure of fair value.").

92. "[Fair price] include[s] all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). "[V]alue under the appraisal statute" is "the true or intrinsic value of his stock. . . . [which factors in] market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts . . ." *Id.* at 713 (quoting Tri-Cont'l Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950)).

appraisal cases when deciding whether a price is fair, reasoning that a fair value in appraisal will be a fair price in entire fairness.[93] The major difference between entire fairness and appraisal is that entire fairness can award rescissory damages.[94] In contrast, undoing a short-form merger is rarely appropriate, and misconduct supporting such a remedy in a short-form merger would likely open up a fiduciary duty claim, for which rescissory damages are also available.[95]

Establishing appraisal as an exclusive remedy would also benefit majority shareholders by providing an inexpensive procedure for eliminating minority shareholders.[96] Appraisal litigation is less expensive than other forms of litigation challenging mergers, such as entire fairness.[97] Benefiting controlling shareholders alone, however, is not a sufficient justification for making appraisal exclusive because the controlling shareholder decides whether to undertake the transaction. Nevertheless, because appraisal yields the same payout as entire fairness, the minority shareholder, while not better off, is not worse off under an exclusive appraisal approach. Therefore, exclusivity will increase social value by lowering transaction costs while compensating the minority shareholders under the same scheme.

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93. *See, e.g.*, Ala. By-Prods. Corp. v. Neal, 588 A.2d 255, 258 n.1 (Del. 1991) ("If a particular merger price would not be 'entirely fair' in an equitable action claiming breach of fiduciary duty, no different result should obtain in an appraisal, where the issue is whether that identical merger price constitutes 'fair value.'" (quoting Pinson v. Campbell-Taggart, Inc., No. CIV.A.7499, 1989 WL 17438, at *7 (Del. Ch. Feb. 28, 1989))); Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989) ("The fairness concept has been said to implicate two considerations: fair dealing and fair price."); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 845 (Del. 1987) (stating that in an entire fairness case, the concept of fair price "flows from" the requirements of Delaware's appraisal statute).

94. *Compare* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 371 (Del. 1993) ("The Chancellor may incorporate elements of rescissory damages into his determination of fair price, if he considers such elements: (1) susceptible to proof; and (2) appropriate under the circumstances."), *with* Stauffer v. Standard Brands Inc., 187 A.2d 78, 80 (Del. 1962) ("[I]t is difficult to imagine a case under the short [-form] merger statute in which there could be such actual fraud as would entitle a minority to set aside the merger.").

95. *See Weinberger*, 457 A.2d at 714:

> The appraisal remedy we approve may not be adequate in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved. Under such circumstances, the Chancellor's powers are complete to fashion any form of equitable and monetary relief as may be appropriate, including rescissory damages.

(citation omitted).

96. Thomas, *supra* note 59, at 17.

97. *Id.* at 17–18.

B. Problems with Abandoning Entire Fairness for Appraisal

Even though appraisal facilitates the market for corporate control in short-form mergers, it must also fulfill its most important purpose—checking majority shareholder opportunism.[98] To check majority opportunism effectively, appraisal should provide minority shareholders with a "reasonably attractive alternative" to accepting the terms of the merger.[99] By doing so, the threat of appraisal will force majority shareholders to pay a just price for the minority shares. In theory, such an appraisal remedy will protect minority shareholders from majority overreaching. In practice, however, "the appraisal remedy is replete with shortcomings and therefore fails to protect adequately minority shareholders from majoritarian abuse."[100] The *procedural* differences between entire fairness and appraisal illustrate why the current appraisal remedy fails in practice.

First, entire fairness is an opt-out remedy, while shareholders must opt in if they want to seek appraisal. Shareholders usually bring fairness claims as a class action.[101] Under the class action format, named plaintiffs can be "small stockholder[s] who [have] a very slight interest in the matter." Absent the favorable class action treatment, it would be uneconomical for such stockholders to challenge the transaction.[102] The most significant economic incentive for bringing these class actions is that a successful plaintiff can petition the court for attorneys' fees and expert witness costs.[103] Thus, the class action format and resulting cost-savings benefits provide the plaintiffs' bar with an added incentive to accept fairness cases, even when the claim presents only minimal damages.[104]

In contrast, the opt-in, non-class action structure of an appraisal proceeding makes it difficult for owners of a small amount of stock to

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98. Thompson, *supra* note 19, at 4.

99. *See* Weiss, *supra* note 56, at 21 ("The argument in favor of making appraisal the exclusive remedy holds up, however, only if appraisal presents a dissatisfied minority shareholder with a reasonably attractive alternative . . . .").

100. Aronstam et al., *supra* note 33, at 546.

101. Herzel & Colling, *supra* note 48, at 1526.

102. *Id*.

103. Aronstam et al., *supra* note 33, at 546–47; *see also* Andra v. Blount, 772 A.2d 183, 194 (Del. Ch. 2000) ("[T]he appraisal action will not involve a determination that there was a fiduciary breach and the concomitant possibility for an award of attorneys' fees against the defendants.").

104. *Andra*, 772 A.2d at 194. In *Andra*, Vice Chancellor Strine named the cost-savings benefits of class action lawsuits "Litigation Cost Benefits." *Id*.

challenge a freeze-out valuation.[105] Each party to an appraisal proceeding bears its own litigation expenses, including both attorneys' fees and expert witness fees.[106] Dissatisfied minority shareholders must not only offset any gain by such expenses, but must also advance large sums to both their attorneys and experts. Without the possibility of a successful litigant obtaining any of these cost-savings benefits, few members of the plaintiffs' bar would be willing to undertake appraisal challenges on a contingency basis.[107] Making matters worse, few shareholders perfect their appraisal rights, reducing the possibility that such claimants will be able to spread the extensive cost of litigation over enough appraised shares to justify the appraisal proceeding.[108] Still, courts do have the ability to spread the costs of the proceeding—excluding attorneys' or expert witness fees—among "the parties as the Court deems equitable."[109]

Second, compared to the more generalized nature of a fairness claim, appraisal is procedurally complex, requiring that each shareholder complete multiple steps to perfect the right to appraisal.[110] These procedures drag out the average appraisal proceeding to 727 days,[111] which is critical because dissenting shareholders receive no compensation for their shares until after the appraisal proceeding concludes.[112] Not only must challenging shareholders advance fees to lawyers and experts, but they must also hold an illiquid claim for almost two years, forgoing investment in other promising opportunities that may arise in the interim.[113]

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105. Coffee, *supra* note 13, at 364; Herzel & Colling, *supra* note 48, at 1530.

106. Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 301 (Del. 1996); Thomas, *supra* note 59, at 15.

107. Weiss, *supra* note 56, at 21–22; *see also Andra*, 772 A.2d at 194 (recognizing that it is "much less attractive" for attorneys to represent a small block of shares in an appraisal proceeding than to represent most or all the company's shareholders in a class action proceeding).

108. Coffee, *supra* note 13, at 412; Marc I. Steinberg, *Short-Form Mergers in Delaware*, 27 DEL. J. CORP. L. 489, 492 (2002); Thomas, *supra* note 59, at 27. If a challenging stockholder obtains an appraisal award, the court may divide all or a portion of the appraisal expenses, including attorney and expert fees, on a pro rata basis against the value of shares entitled to appraisal. DEL. CODE ANN. tit. 8, § 262(j) (2001).

109. DEL. CODE ANN. tit. 8, § 262(j).

110. *Id.* § 262(g). For a description of the steps Delaware requires to perfect appraisal, see *supra* Part I.C.1.

111. Thomas, *supra* note 59, at 22.

112. Weiss, *supra* note 56, at 55 n.345.

113. *See* Thomas, *supra* note 59, at 29 (recognizing that the challenging shareholder's investment is illiquid during an appraisal action); Alexander Khutorsky, Note, *Coming in From*

Additionally, the defendant corporation may argue, and the court may hold, that the fair value of the shares is actually less than the price the corporation originally offered.[114] Even if a challenging stockholder receives a favorable appraisal, the court can only reimburse the shareholder for the delayed compensation at the legal rate of interest.[115] There is even uncertainty over whether the interest should be calculated as simple or compound, although courts seem to be moving toward awarding compound interest.[116] Compound interest is more likely when the parent did not initially value the shares in good faith.[117]

III. MINORITY DISCOUNTS

The procedural inadequacy of Delaware's appraisal remedy, which leaves shareholders unprotected against the risk of majority overreaching, suggests the possibility that minority shareholders account for the risk of an unfair freeze-out ex ante, when pricing the corporation's stock.[118] The basic premise behind ex ante pricing—and the consequent "minority discount"—is an efficient capital market. In

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the Cold: Reforming Shareholders' Appraisal Rights in Freeze-Out Transactions, 1997 COLUM. BUS. L. REV. 133, 149 ("[T]he problems of illiquidity and the time value of money loom large. Appraisal statutes generally allow corporations to withhold payment until a determination is made by the court, a period which can last a year or more.").

114. Weiss, *supra* note 56, at 55 n.345.

115. Borruso v. Communications Telesystems Int'l, 753 A.2d 451, 461 (Del. Ch. 1999).

116. *See* ONTI, Inc. v. Integra Bank, 751 A.2d 904, 926 (Del. Ch. 1999) ("It is simply not credible in today's financial markets that a person sophisticated enough to perfect his or her appraisal rights would be unsophisticated enough to make an investment at simple interest . . . ."); Wertheimer, *supra* note 21, at 710 n.517 ("The award of simple interest penalizes dissenting shareholders and does not accord with economic realities."). *Contra* Thompson, *supra* note 19, at 41–42 ("Interest payments have become common only in recent years, and Delaware still adheres to a standard practice of paying simple rather than compound interest . . . .").

117. *Borruso*, 753 A.2d at 461 (awarding compound interest after "not[ing] that [the corporation] did not make a good faith effort to value [the minorities' stock] in the merger").

118. *See* Coates, *supra* note 74, at 1298 (arguing that investors pass costs back to the firm by way of an increased cost of capital).

such a market, prices will reflect all available information,[119] including appraisal's inability to protect minority shareholders.[120]

Shares of stock trade at different prices in an efficient market depending on whether a particular share belongs to the control or minority block.[121] In other words, noncontrolling shares are subject to a minority discount, "an adjustment downward from some reference value,[122] reflecting [minority risks]."[123] Such premiums are "well known and well documented,"[124] and the corresponding minority discounts can be up to 35 percent or more of the reference value.[125] Professor John Coates examines the source of these control premiums (or discounts) in the context of change of control transactions and identifies three main components: (1) synergy value, (2) pure control value, and (3) expropriation value.[126]

Synergy value represents the gain possible from a transaction—essentially, the amount by which the whole is more valuable than the sum of the two parts.[127] Synergies derive from numerous sources, such as operating economies achieved through the elimination of duplicated functions, tax savings, stock market or financial benefits,[128] and reduced agency costs.[129] Recent regulation by both the Securities and Exchange Commission and national exchanges has rendered these synergy gains even more valuable, as

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119. Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 383 (1970); *see* Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1240–41 (1990) ("Efficient market theory predicts that in a well-developed securities market, publicly available information relevant to stock values is so quickly reflected in market prices that, as a general matter, investors cannot expect to profit from trading on such information.").

120. Kimble C. Cannon, *Augmenting the Duties of Directors to Protect Minority Shareholders in the Context of Going-Private Transactions: The Case for Obligating Directors to Express a Valuation Opinion in Unilateral Tender Offers after* Siliconix*,* Aquila *and* Pure Resources, 2003 COLUM. BUS. L. REV. 191, 196–97.

121. Coates, *supra* note 74, at 1262.

122. "Reference values include comparable company market value, market value, asset value, liquidation value, replacement value, and earnings or going concern value." *Id.* at 1263 n.38.

123. *Id.* at 1263.

124. *Id.* at 1273.

125. *Id.* at 1254.

126. *Id.* at 1274.

127. Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 706 (1982).

128. Brudney & Chirelstein, *supra* note 11, at 308.

129. Easterbrook & Fischel, *supra* note 127, at 723.

corporations save executive time, legal expenses, accounting costs, and filing fees by merging or going private.[130]

Next, pure control value represents the benefits of holding a controlling interest in a corporation under a system of majority-rule governance.[131] These benefits include "such things as the certainty of being able to direct operations, obtain further (potential) synergies, freeze out the minority shareholders, and choose the time for payouts through dividends, liquidation, or recapitalization."[132] Many of the pure control benefits stem from the fact that controlling shareholders elect and have influence over the board of directors and, through the board, management.[133] Given the ability to make corporate decisions and the reduced uncertainty that stems from making corporate decisions, controlling a corporation is a valuable asset in and of itself.[134]

Finally, while pure control value involves the legitimate (and expected) benefits of control in a majority-rule system, expropriation value arises from majority opportunism. The expropriation value of the control premium derives from the majority's "ability to expropriate wealth from minority shareholders through fraud, theft, or breach of fiduciary duties, such as freeze-outs at a clearly unfair price."[135] By failing to provide an adequate remedy for unfair freeze-outs, appraisal expands the expropriation element of the control premium.

Assuming an efficient market, minority shareholders will return the increase in expropriation value to their majority shareholders by way of a lower ex ante stock price.[136] Such reduced stock prices increase the majority's cost of capital;[137] however, firms accept this

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130. Cannon, *supra* note 120, at 206–12.

131. *See* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994) (listing examples of the "fundamental corporate changes" that majority shareholders can undertake through their power of majority-vote governance).

132. Coates, *supra* note 74, at 1277.

133. *See* Cannon, *supra* note 120, at 194 ("Controlling shareholders often have significant influence over the board of directors as well as over management . . . .").

134. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112 (1965) (arguing that "control of corporations may constitute a valuable asset; that this asset exists independent of any interest in either economies of scale or monopoly profits; [and] that an active market for corporate control exists").

135. Coates, *supra* note 74, at 1275.

136. *Id.* at 1298.

137. *Id.*; *see* Cannon, *supra* note 120, at 196–97 ("This phenomenon will initiate a cycle in which the value of the shares in companies controlled by . . . majority shareholders will become

cost because of their need for liquidity.[138] Although the control premium (minority discount) exists in the financial markets, Delaware rejects any minority discount analysis when valuing shares.[139]

IV. REFORMING APPRAISAL TO ACHIEVE A PARETO OPTIMAL OUTCOME

As currently used in Delaware, the appraisal remedy only achieves one of its three goals: it facilitates the market for corporate control, but it neither provides minority shareholders adequate liquidity nor checks majority shareholder opportunism. Appraisal facilitates the market for corporate control by giving majority shareholders almost unlimited discretion to freeze out their minority counterparts. However, appraisal's procedural limitations deny shareholders liquidity unless they accept a potentially unfair merger price. Appraisal's procedural limitations also permit majority shareholder opportunism because few shareholders are able to challenge an unfair freeze-out price.[140] Given that minority shareholders bargain away part of appraisal's shortcomings through the minority discount, majority shareholders share the loss by paying a premium when raising capital.[141]

Appraisal should be reformed to realign the remedy with its traditional goals. When *Glassman v. Unocal Exploration Corp.* established appraisal as a dissatisfied shareholder's sole remedy following a short-form merger,[142] it correctly identified the high value of short-form mergers and the need for a quick and inexpensive shareholder remedy. However, the court should have appreciated appraisal's current flaws and crafted an alternative appraisal remedy modeled off Pareto concepts. Section A sketches out the benefits of developing a Pareto remedy for appraisal's shortcomings. Then, Section B proposes specific appraisal reforms that implement the theoretical outline of a Pareto optimal appraisal remedy. Section C

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ever more depressed due to the perceived risk that minority shareholders will be eliminated at an unfair price through a related-party tender offer.").

138. Coates, *supra* note 74, at 1262 n.35 (acknowledging that commentators have identified "other types of discounts relevant to fair value," including "illiquidity discount[s]").

139. Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1145 (Del. 1989); Coffee, *supra* note 13, at 367; Thomas, *supra* note 59, at 15.

140. *See supra* Part II.B.

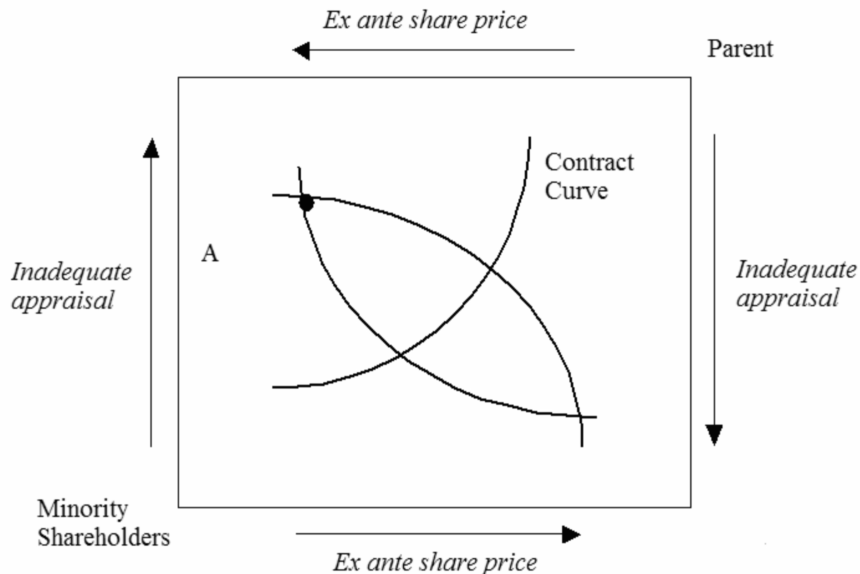
141. *See supra* Part III.

142. *See supra* note 36 and accompanying text.

briefly examines valuation, before Section D argues that reforming appraisal will not chill efficient mergers.

A. Pareto Theory of Reforming Appraisal

In general, a Pareto optimal outcome is an allocation of goods where it is impossible to make one person better off (under a different allocation) without making at least one other person worse off.[143] A typical Pareto situation, applied to a short-form merger, is diagramed as:



The horizontal axis represents the minority shareholders' ex ante share price, the price the minority initially paid for their shares. The vertical axis depicts the inadequacy of the appraisal remedy. Following the arrows on the axes, minority shareholders will pay less for their stock as appraisal becomes increasingly inadequate. Correspondingly, majority shareholders receive less money for selling stock as appraisal becomes more inadequate because they pay a higher cost of capital.

Realizing that ex ante share price and appraisal's inadequacy have an inverse relationship, both majority and minority shareholders

143. FRANK, *supra* note 22, at 559.

select combinations of the two goods that are advantageous to their respective positions. These combinations are called indifference curves, and simply represent a sliding scale of the amount each party will pay/receive in the initial sale of stock given the adequacy of the appraisal remedy. The contract curve represents Pareto optimal outcomes, and allocations on the curve are desirable because at these points neither party can improve its situation without harming the other side.

Currently, the parent and minority "contract" where their indifference curves intersect at Point A. Point A is not Pareto optimal. To reach a Pareto preferred or optimal point, the parent, the minority, or both must adjust its current indifference curve. By employing an externality—a modified Delaware appraisal statute or judicial doctrine—the parent and/or minority shareholders can move off their indifference curve and contract for a more efficient allocation of goods. To be successful, this externality should modify the appraisal perfecting process, providing minority shareholders with the liquidity and the ability to check majority overreaching that they currently lack. Minority shareholders will then remit a portion of these benefits to the parent through a smaller minority discount—in other words, a lower cost of capital.[144]

The current Pareto inefficient allocation arose from the holding in *Glassman*. Before *Glassman*, majority shareholders were uncertain about the level of fairness they owed minority shareholders in a short-form merger. For example, majority shareholders would appoint special negotiating committees, bring in outside advisors to simulate an arms-length negotiation, and take other steps consistent with a regular entire fairness review.[145] The court recognized that such procedures would be inconsistent with an efficient and inexpensive process and granted majority shareholders the right to follow Delaware's statutory summary process.[146] In doing so, the court benefited the majority, but made the minority position worse by removing protections against illiquidity and majority overreaching.

The *Glassman* court left minority shareholders with an appraisal procedure that delivers the same price as entire fairness and should be adequate in theory, but that proves inadequate in practice due to

144. POSNER, *supra* note 23, at 458.

145. *E.g.*, Glassman v. Unocal Exploration Corp., 777 A.2d 242, 243 (Del. 2001).

146. *Id.* at 247–48.

its numerous procedural disadvantages.[147] Similar to a law without enforcement, a remedy without access is ineffective.[148]

B. Changing the Method of Appraisal

In order to achieve a Pareto optimal outcome, the procedure for seeking appraisal should change. Appraisal reform should "balanc[e] the relative dangers of oppression by the majority and harassment by the minority."[149] Because appraisal currently fails to check majority oppression, any reform should elevate small shareholders to the level where appraisal offers them an effective remedy.

First, Delaware should implement a summary process that enables dissatisfied minority shareholders to obtain a judgment sooner than the 727-day average that currently scares shareholders into accepting merger terms.[150]

Second, Delaware's appraisal law should provide challenging shareholders with some liquidity by following the intent of the Model Business Corporation Act's (MBCA) payout provision.[151] The MBCA payout provision provides that a parent must compensate a minority shareholder with what the parent calculates as a "fair value" for the minority's shares within thirty days of receiving the shareholder's demand for appraisal.[152] While the MBCA facilitates appraisal actions by providing some instant liquidity, it goes too far in protecting minority shareholders by awarding a price that might exceed the appraised value of the shares. In an appraisal hearing, courts are free to appraise shares for less than the merger price—the price the parent initially determined was a fair value.

To incorporate the benefits of the MBCA provision while avoiding its disadvantages, a better approach is to require parents to pay challenging shareholders a sum equal to the market price of the

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147. *See supra* Part II.B.

148. *See* Franco Modigliani & Enrico Perotti, *Protection of Minority Interest and the Development of Security Markets*, 18 MANAGERIAL & DECISION ECON. 519, 520 (1997) ("It is important to realize that legal rules alone are not sufficient to create a favorable legal framework; their proper enforcement is just as important.").

149. James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1216–17 (1964).

150. *See supra* note 111 and accompanying text.

151. MODEL BUS. CORP. ACT § 13.24 (1992).

152. *Id*. Note that the "fair value" price under this provision is not necessarily the same as the merger price. Parents have an incentive to pay the merger price, however, because if parents regularly paid higher prices, minority shareholders would seldom accept the initial merger price but instead hope for a quick settlement at a higher price.

shares immediately prior to the merger. While market price is an unreliable indicator of value, particularly in the presence of a controlling block of stock that lowers trading volume and liquidity,[153] it still provides minority shareholders with some value for their shares. Also, courts are unlikely to appraise minority shares for less than their market value prior to the freeze-out, so the risk of overpayment is minimized. The majority shareholder can then remit any additional court-appraised value to the minority shareholder, with interest.[154]

Appraisal should also be a less expensive process for minority shareholders. The most important reform in this regard is to grant courts the discretion to award successful shareholders reasonable attorneys' fees (and expert fees[155]). Essentially, appraisal should apply the test courts use when awarding compound interest over simple interest: award attorneys' fees when the parent fails to act in good faith.[156] Courts should use their equitable authority to grant attorneys' fees when parents have severely understated fair value. To limit frivolous lawsuits, however, courts should not award attorneys' fees when minority shareholders lack a good faith basis for challenging the merger price.

While appraisal should be more accessible to minority shareholders, courts should retain appraisal's opt-in requirement and the initial procedures for perfecting appraisal rights. Unlike a claim for breach of fiduciary duty, an appraisal action does not guarantee that the appraised price will exceed the merger price. Though this risk is necessary to prevent every minority shareholder from challenging a freeze-out—essentially, shareholders would have nothing to lose by an appraisal challenge—many shareholders prefer to forgo the risk and instead accept the merger price.[157] To allow these shareholders to

153. Wertheimer, *supra* note 21, at 640.

154. Courts should end the uncertainty surrounding whether simple or compound interest is the correct method for compensating victorious shareholders for the time value of money and award minority shareholders compound interest for any amount by which the appraised value exceeds the market price payout. It is unreasonable to assume that individual stockholders and institutional investors lack the financial knowledge to seek out compound interest returns.

155. Rapid-Am. Corp. v. Harris, 603 A.2d 796, 802 (Del. 1992) ("It is frequently the case in appraisal proceedings that valuation disputes become a battle of experts.").

156. *See supra* note 117 and accompanying text.

157. In fact, courts should encourage majority shareholders to argue that the merger price exceeded a fair price. While appraisal should allow minority shareholders to sue when parent corporations or majority shareholders treat them unfairly, appraisal should also discourage suits when the merger price is fair. When shareholders blindly seek appraisal after a freeze-out, they

make an informed decision about the risk of challenging a freeze-out price, Delaware should continue to require strict disclosures in freeze-out mergers.[158]

C. *Valuation in Appraisal*

When minority shareholders make it to the appraisal court, Delaware should adhere to *Weinberger's* flexible valuation standard of using techniques widely accepted in the financial community.[159] Shareholders will likely rely on similar valuation techniques when they enter financial markets, and thus appraisal should compensate minority shareholders for the expectations they develop. Currently, the discounted cash flows (DCF) method of valuation is the most accurate valuation technique employed in the financial market.[160] Under DCF, an appraiser must estimate the continuing company's future cash flows and then discount the cash flows to their present value using the corporation's weighted average cost of capital (WAAC).[161]

The underlying inquiry in valuing shares in a freeze-out is to determine the stockholder's "proportionate interest in the going concern."[162] Although focusing on market price might seem natural during valuation,[163] appraisal recognizes correctly that market price is not reliable in freeze-out mergers because the small market for minority shares does not permit a sufficient volume of trading to achieve an accurate price.[164] Furthermore, freeze-outs often occur

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will increase the transaction costs of the merger and thus could frustrate socially beneficial mergers.

158. *See supra* Part I.D.

159. Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

160. Wertheimer, *supra* note 21, at 627.

161. STEPHEN A. ROSS ET AL., CORPORATE FINANCE 372–73 (5th ed. 1999). *See generally* Steven N. Kaplan & Richard Ruback, *The Market Price of Cash Flow Forecasts: Discounted Cash Flows v. the Method of Comparables*, J. APPLIED CORP. FIN., Winter 1996, at 45. WAAC accounts for the corporation's capital structure, including the cost of both equity and debt. ROSS, *supra*, at 372–73. *See generally* F. Modigliani & M.H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261, 276–93 (1958).

162. *Weinberger*, 457 A.2d at 713.

163. Bebchuck & Kahan, *supra* note 91, at 4.

164. Wertheimer, *supra* note 21, at 640; *see also* Modigliani & Perotti, *supra* note 148, at 522 ("Low demand by small investors may cause thin trading."). In contrast, the stock market exception discussed in *supra* note 62 describes a situation when markets can support valuation based on market price. "The rationale of the stock market exception is that appraisal is an unnecessary protection for investors whose shares are traded in such well-organized, and presumably efficient, markets." Stout, *supra* note 119, at 1286. It is important to note that the

when the market price is below a firm's going-concern value as majority shareholders can use their private information to time freeze-outs.[165] DCF accounts for both problems by focusing on the going concern's future cash flows, not current stock price.

DCF has several limitations, however, which courts should control for during an appraisal valuation. First, calculating future cash flows might be difficult because the majority shareholder controls the financial information.[166] Required disclosure should alleviate much of this insider problem, but managers remain in the best position to estimate future cash flows. Second, DCF is of limited use with emerging corporations, which are frequent targets in freeze-out mergers.[167] Estimating the future cash flows of these companies will likely either grossly understate or overstate the corporation's value. Finally, DCF requires accurate estimates for each variable, and even slight variations in cash flows, the discount rate, or the growth rate will dramatically swing the corporation's present value.

D. Effect on Short-Form Mergers

Finally, any appraisal reform should be tested against the criticism that it will impose costs on majority shareholders that are so large as to prevent majority shareholders from undertaking socially beneficial transactions.[168] Any such chilling, however, would occur only for transactions on the margin because high value deals will close regardless of the protections afforded to minority shareholders.[169] Nevertheless, under the proposed Pareto approach to reforming appraisal in short-form mergers, the improved minority protections

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legislature excluded short-form mergers from the stock market exception. DEL. CODE ANN. tit. 8, § 262(b)(3) (2001).

165. James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1203–04 (1964).

166. Wertheimer, *supra* note 21, at 629–30.

167. *See* O'NEAL, *supra* note 25, at 4 ("Squeeze-outs are most often effected in relatively small corporations . . . .").

168. *See* Jon E. Abramczyk et al., *Going-Private "Dilemma"?—Not in Delaware*, 58 BUS. LAW. 1351, 1365 (2003) (arguing that a proposal to hold a "limited fairness" hearing after freeze-out mergers would "impose costs so great on the majority stockholders that such stockholders would likely not propose going-private transactions in the first place").

169. *Cf.* Glassman v. Unocal Exploration Corp., 777 A.2d 242, 243–44 (Del. 2001) (recognizing that Unocal Corporation implemented procedures that it thought would satisfy entire fairness when freezing out the minority shareholders of its subsidiary, Unocal Exploration Corporation); Cannon, *supra* note 120, at 201 (describing Kohlberg, Kravis & Robert's acquisition of Duracell, and how a $350 million original investment to take Duracell private returned $4.22 billion).

will not chill beneficial transactions. Majority shareholders can continue to employ Delaware's short-form merger statute, while avoiding an increase in their cost of capital from the risk of expropriation or overreaching.

Reforming appraisal for freeze-out mergers also raises fewer concerns than in some of the other contexts in which appraisal applies. Most acquiring groups must make a substantial investment in research before identifying possible target groups and corporations.[170] Such costs are irrelevant in freeze-out mergers because the acquiring group consists of insiders who "are inherently in possession of nonpublic information about their own company."[171] Similarly, controlling shareholders will require few resources to transition because they already control the corporation. Therefore, many of the traditional concerns about chilling efficient mergers do not apply in the context of freeze-out mergers.

CONCLUSION

In *Glassman v. Unocal Exploration Corp.*, the court significantly weakened the position of minority shareholders in a short-form merger by declaring that appraisal, a currently ineffective remedy, is the sole remedy they may seek absent fraud or illegality. Appraisal is ineffective because its complicated procedures and great expense render it unavailable for all but the largest minority shareholders. Most shareholders are simply better off accepting the merger terms, which usually impart some premium over the current market price, and then reinvesting the payout in a new going concern.

Both minority and majority shareholders are aware of the comparative advantage majority shareholders hold. Through efficient markets, however, minority shareholders partially offset the competitive advantage with an ex ante minority discount. Although the minority discount serves control and liquidity purposes, it also includes a portion of the synergies that minority shareholders relinquish during appraisal. Given this interconnection, both shareholders and parents would be better off reducing the transaction costs of appraisal.

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170. Peter Holl, *Control Type and the Market for Corporate Control in Large U.S. Corporations*, 25 J. INDUS. ECON. 259 (1977), *reprinted in* ECONOMICS OF CORPORATE LAW AND SECURITIES REGULATION 205–11 (Richard A. Posner & Kenneth E. Scott eds., 1980); Coffee, *supra* note 13, at 410–11.

171. Coffee, *supra* note 13, at 410.

Delaware should borrow from the concept of Pareto optimality and reform its appraisal statute to reduce the transaction costs involved in an appraisal action. Doing this will enable shareholders to bring expedient appraisal actions and receive fair value for their shares. If Delaware is able to make appraisal a viable alternative to simply accepting an unfair freeze-out price, minority shareholders will finally realize their proportionate share of merger synergies. Consequently, investors looking to buy minority interests in corporations will not price as large a minority discount into their initial purchase price, and a higher purchase price will translate to a lower cost of capital for the corporation. It is at this point, Pareto optimality, that parent corporations have the ability to execute quickly freeze-out mergers, shareholders receive fair value through an adequate remedy, and the public benefits through increased investment and wealth-creating mergers.