Washington University Law Review

Volume 92 | Issue 6

2015

Appraisal Arbitrage and the Future of Public Company M&A

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ABSTRACT

In this Article, we demonstrate that the stockholder's appraisal remedy—long-dismissed in corporate law scholarship as useless or worse—is in the middle of a renaissance in public company mergers. We argue that this surge in appraisal activity promises to benefit public shareholders in circumstances where they are most vulnerable.

We first show a sea change in the use of appraisal in Delaware. Relying on our hand-collected data, we document sharp recent increases in the incidence of appraisal petitions, in the size of the petitioners' holdings, and in the sophistication of the petitioners targeting public deals. These litigants appear to invest in target company stock after the announcement of the merger and with the intention of pursuing appraisal. In short, this is appraisal arbitrage. There is every reason to believe that appraisal now stands as the most potent legal challenge to opportunistic mergers.

We also present evidence showing that these appraisal petitions bear strong markers of litigation merit—they are, in other words, targeting the right deals. Nevertheless, defense lawyers have recently suggested that appraisal arbitrage constitutes some sort of "abuse" of the remedy and ought to be stopped. This nascent argument has matters precisely backwards.

This new world of appraisal should be welcomed and indeed encouraged. Our analysis reveals that appraisal arbitrage focuses private enforcement resources on the transactions that are most likely to deserve

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* Korsmo is Associate Professor at Case Western Reserve University School of Law, and Myers is Associate Professor at Brooklyn Law School. We have received helpful input and comments on earlier drafts from Barry Adler, Ian Ayres, Quinn Curtis, Brad Davey, Steven Davidoff, George Geis, Jeffrey Gordon, Lawrence Hamermesh, J. Travis Laster, John Morley, Adam Pritchard, Roberta Romano, and participants at the American Law & Economics Association Annual Meeting, the Harvard/Stanford/Yale Junior Faculty Forum, the National Business Law Scholars Conference, the Federalist Society Junior Scholars Colloquium, the George Washington C-LEAF Workshop, the 2013 Corporate & Securities Litigation Workshop, the Widener University School of Law faculty workshop, and the University of Western Ontario Faculty of Law workshop. Since a draft of our companion paper on this topic was first circulated, we have provided compensated advice on appraisal.

scrutiny, and the benefits of this kind of appraisal accrue to minority shareholders even when they do not themselves seek appraisal. In this way, the threat of appraisal helps to minimize agency costs in the takeover setting, thereby decreasing the ex ante cost of raising equity capital and improving allocative efficiency in public company mergers and acquisitions. We offer some modest reforms designed to enhance the operation of the appraisal remedy in Delaware.

TABLE OF CONTENTS

INTRODUCTION

Stockholder appraisal is undergoing a profound transformation in Delaware. We demonstrate that appraisal activity has grown rapidly over the past three years, and this rise in appraisal litigation has been accompanied by the appearance of a new breed of appraisal arbitrageur. These developments—in stark contrast to other types of stockholder litigation—hold out great promise for stockholders and corporate law generally.

Stockholder appraisal is a unique remedy in corporate law: it allows the stockholder to forego the merger consideration and instead file a judicial proceeding to determine the "fair value" of the shares.[1] We have collected data on all appraisal cases in Delaware for the ten-year period from 2004 to 2013 and present the main results of our study in this Article.[2] Our Article is the first to provide a comprehensive examination of appraisal litigation. The lack of prior work no doubt stems from the prevailing academic view that appraisal "is seldom utilized"[3] and that the hurdles involved make it too cumbersome for stockholders to call upon profitably.[4] These dismissive attitudes towards appraisal are consistent with prior research finding that the appraisal remedy is not economically significant.[5]

With this Article, we show that this view is now badly out of date. Appraisal activity involving public companies is undergoing explosive growth in Delaware, driven by sophisticated parties who specialize in bringing appraisal claims. The value of claims in appraisal in 2013 was nearly $1.5 billion, a tenfold increase from 2004 and nearly one percent of the equity value of all merger activity in 2013.[6] Furthermore, the institutions bringing these claims are not the Potemkin "institutions" that often appear in securities or derivative litigation.[7] Appraisal claims are being brought by sophisticated entities that appear to have developed specialized investment strategies based on appraisal. This type of investing has come to be known as appraisal arbitrage and has utterly transformed what may once have been accurately characterized as a sleepy corporate law backwater.

While we can offer no perfect explanation for the rise in appraisal arbitrage, we can confidently dismiss two possible explanations that have been suggested.[8] The first ties the increase in appraisal to *In re Appraisal*

1. *See* DEL. CODE ANN. tit. 8, § 262 (2015).

2. Our focus is on Delaware because it is the most influential corporate law jurisdiction, home to more than half of all publicly traded companies in the United States and nearly two-thirds of the Fortune 500.

3. 2 PRINCIPLES OF CORPORATE GOVERNANCE, 282 introductory note (1995).

4. *E.g.*, COX, HAZEN & O'NEAL, 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.").

5. Paul Mahoney and Mark Weinstein found no evidence that the availability of appraisal is associated with higher merger premiums for target shareholders. Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 242 (1999).

6. *See infra* Part II.A.

7. *See infra* note 91 and accompanying text.

8. *See infra* notes 96–104 and accompanying text.

of Transkaryotic Therapies, Inc., a 2007 Chancery Court decision.[9] *Transkaryotic* expanded the time frame for purchasing appraisal-eligible stock in advance of a stockholder vote to approve a merger. But the judicial ruling itself likely contributed little, if at all, to the rise in appraisal arbitrage. *Transkaryotic* only marginally expanded the time available to arbitrageurs for evaluating appraisal claims and, more importantly, only affected a subset of merger transactions. Thus, the larger trend is unlikely to be the result of the *Transkaryotic* holding. Likewise, a new statutory interest rate available to appraisal petitioners (the federal funds rate plus five percent) is unlikely to have been the catalyst for the appraisal boom.[10] Given the risks an appraisal petitioner must assume—an extended period of illiquidity with an unsecured claim against a surviving company that may be highly leveraged, plus the risk of the legal claim itself—the idea that interest rates are driving sophisticated parties to target appraisal is implausible.

Whatever its cause, the surge in appraisal litigation implicates a host of important public policy questions. The increased activity coincides with a rise in stockholder fiduciary litigation generally.[11] By many accounts, that fiduciary litigation is a hotbed of nuisance claims of dubious social value.[12] Accordingly, it is natural to fear that the increase in appraisal arbitrage is an ominous development. Appraisal litigation, however, is structured in a way that renders the risks of meritless, attorney-driven litigation remote.

In particular, two unique features distinguish appraisal.[13] First, appraisal claims can be purchased: a stockholder need not own the stock on the date the challenged merger is announced.[14] This feature stands in contrast to a standard stockholder claim, where the only stockholders who may press a claim are those who owned the stock at the time of the alleged wrong.[15] Second, there is no conventional class action: a stockholder is

9. 2007 WL 1378345 (Del. Ch. 2007).

10. *See* DEL. CODE ANN. tit. 8, § 262(h) ("Unless the Court in its discretion determines otherwise for good cause shown, interest from the effective date of the merger through the date of payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate . . . .").

11. *See* Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465 (2015) (documenting the rising incidence of merger class actions).

12. *See infra* note 117.

13. *See infra* Part III.A.

14. *See In re* Transkaryotic Therapies, Inc., 954 A.2d 346, 368 (Del. Ch. 2008).

15. *See* Charles Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When Do the Merits Matter?*, 75 OHIO ST. L.J. 829, 892–93 (2014).

only eligible to file an appraisal petition if she affirmatively opts-in by meeting certain procedural requirements.[16] The result is a form of aggregate litigation where the aggregation is performed, and the litigation controlled, by the actual plaintiff—the appraisal arbitrageur—rather than the plaintiffs' attorney. Indeed, some of the largest appraisal petitioners appear to shun contingency arrangements altogether and instead pay their attorneys by the hour. In addition, the narrow focus of an appraisal claim and the possibility a court will determine fair value to be below the merger price render the risks and costs of litigation far more symmetric than in other forms of shareholder suit, further reducing the potential for nuisance claims.

We test these propositions empirically and show that appraisal suits indeed bear multiple indicia of litigation merit.[17] The analysis presented below reveals that appraisal petitioners target transactions with lower deal premia and also going-private transactions, where minority shareholders are most likely to face expropriation. By contrast, the size of the transaction—believed to correlate more with the size of the potential nuisance settlement and long the chief determinant of fiduciary litigation—does not appear to matter at all for appraisal petitioners.[18] We present summary results on these points here and report these findings more fully in a companion paper.[19]

In light of these empirical findings, we argue here that the rise of appraisal arbitrage is, on balance, a beneficial development.[20] Much as the market for corporate control generates a disciplining effect on management, a robust market for appraisal arbitrage could serve as an effective back-end check on expropriation from stockholders in merger transactions. The implications in related-party mergers are plain: appraisal can protect minority holders against opportunism at the hands of controlling stockholders. And in third-party transactions, appraisal can serve as a bulwark against sloth, negligence, or unconscious bias in the sales process. For appraisal to perform such a role, however, a deep and active appraisal arbitrage market is necessary.[21] By buying up large positions after the announcement of a transaction, arbitrageurs can overcome the collective action problems that would otherwise render

16. *See infra* note 56.
17. *See infra* Part III.B.
18. *See* Korsmo & Myers, *supra* note 15, at 882–84.
19. *Id*.
20. *See infra* Part IV.
21. *See infra* Part IV.

appraisal ineffective. At bottom, appraisal arbitrage solves the same collective action problems that class action and other aggregate litigation seeks to solve, but without generating a serious agency problem in the process.

A highly developed appraisal arbitrage market would aid minority shareholders—even those not equipped to pursue appraisal themselves—by deterring abusive mergers and by causing shares traded post-announcement to be bid up to the expected value of an appraisal claim.[22] Such a result would benefit not only minority shareholders, but also—in the long run—controlling shareholders, entrepreneurs, and the economy at large. If appraisal arbitrage reduces the risk of expropriation faced by minority shareholders, it will increase the value of minority stakes and thus reduce the costs of capital for companies and increase the allocative efficiency of capital markets as a whole.[23]

In spite of our empirical findings that appraisal activity is associated with merit, and the benefits we argue will be generated by increased appraisal arbitrage, defendants have already begun to argue that appraisal arbitrage constitutes an abuse of the appraisal process.[24] This may be, in part, an attempt to re-litigate the point in *Transkaryotic* and foreclose any shares acquired after the voting record date from seeking appraisal. More generally, this may be the opening salvo in an attempt to curtail appraisal rights by altering the substantive standard in appraisal proceedings. We believe that either would be a regrettable misstep for Delaware law. One of the great virtues of appraisal litigation is that its substantive standard defies manipulation and cannot be evaded or altered by purely procedural means such as the formation of a committee or inclusion of a particular voting provision in a merger agreement.[25] We show here that the choice to initiate appraisal proceedings appears strongly focused on litigation merit. It would be a cruel irony if appraisal litigation—where the evidence suggests that the merits matter—were to be "reformed" by importing features of fiduciary merger litigation, where the evidence suggests the

22. *See infra* Part IV.

23. *See infra* note 160.

24. *See In re* Appraisal of Dole Food Co., No. 9079-VCL, Letter to J. Travis Laster from Bruce L. Silverstein, Dec. 27, 2013, at 3 ("These appraisal actions are being pursued by 'appraisal arbitrageurs,' who [sic] Dole understands to have acquired all or substantially all of their shares following the public announcement of the transaction—including many shares acquired after the record date for the vote on the merger, and some shares acquired even after the merger was approved by public stockholders. Dole respectfully submits that this is an abuse of the appraisal process . . . .").

25. *See In re* MFW S'holders Litig., 67 A.3d 496 (Del. Ch. 2013).

legal merits are functionally irrelevant.[26] Indeed, the more promising direction of reform is the reverse: borrowing features from appraisal and applying them to other forms of shareholder litigation. We offer some tentative thoughts on potential reforms along these lines.[27]

This is not to suggest that the appraisal remedy, as currently constituted, could not be improved. Indeed, the basic premise of appraisal—that a judicial proceeding can provide a more reliable valuation of stock than some market process—fails in predicable circumstances. In our view, a genuine market test of the target company will necessarily provide a superior valuation of the stockholders' interest, and in such circumstances an appraisal proceeding can only cause mischief. For this reason, we would support the development of a safe harbor to eliminate appraisal where the transaction has undergone a true auction. A target could affirmatively seek the protection of the safe harbor only by subjecting itself to a genuine market test, not merely by engaging in a procedural kabuki dance that happens to satisfy *Revlon*.[28] Our second reform proposal focuses on decoupling appraisal rights from the form of merger consideration. Delaware currently limits the availability of appraisal to mergers where the consideration takes certain forms—primarily cash or non-public shares. We argue that the form of merger consideration should be irrelevant to eligibility for appraisal. The adequacy of the consideration paid in a merger does not, at the end of the day, depend on the form of that consideration. Our two reform proposals together would improve the functioning of appraisal arbitrage as a mechanism of corporate governance.

This Article proceeds as follows. Part I provides a brief summary of the structure of appraisal litigation and prior scholarly perspectives. Part II presents the results of our empirical investigation of appraisal activity, showing since 2011 a large increase in activity and the emergence of appraisal arbitrageurs. Part III demonstrates that the merits appear to matter in the decision to file appraisal petitions. Part IV argues that, in light of these empirical findings, appraisal arbitrage has the potential to play a beneficial role in corporate governance. Part V suggests reforms for appraisal and for fiduciary litigation.

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26. *See* Korsmo & Myers, *supra* note 15, at 870–78
27. *See infra* at Part V.
28. *See* Barkan v. Amsted Indus., 567 A.2d 1279 (Del. 1989).

I. THE ROLE OF APPRAISAL IN CORPORATE LAW

Appraisal allows a stockholder to dissent from a merger and forego the merger consideration in favor of filing a judicial proceeding that will determine the "fair value" of the stock cancelled in the merger.[29] This Part describes the design of modern appraisal statutes in Delaware and elsewhere and also outlines the overwhelmingly pessimistic view of appraisal in prior legal scholarship.

A. The Statutory Design of Appraisal

The origin of the modern appraisal action can be traced back to basic changes in American corporate law at the beginning of the twentieth century.[30] Older corporate codes required the unanimous consent of all shareholders before a merger or other fundamental change.[31] The holdout problem—a single shareholder could stand in the way of any significant transaction—became severe as companies increasingly tapped public equity markets.[32] In response, states amended their corporate codes to eliminate the requirement of unanimity and replace it with a majority-voting rule.[33] This change stripped minority shareholders of protection against majority expropriation, and the appraisal remedy emerged as something of a replacement.[34] Appraisal affords minority shareholders

29. *See generally* DEL. CODE ANN. tit. 8, § 262 (2015); MODEL BUS. CORP. ACT § 13.02 (2008). In this paper, we focus on mergers involving Delaware entities and will therefore largely limit the discussion to Delaware law.

30. While some form of appraisal rights existed in a few jurisdictions as long ago as the middle of the nineteenth century, they only became available widely in their modern form in the early twentieth century. *See* MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS § 7.1, at 75 (1976).

31. *See* Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 11–14 (1995); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 618–19 (1998).

32. *See* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 81 ("It became increasingly apparent to observers that great benefits to society, to the corporation, and derivatively to the rest of the shareholders were sometimes blocked to protect interests that seemed quite minor . . . to the remaining shareholders and perhaps to most outsiders."); Thompson, *supra* note 31, at 12–13.

33. *See* Carney, *supra* note 32, at 94 ("Over the first third of the twentieth century the pattern of allowing fundamental changes in all corporations to take place on something less than a unanimous shareholder vote became the norm . . . .").

34. *See, e.g.*, George S. Geis, *An Appraisal Puzzle*, 105 NW. L. REV. 1635, 1642 (2011) ("[Appraisal] mushroomed in the early 1900s, when state lawmakers granted appraisal rights to shareholders—apparently in exchange for an easing of merger voting requirements.") (footnote omitted); Thompson, *supra* note 31, at 14 ("Appraisal statutes are often presented as having been enacted in tandem with statutes authorizing consolidation or merger by less than unanimous vote . . . ."); Joseph L. Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547, 547–48 & n.7

who object to a fundamental transaction the opportunity to exit from the enterprise on terms set by a judge instead of majority shareholders.[35]

The availability of appraisal rights varies from jurisdiction to jurisdiction. In MBCA states, appraisal rights are available in a wide array of circumstances, including a merger, a sale of assets, or an amendment to the certificate of incorporation.[36] In Delaware, by contrast, only mergers give rise to appraisal rights.[37] For public companies, the form of consideration also affects eligibility for appraisal. The remedy is available if cash is the merger consideration but not if shareholders receive stock in the surviving entity or in another widely traded entity—the so-called "market out" exception.[38] Even when a transaction gives rise to appraisal rights, stockholders must affirmatively comply with a number of requirements to be eligible to pursue the remedy. For example, the stockholder must not vote in favor of the merger,[39] must deliver to the company a written demand of appraisal rights,[40] and must file a petition in the Court of Chancery within 120 days of the merger's effective date.[41]

(1927) (listing states enacting an appraisal remedy in the early twentieth century); Wertheimer, *supra* note 31, at 614 ("The origin of the appraisal remedy typically is tied to the move in corporate law . . . away from a requirement of unanimous shareholder consent."). *But see* Mahoney & Weinstein, *supra* note 5, at 243 (questioning whether appraisal statutes were a direct reaction to elimination of unanimity requirements).

35. *See* Geis, *supra* note 34, at 1643 ("[A]ppraisal rights were therefore enacted in most jurisdictions as an emergency exit from majority rule. A merger could move forward with less-than-unanimous approvals, but minority owners had an escape if they disliked the shift in direction."); Thompson, *supra* note 31, at 26. In this respect—as in others—appraisal is a highly unusual remedy in corporate law. Shareholders do not, under normal circumstances, have the power to withdraw their proportional interest from the firm's assets. *See In re* Trados Inc. S'holder Litig., 73 A.3d 17, 37 (Del. Ch. 2013) ("Equity capital, by default, is permanent capital."); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). Usually, the only "exit" for disgruntled shareholders is to sell their shares in a secondary market. But appraisal is an instance where a shareholder may, in effect, withdraw their interest in the firm other than via market exit.

36. *See* MODEL BUS. CORP. ACT § 13.02(a)(3).

37. *See* DEL. CODE ANN. tit. 8, § 262 (2015).

38. *See id.* § 262(b).

39. *Id.*

40. *Id.* § 262(d)(1). Such a demand is usually simply a short statement informing the issuer of the number of shares held and the intent to seek appraisal.

41. *Id.* § 262(e). A shareholder that makes demand need not ultimately file a petition for appraisal, and retains the right to back out and take the merger consideration within sixty days of the effective date of the merger. *Id*.

B. The Critique of Appraisal

Appraisal has long been regarded in the corporate law literature as an almost useless remedy. Scholarly commentators throughout the 1960s and 1970s heaped scorn on it. Bayless Manning issued perhaps the most well-known indictment in a 1962 *Yale Law Journal* piece, describing appraisal as "of virtually no economic advantage to the usual shareholder except in highly specialized situations."[42] Similarly, Victor Brudney and Marvin Chirelstein called it a "last-ditch check on management improvidence,"[43] and Melvin A. Eisenberg described it as a "remedy of desperation."[44] Part of the reason these commentators found appraisal so pointless is that transactions can often be structured to avoid it. At a Delaware firm, for example, a sale of all assets would have the same economic effect as a merger but, unlike a merger, would not give rise to appraisal rights.

Academic commentary continues to take a sweepingly dismissive view of appraisal.[45] The modern critique faults appraisal because, as one Delaware court noted, it is "chock-full of disadvantages for shareholders."[46] These disadvantages tend to fall into three categories:

42. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 260 (1962) ("The appraisal remedy is of virtually no economic advantage to the usual shareholder except in highly specialized situations.").

43. Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 304 (1974).

44. Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1, 85 (1969).

45. *E.g.*, Bradley R. Aronstam, R. Franklin Balotti & Timo Rehbock, *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 546 (2003) ("[I]n practice, the appraisal remedy is replete with shortcomings and therefore fails to protect adequately minority shareholders from majoritarian abuse."); 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, 412 (1996) ("Standing alone, the appraisal remedy cannot begin to assure the receipt of proportionate value."); Jesse Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 1005 (2006) ("The shortcomings of the appraisal remedy are widely known. Commentators have long recognized that appraisal is a remedy that few shareholders will seek under any circumstance.") (footnote omitted); Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 830 (1984) (arguing that appraisal suffers from "substantial defects in the ability of state corporate law to ensure dissenting shareholders the fair value of their shares."); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 31 (2005) ("[I]t is well accepted among academic commentators and practitioners that appraisal is a weak remedy compared to entire fairness review."). *See also* COX, HAZEN & O'NEAL, *supra* note 4, at 601 ("[T]he risk of considerable expense as well as the procedural difficulties in pursuing the [appraisal] remedy further decrease its effectiveness in protecting minority shareholders."); 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 2, at 282 ("The practical utility of the appraisal remedy as a protection for minority shareholders has been the subject of much debate, and few legal commentators have been confident that the remedy works sufficiently well to play a major role in corporate governance.").

46. Turner v. Bernstein, 776 A.2d 530, 547 (Del. Ch. 2000).

(1) the procedural burdens of preserving and asserting an appraisal remedy; (2) the inability to proceed as a class and shift attorneys' fees to shareholders as a whole or to defendants; and (3) the narrow and inflexible nature of the remedy available. Taken together, these disadvantages have led many scholars to believe that appraisal will almost never prove useful.

The literature is replete with references to the supposedly Byzantine procedure for asserting one's appraisal rights. Leading casebooks refer to appraisal as "a cumbersome remedy,"[47] and one that requires shareholders of Delaware corporations to navigate a "complicated maze . . . to successfully assert appraisal rights."[48] Others have suggested that "[a]ppraisal litigation is complicated and expensive" and that "many shareholders find it difficult to meet the complicated procedural requirements and deadlines of the appraisal remedy."[49] On top of the supposed complexity, a shareholder bringing an appraisal action in Delaware is required to forego the merger consideration, and thus may not finance the litigation out of the merger proceeds, such that they "may receive no return on their investment for prolonged periods of time."[50] Indeed, courts in appraisal actions can, and occasionally do,[51] determine fair value of the plaintiff's shares to be *less* than the merger consideration.[52] In contrast, fiduciary duty class action plaintiffs have typically already received the merger consideration and face no financial downside, giving fiduciary litigation an option value that is absent in appraisal actions.[53]

Perhaps the main reason given for the supposed impotence of the appraisal remedy is the inability to proceed as a class.[54] While shareholders not desiring to be represented in a typical stockholder class

47. ROBERT CHARLES CLARK, CORPORATE LAW § 12.2, at 508 (1986) ("[A]ppraisal is often a cumbersome remedy.").

48. PETER V. LETSOU, CORPORATE MERGERS AND ACQUISITIONS 429 (2006).

49. Fried & Ganor, *supra* note 45, at 1004.

50. Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. LEGIS. 79 (1995).

51. *See infra* Part III.A, at n.126.

52. *See* Siegel, *supra* note 50, at 103 ("[S]hareholders in appraisal actions risk the possibility of receiving less than the transaction price.").

53. *Id*.

54. *See, e.g.*, Andra v. Blount, 772 A.2d 183, 192 (Del. Ch. 2000) (noting the "unavailability of a class action and fee shifting in appraisal actions"); Turner v. Bernstein, 776 A.2d 530, 548 (Del. Ch. 2000) ("[T]he unavailability of the class action mechanism in appraisal also acts as a substantial disincentive for its use."); Fried & Ganor, *supra* note 45, at 1004 n.105 (2006) ("In Delaware, shareholders seeking appraisal are barred from using class action suits.").

action must try to opt-out,[55] shareholders seeking judicial appraisal must "opt-in."[56] Moreover, because dissenting shareholders must vote against the merger and give notice of intent to pursue appraisal, the process of opting-in must actually begin long before the appraisal petition is filed.[57] As Ronald Gilson and Jeffrey Gordon note, this procedural difference between opt-out fiduciary litigation and opt-in appraisal litigation is "ultimately of enormous substantive consequence."[58]

Given the superficial similarity of the issues and remedies involved in a fiduciary duty proceeding and in an appraisal action, the availability of class treatment in the former potentially makes it far more attractive, at least in theory.[59] The major benefit of class treatment to the plaintiff (or her attorney) is that it allows litigation costs to be spread over the potentially much larger class of aggrieved minority shareholders.[60] Some

55. Indeed, this option is not necessarily available in a fiduciary class action. *See* In re Celera Corp. S'holder Litig., 59 A.2d 418, 434–37 (Del. 2012) (describing the limited circumstances where stockholder can opt-out of merger class actions certified under Rule 23(b)(2)).

56. *See, e.g.*, 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, at 267 n.6 ("[T]he appraisal remedy differs from the procedural rules applicable to the class action, which assume that investors who do not 'opt out' desire to be represented."); Aronstam, Balotti, & Rehbock, *supra* note 45, at 547 ("[T]he appraisal statute creates an 'opt-in' class for minority shareholders as opposed to the 'opt-out' default mechanism of class action lawsuits. Thus, only shareholders specifically electing to opt in will be able to benefit from a judicial determination diverging from the corporation's initial valuation.").

57. *See* Alabama By-Products Corp. v. Cede & Co. *ex rel.* Shearson Lehman Bros., Inc., 657 A.2d 254, 260 n.10 (Del. 1995) ("In an appraisal proceeding, however, shareholders enter the appraisal class by complying with the statutory formalities required to perfect their appraisal rights. Thus, shareholders seeking appraisal 'opt in' to a class, invariably before suit is even filed, rather than 'opt out.'").

58. Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 798 (2003).

59. *Id.* at 831–32 ("[A]n entire fairness proceeding . . . provides the equivalent of a class appraisal proceeding without the need for shareholders actually to perfect their appraisal rights").

60. Andra v. Blount, 772 A.2d 183, 194 (Del. Ch. 2000) ("In a class action, the plaintiff's lawyers can take their fees and expenses against any class-wide recovery, whereas in an appraisal action the fees and expenses can be recovered only as an offset against the appraisal award to the usually far smaller group of stockholders who perfected their appraisal rights."). Elsewhere in its opinion, the *Andra* court notes that in an "entire fairness" proceeding, "the non-tendering stockholder may spread her litigation costs over any classwide recovery and may obtain an order requiring the defendants to pay her attorneys' fees, thus making it easier for her to find legal representation and enabling her the possibility of a full recovery." *Id*. at 184. The court goes on to point out that "[i]f relegated to an appraisal action, the non-tendering stockholder will have to cover her attorneys' fees out of any recovery she (and the usually smaller group of appraisal petitioners) obtain and will be unable to proceed as a class representative on behalf of all similarly situated stockholders." *Id*. *See, e.g.*, WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 215 (9th ed. 2004) ("[T]he appraisal remedy lacks the class action's ability to secure automatic representation and a greater recovery for shareholders."); Fried & Ganor, *supra* note 45, at 1004 n.105 ("In Delaware, shareholders seeking appraisal are barred from using class action suits. Because each shareholder must pursue his own individual claim, shareholders lose the important

commentators also suggest that the unavailability of attorney fee-shifting in most Delaware appraisal actions further increases the relative costs of appraisal litigation to the plaintiff.[61] Fee shifting, however, may be less economically significant than it appears at first glance. Even where fee shifting is available, any fees must come out of what the defendant would otherwise be prepared to offer to settle the case. In most cases, it will make little economic difference whether the defendant pays the plaintiffs' attorneys—in which case the defendant will be willing to pay less to settle the case—or if the plaintiff pays—in which case it will come out of the settlement. In either situation, the plaintiff ends up bearing most or all of the economic cost. The more significant difference between a fiduciary class action and an appraisal action stems not from the unavailability of fee shifting, but rather that a larger class leads to a larger plaintiff group and greater leverage to extract a settlement. Plaintiffs' attorneys in fiduciary class actions can bear the up-front costs of bringing a claim,[62]

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economic benefits of class actions, which spread the costs of litigation and facilitate contingency financing.").

61. *See, e.g.*, *Andra*, 772 A.2d at 194–95 ("Class actions and fee shifting are crucial if litigation is to serve as a method of holding corporate fiduciaries accountable to stockholders. Without them, collective actions problems would make it economically impractical for many meritorious actions to be brought."); Aronstam, Balotti, & Rehbock, *supra* note 45, at 546 ("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 for appraisal rights requires individual shareholders to foot these costly expenses on their own."); Subramanian, *supra* note 45, at 30 ("[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.").

62. Gilson and Black describe the dynamic thusly:

> Most importantly, the [fiduciary duty] suit can be brought as a class action. Minority shareholders need take no affirmative action in order to participate, nor need they expend any resources to pursue the action. All the responsibility—both for initiating the action and for its expenses—is borne by the self-designated lawyer for the class who is compensated, one way or the other, out of the amount recovered. The lawyer then stands, in effect, as an independent investor who balances his estimate of the potential recovery to all shareholders against the cost of the proceeding and the uncertainty associated with its outcome.

RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 1267 (2d ed. 1995). Similarly, Mary Siegel notes:

> Just as shareholders have financial incentives to pursue non-appraisal actions, plaintiffs' attorneys are similarly motivated by the size of potential fees. While most jurisdictions provide that attorneys' fees in appraisal awards may be apportioned from the recovery, as are fees in class actions, these equivalent structures often do not produce equivalent results. The potential amount of the attorneys' fees—and therefore their willingness to undertake a matter—is directly linked to the number of shares in the plaintiff class. In appraisal proceedings, the class tends to be small. In contrast, the representative nature of a class action does not require any action by individual shareholders, except for those shareholders desiring to 'opt out' of the class. Ease of formation, coupled with a lack of financial concerns, tends to make the plaintiff group in class actions relatively large. The allocation of attorneys' fees as a

secure in the knowledge that they will be able to settle the claim for at least nuisance value.

Appraisal is potentially even less attractive in view of the narrow scope of the remedy available. Plaintiffs in appraisal actions are limited to receiving fair value for their shares.[63] Typically, of course, that is precisely the remedy the shareholder wants. Nonetheless, this limited remedy has a tactical drawback compared to the otherwise similar fiduciary duty class action.[64] The threat of injunction or rescission—even where it is not really what the stockholder is after—can significantly increase the settlement leverage of a plaintiff in a fiduciary duty class action.[65]

With these disadvantages in mind, it is easy to see why so many commentators have come to the conclusion that plaintiffs will rarely, if ever, choose to pursue an appraisal action instead of a fiduciary duty class action. All of the "incentive[s] for plaintiffs [are] to reject the technically easier option of an appraisal action for the more onerous burden of proving a fiduciary breach."[66] With a fiduciary class action almost always

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> percentage of the recovery of the class, when the process is skewed toward creating a large class, may be the pivotal reason for the preference for class actions.

Siegel, *supra* note 50, at 103–04.

63. *See* DEL. CODE ANN. tit. 8, § 262(h)–(i); Cede & Co. v. Technicolor, Inc., 542 A.2d 1182, 1187 (Del. 1988) ("[I]n a section 262 appraisal action the only litigable issue is the determination of the value of the appraisal petitioners' shares on the date of the merger, the only party defendant is the surviving corporation and the only relief available is a judgment against the surviving corporation for the fair value of the dissenters' shares."); Nagy v. Bistricer, 770 A.2d 43, 55 (Del. Ch. 2000) ("[I]t is clear that the sole remedy that will be available in an appraisal proceeding is a fair value award. . . .").

64. *See Cede*, 542 A.2d at 1187 ("In contrast [to appraisal], a fraud action asserting fair dealing and fair price claims affords an expansive remedy and is brought against the alleged wrongdoers to provide whatever relief the facts of a particular case may require.").

65. *See* Siegel, *supra* note 50, at 104 (1995) ("The ability to seek an injunction or rescissory damages significantly strengthens the minority's bargaining power. As a result, plaintiffs are drawn to class actions to air a broader range of grievances."). The *Andra* court recognizes this possibility, while emphasizing the relatively greater importance of the class size. *See Andra*, 772 A.2d at 194 ("[T]he Litigation–Cost Benefits of a class action that most often makes an unfair dealing claim so much more attractive than appraisal from a plaintiff's perspective, not the theoretical possibility of an award of (rarely granted) rescissory damages.").

66. Turner v. Bernstein, 776 A.2d 530, 548 (Del. Ch. 2000). *See, e.g.*, Wertheimer, *supra* note 31, at 623 n.52 ("There are numerous economic incentives for shareholders to challenge acquisition transactions in class action lawsuits alleging breach of fiduciary duty, rather than in appraisal proceedings."); *see Andra*, 772 A.2d at 196 ("The substantial procedural advantages of equitable actions has naturally led to a strong preference for such actions over the otherwise seemingly attractive (from a plaintiff's perspective) prospect of appraisal actions focused solely on a fair value remedy."); Siegel, *supra* note 50, at 103 ("For a variety of reasons, shareholders have incentives to pursue class actions instead of, or in addition to, their appraisal action.").

available to challenge suspect transactions,[67] one might simply conclude that appraisal is unnecessary and can safely be abandoned.

Several commentators, however, have suggested that appraisal should be reformed, rather than consigned to the scrap heap.[68] Naturally enough, suggestions for reform center on making the appraisal action look more like the typical fiduciary duty class action.[69] Most prominently, a number of scholars have suggested extending opt-out class treatment to appraisal actions.[70]

Modifying appraisal to allow opt-out class treatment would, however, potentially have substantial downsides, in addition to any upside gained. Class treatment would almost certainly expand the practical availability of appraisal and could theoretically help address any under-deterrence problem. But it would also introduce the same agency-cost dynamics that have traditionally bedeviled shareholder litigation. As we explain, the very feature of appraisal action that attracts the most criticism—the unavailability of class treatment—also has the great virtue of largely eliminating the kinds of agency problems that can lead to abusive and wasteful shareholder litigation.[71] Furthermore, the new phenomenon of appraisal arbitrage has the potential to solve the same collective action

67. *Andra*, 772 A.2d at 192 ("[I]t has become nearly impossible for a judge of this court to dismiss a well-pled unfair dealing claim on the basis that appraisal is available as a remedy and is fully adequate.").

68. *See, e.g.*, GILSON & BLACK, *supra* note 62, at 1267 ("[E]specially because the absence of a class action mechanism makes it impossible for lawyers to act, in effect, as surrogates for minority shareholders with respect to whether to invest in an appraisal proceeding, most shareholders will not dissent. As a result, many of the minority shares can be purchased for less than what would be the 'appraisal' price."); KLEIN & COFFEE, *supra* note 60, at 215 ("[T]hose planning the merger or other transaction have an incentive to offer an unfairly low price, even if they expect to be required to pay a much higher price to shareholders who seek appraisal, because they anticipate that only a small minority of shareholders will do so."); Siegel, *supra* note 50, at 104 (footnote omitted) ("Thus, as shareholders often choose a non-appraisal remedy, the appraisal remedy today does not provide the protection for majority shareholders that Dean Manning envisioned.").

69. *See, e.g.*, KLEIN & COFFEE, *supra* note 60, at 215 ("[T]he key policy issue about the appraisal remedy is the degree to which it should be reformed to resemble the class action and thereby provide some form of collective representation that may be elected at low cost.").

70. *See, id.*; *see, e.g.*, GILSON & BLACK, *supra* note 62, at 1268 ("[E]ven if the substance of the remedy for failing the entire fairness standard did not differ one whit from that which would be forthcoming in an appraisal proceeding, the availability of the class action mechanism to enforce a violation . . . meant that substantially more shareholders could benefit from it."); KLEIN & COFFEE, *supra* note 60, at 215 ("[T]he appraisal remedy lacks the class action's ability to secure automatic representation and a greater recovery for shareholders."); Gilson & Gordon, *supra* note 58, at 837 ("[A] class-based appraisal remedy—the equivalent of a *Sinclair* remedy—is called for regardless of the transaction form, and the holding that the Delaware Supreme Court should reconsider is the chancery court's application of *Solomon* to freeze-out tender offers, rather than *Kahn I*'s provision of class-based appraisal.").

71. *See infra* note 116.

problems addressed by aggregate litigation, while avoiding the agency problems that plague class actions.

A singular feature of appraisal litigation—and one essential to the rise of appraisal arbitrage—is that standing to bring an appraisal petition is not limited to investors who held stock at the time of the announcement. In securities and derivative litigation, standing to bring the claims is limited by the so-called contemporaneous ownership requirement.[72] This means that investors who acquire the stock after the alleged wrong may not bring suit to remedy it. Appraisal is different in an important way: an investor who acquires the stock after the announcement of the merger may still pursue appraisal. The cutoff for acquiring stock with appraisal rights depends on the structure of the transaction,[73] but investors generally have long enough to examine proxy statements, tender offer statements, or other informational material before deciding whether to acquire stock with appraisal rights. This means that an investor can accumulate a large stake in a company *after* the announcement of a merger and still pursue appraisal rights in court.[74]

II. THE RISE OF APPRAISAL ARBITRAGE

Prior examinations of appraisal have largely taken place in an empirical vacuum. To remedy this, we have collected all appraisal petitions filed in the Delaware Court of Chancery for the ten-year period from the start of 2004 through the end of 2013. In addition, by examining public filings we have collected information on the dissenters and their claims.[75] The focus of our analysis is on appraisal petitions filed against public companies.[76]

72. *See* DEL. CODE ANN. tit. 8, § 327 (2015) (requiring for derivative suits that "the plaintiff was a stockholder of the corporation at the time of the transaction of which such stockholder complains."). While on its terms, Section 327 only applies to derivative suits, a contemporaneous ownership requirement has also been imposed in direct actions in the context of lead counsel or lead plaintiff selection. *See* Omnicare, Inc. v. NCS Healthcare, Inc., 809 A.2d 1163, 1169–70 (Del. Ch. 2002) (dismissing fiduciary duty claims because plaintiffs' shares were purchased after the merger announcement); *see also* J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673, 680 n.36 (2008) (noting that Delaware courts "bar direct actions by after-acquiring shareholders").

73. *See infra* text accompanying note 99.

74. *See* Merion Capital v. BMC Software, Inc., No. 8900-VCG, 2015 WL 67586, at *1 (Del. Ch. Jan. 5, 2015) (holding that petitioner who acquired stock after the announcement of the merger was entitled to pursue appraisal); *In re* Appraisal of Ancestry.com, Inc., No. 8173–VCG, 2015 WL 66825, at *1 (Del. Ch. Jan. 5, 2015) (same).

75. Our data collection is described more fully in our companion paper. Korsmo & Myers, *supra* note 15.

76. We restrict our study to public companies for three reasons. First, the scarcity of data regarding private companies renders them less amenable to study. Second, public company mergers

We use this data set to provide the first full picture of modern appraisal activity.[77]

Our data reveal Delaware is in the midst of a sea change in appraisal litigation. While appraisal may once have been a quiet corner of corporate law, it is now an area of active litigation undergoing a period of explosive growth. Furthermore, the parties driving that growth are a new group of sophisticated investors who appear to specialize in pursuing appraisal claims.[78] In short, we have documented the rise of appraisal arbitrage.

A. The Surge in Appraisal Activity

A basic result of our investigation is that appraisal activity involving public companies increased substantially starting in 2011, as measured both by the number of petitions filed and the value of the dissenting shares.

The most basic way to measure appraisal activity is by the raw counts of petitions filed. During our ten-year period of study, 129 appraisal petitions were filed in Delaware involving counseled petitioners.[79] Figure 1 shows the number of petitions filed per year.

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and their accompanying appraisal actions are far more economically significant. *See* Korsmo & Myers, *supra* note 15, at 879–82. Third, the type of appraisal arbitrage we discuss is generally only possible for public company mergers.

77. Earlier empirical studies of appraisal activity include Randall Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1 (2000) (examining appraisal actions filed between 1977 and 1997), and Randall Thomas & Robert Thompson, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133 (2004) (including data on appraisal actions from 1999 and 2000).

78. By contrast, in a 2007 article, Kahan and Rock observed that hedge funds bringing appraisal actions did so primarily as a last resort. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1038–39 (2007) (suggesting that "[w]hen hedge funds are dissatisfied with the terms of an acquisition and unable to obtain better terms, they also resort to litigation" and giving examples including appraisal).

79. Seven petitions involved disputes with only pro se petitioners. We exclude them from our analysis because they are of little economic significance and are unlikely to reflect any broader pattern.

FIGURE 1
COUNSELED APPRAISAL PETITIONS PER YEAR, 2004–2013

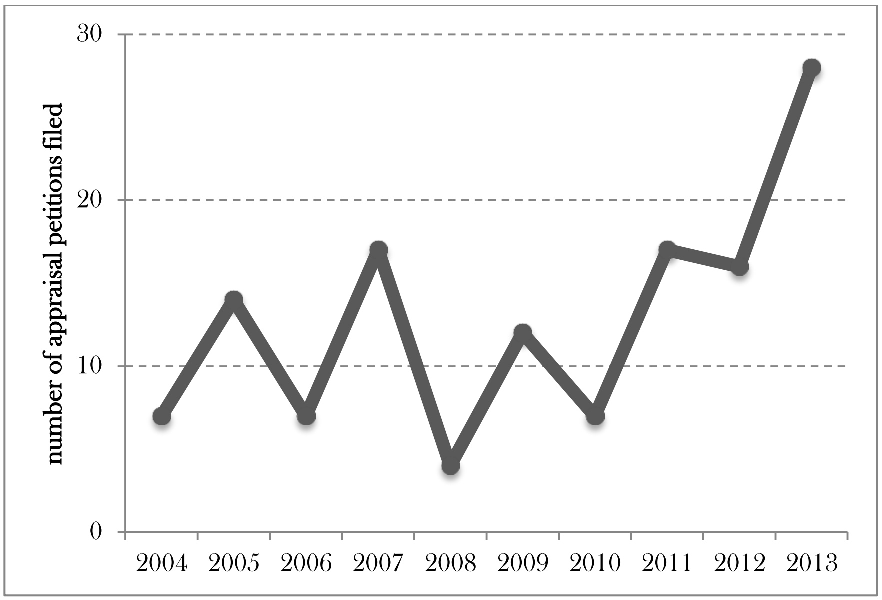


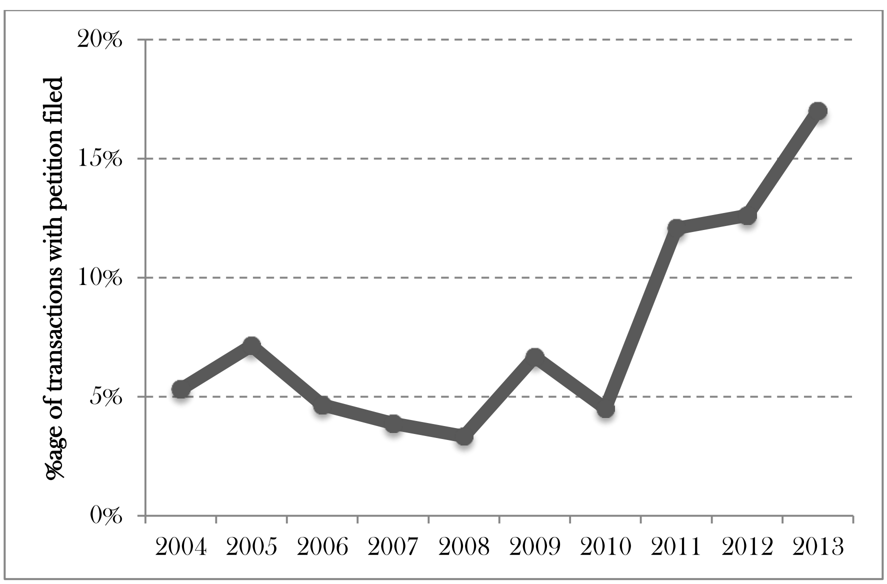
Figure 1 shows the effective year of the underlying transaction, rather than the filing year of the petition.[80] The reason for focusing on the transaction year is that a petitioner has 120 days following the effective date to file a petition, and the effective date better captures the timing from the perspective of the appraisal investor, who will have already begun the process of dissenting at that point. The basic change in appraisal activity is evident from Figure 1. The level of appraisal activity in 2011 and 2012 was matched earlier only in 2007, and activity in 2013 has only increased. This represents a lower bound of appraisal activity in Delaware because some claims by dissenting shareholders are resolved before the petition is ever filed.[81]

80. If, for example, a transaction closed on December 31, 2012, and a petitioner filed for appraisal on January 1, 2013, the petition would be included in the statistics for 2012.

81. Dissenters have until 120 days after a merger closes to file an appraisal petition. *See* Del. Code Ann. tit. 8, § 262(e). Potential claims may be settled during this period without a petition ever being filed. Because these settlements would only be binding on the parties to them, they would not need to be filed publicly and are thus not reflected in our data set. Thus, the number of actual appraisal disputes is necessarily larger than the universe of petitions that we are able to observe. It is thus possible that total appraisal activity—including settlement discussions that never result in a petition being filed—has not increased as much as Figure 1 suggests. It may be that more appraisal petitioners

The recent change in appraisal activity becomes even more apparent when we compare appraisal claims to the number of appraisal-eligible mergers. From 2004 through 2010, the number of appraisal petitions moved roughly in tandem with the general level of merger activity, rising through 2007 and thereafter falling along with the number of mergers after the financial crisis. A more or less constant percentage of mergers attracted appraisal claims in this period. This pattern changed sharply, however, beginning in 2011. Despite a lower level of overall merger activity, the number of petitions filed in 2011 and 2012 matched the number filed at the peak of the pre-financial crisis merger wave, and the number of petitions in 2013 is larger still. This change in the pattern of appraisal litigation comes into sharper relief in Figure 2, which presents appraisal petitions as percentage of appraisal-eligible mergers.

FIGURE 2
APPRAISAL PETITIONS AS A PERCENTAGE OF APPRAISAL-ELIGIBLE TRANSACTIONS, 2004–2013



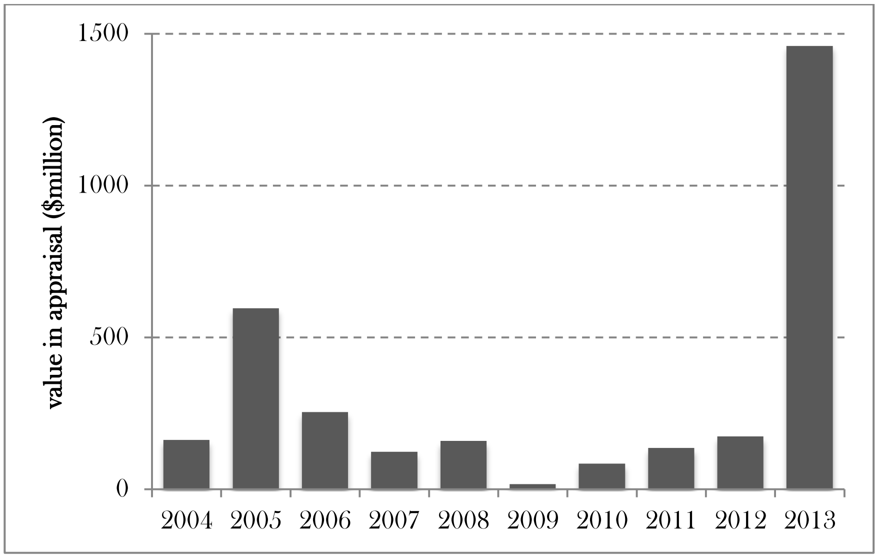
who once would have been able to quietly settle are now being forced to file and thus make their claims public (and observable)—though discussions with experienced counsel make this possibility seem remote.

Approximately five percent of appraisal-eligible transactions attracted at least one appraisal petition from 2004 through 2010. The appraisal rate more than doubled in 2011 and has continued to increase since then. By 2013, more than fifteen percent of transactions attracted an appraisal petition.

The raw numbers or percentage of deals facing appraisal petitions, however, tell us little about the economic significance of appraisal litigation. Using the merger price and the number of dissenting shares, we can calculate the amount of foregone merger consideration in each appraisal dispute, obtaining at least a rough measure of the economic value at stake in the case.

The values at stake in appraisal proceedings have also increased sharply in recent years. The 129 petitions we observed involved 106 separate transactions over our study period. The mean value of the foregone merger consideration in an appraisal dispute over the entire period was $30 million and does not appear to have followed any strong trend over time. When combined with the increase in the number of petitions over time, however, the total dollar amount at stake in appraisal proceedings in each year shows a large increase in recent years, particularly the most recent year. Figure 3 shows the value of the dissenting shares in Delaware appraisal petitions for each year of our study period.

FIGURE 3
VALUE OF DISSENTING SHARES IN DELAWARE APPRAISAL, 2004–2013
(IN MILLIONS OF CONSTANT 2013 DOLLARS)



The amount of money involved in 2013 is nearly three times the amount involved in any prior year and ten times the 2004 amount. To some extent, this effect is driven by outliers. The largest appraisal case over our study period is *Dell*, a 2013 transaction where $654 million worth of shares dissented. The second largest is *Transkaryotic Therapies* ("*Transkaryotic*"), a 2005 transaction where $520 million worth of shares sought appraisal.[82] But in some ways, excluding these two very large cases only makes the new trend clearer. Without *Transkaryotic*, the values at stake in appraisal never exceeded $300 million in any given year; while in 2013 the values at stake approach one billion dollars even excluding *Dell*. Most tellingly, over the ten-year period, only eight appraisal cases have involved more than $100 million, and four of them were in 2013.

Perhaps the most remarkable thing about appraisal activity during the new 2011 to 2013 era is that, unlike 2007 and 2008, the increase in numbers and economic significance of appraisal does not coincide with an

82. *In re* Appraisal of Transkaryotic Therapies, Inc., No. CIV.A 1554-CC, 2007 WL 1378345, at *1 (Del. Ch. May 2, 2007) (noting merger consideration of $37 per share and nearly 11 million shares seeking appraisal).

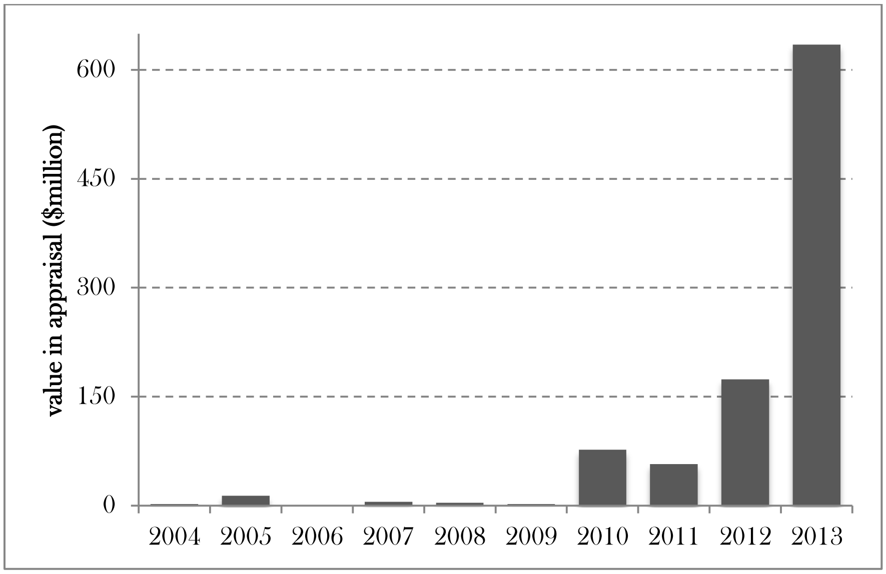
increase in merger activity. In other words, the rise in appraisal activity since 2011 appears to reflect a secular increase in interest in appraisal, rather than a mere cyclical phenomenon tied to the conditions of the merger market. For each year in our study period, we tallied the equity value of all appraisal-eligible transactions and then computed the percentage of value that sought appraisal. In 2013, 0.92% of the equity value dissented, nearly three times higher than any prior year. Indeed, the percentage of dissenting equity value was never higher than 0.10% in any prior year except 2005, the year of *Transkaryotic*.[83]

B. The Sophistication of Appraisal Petitioners

In addition to the increasing volume of appraisal activity—measured both in number of petitions and the dollar values at stake—the profile of the public company appraisal petitioner has changed sharply in the recent period. In particular, petitioners have become increasingly specialized and sophisticated over our time period, with repeat petitioners increasingly dominating appraisal activity. Since 2011, more than eighty percent of appraisal proceedings have involved a repeat petitioner—that is, a petitioner who filed more than one appraisal petition across our study period. Three constellations of related funds appear more than ten times each. Perhaps the most striking result of our investigation is the increase in the economic significance of repeat players in appraisal. Figure 4 shows the value of shares per year in appraisal held by repeat petitioners.

83. In 2005, 0.37% of equity value dissented.

FIGURE 4
REPEAT PETITIONER VALUE IN DELAWARE APPRAISAL, 2004–2013
(IN MILLIONS OF CONSTANT 2013 DOLLARS)



The rise in repeat petitioner value beginning in 2010 is immediately apparent. Before 2010, appraisal appears to have been largely a one-off exercise for aggrieved stockholders. Repeat petitioners played a small role, and there is little evidence that funds were seeking appraisal as part of a considered investment strategy. Starting in 2010, however, and accelerating through 2013, the repeat petitioner dominates. Indeed, every appraisal case filed in 2013 involved at least one repeat petitioner.

By virtue of the unique standing requirements in appraisal,[84] these specialized appraisal petitioners are typically able to invest in the target company after the announcement of the transaction they challenge. The decision to invest, then, is based on a calculation that the amount they will be able to recover in an appraisal proceeding in Delaware—via trial or settlement—will exceed the merger price by enough to offer an attractive return. This practice can be fairly characterized as appraisal arbitrage—by analogy to traditional merger arbitrage[85]—and those who practice it may

84. *See supra* note 74, at 22.

85. Hedge funds have long practiced merger arbitrage, taking positions after announcement of a merger, intending to profit by either predicting the reaction of the stock prices of the target and

be termed appraisal arbitrageurs.[86] Table 1 presents summary statistics for repeat dissenters. The first column reports the total value of stock the fund or group of funds has dissented on in our study period; the second column reports the number of transactions in which the fund has publicly dissented; the third column reports the mean value of the petitioner group filing the case. The second column reports the mean value of all dissenters in the case (including those who did not file petitions), which compared to the third column reveals whether the fund tends to operate by itself or often ends up in cases with other dissenters.

TABLE 1
REPEAT DISSENTERS IN DELAWARE, 2004 TO 2013
(IN MILLIONS OF CONSTANT 2013 DOLLARS)

Fund name	*Total value of dissenting stock*	*Number of cases*	*Mean value of petitioners in case*	*Mean value of all dissenters in case*
Merion	$718,000,000	8	$89,700,000	$107,000,000
Magnetar	$163,000,000	3	$54,400,000	$317,000,000
Verition	$96,200,000	4	$24,000,000	$37,100,000
Merlin	$51,000,000	22	$2,318,373	$5,592,174
Quadre	$18,700,000	10	$1,869,953	$4,258,385
Patchin	$22,700,000	16	$1,420,945	$1,557,664
Predica	$5,197,291	5	$1,039,458	$1,039,458

Unlike in fiduciary litigation—where "professional plaintiffs" tend to be small shareholders with close ties to plaintiffs' firms—the repeat appraisal petitioners, especially at the top end of the field, appear to be sophisticated parties specializing in appraisal. For example, the largest

acquiring companies or by predicting the likelihood and timing of the consummation of the announced merger. *See, e.g.*, INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 52 (Sept. 2004), *available at* http://www.imf.org/external/pubs/ft/gfsr/2004/02/pdf/chp2.pdf (defining merger arbitrage); Mark Mitchell & Todd Pulvino, *Characteristics of Risk and Return in Risk Arbitrage*, 56 J. FIN. 2135 (2001) (describing merger arbitrage strategies); Houman B. Shadab, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6 BERKELEY BUS. L.J. 240, 270 (2009) ("A type of corporate event driven strategy is merger arbitrage, which seeks to purchase the stock of a company that has just announced it will be acquired and sell short the stock of the acquiring company with the expectation that the acquiring company's stock will fall after the acquisition and the acquired company's stock will increase.").

86. In fact, appraisal arbitrage is not true "arbitrage," in the sense that it does not involve exploiting a price difference that is eventually expected to disappear. The term "arbitrage" is used somewhat loosely here in order to draw an analogy to merger arbitrage.

repeat petitioner is Merion Capital, with over $700 million invested in appraisal claims. Merion has been involved in seven cases since 2010, with increasingly large amounts at stake. The fund is based in Pennsylvania and headed by Andrew Barroway, a successful plaintiffs' lawyer from Philadelphia. It made its first public appraisal investment in 2010, with $8.5 million at stake. After a number of appraisal petitions averaging around $50 million in value at stake during 2012 and 2013, Merion reportedly raised a targeted amount of $1 billion for a dedicated appraisal fund in 2013.[87] During 2013, it filed two appraisal petitions with an average value at stake of $177 million.

Another large and recent repeat petitioner is Verition Fund, a Greenwich-based fund that has been involved in four cases, all in 2013, with an average of $25 million at stake. Verition is managed by Nicholas Maounis, who formerly headed Greenwich-based Amaranth Advisors.[88] Other recent entrants are Fortress Investment Group, a large publicly traded hedge fund, and Hudson Bay Capital Management, both of which filed large appraisal petitions in 2013. Similarly, major mutual funds and insurance companies—two types of institutions that have entirely avoided standard stockholder litigation—have recently filed appraisal petitions.[89] Much is often made of the involvement of institutional investors (or the lack thereof) in corporate governance.[90] All too often in corporate litigation, the so-called "institutions" are akin to the Bailiffs' Retirement Fund of Chippewa Falls, while sophisticated financial players remain on the sidelines.[91] The institutions that are beginning to specialize in

87. Miles Weiss, *Dell Value Dispute Spotlights Rise in Appraisal Arbitrage*, BLOOMBERG NEWS, Oct. 2, 2013.

88. *See* Gretchen Morgenstern & Jenny Anderson, *A Hedge Fund's Loss Rattles Nerves*, N.Y. TIMES, Sept. 19, 2006, at C1.

89. Examples of mutual funds that have recently filed are T. Rowe Price (C.A. 9322-VCL) and John Hancock (C.A. 9350-VCL). Examples of insurance companies are Prudential (C.A. 9351-VCL) and Northwestern Mutual (C.A. 9321-VCL). All of these petitions challenge the merger price in the *Dell* transaction.

90. *See, e.g.*, Lucian Ayre Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991); Elliot J. Weiss & John S. Beckerman, *Let the Money do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995).

91. *See, e.g.*, Leo E. Strine, Jr., Lawrence A. Hamermesh & Matthew C. Jennejohn, *Putting Stockholders First, Not the First-Filed Complaint*, 69 BUS. LAW. 1, 11, n.36 (2013) (noting the prevalence of cases involving "institutional investor" plaintiffs with trivial stakes); David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 DEL. J. CORP. L. 907 (2013–2014).

appraisal, by contrast, are among the most sophisticated financial entities in the United States.

Beyond the bulge bracket appraisal petitioners are a handful of specialized smaller funds that have been quite active. Some join larger petitioner groups, perhaps to capture economies in pursuing the case. A larger group may make the threat to go to trial more credible, increasing the bargaining position of all dissenters. Two features of the Delaware appraisal statute make this strategy possible. First, after the merger closes, a dissenter stockholder is entitled under Section 262(e) to demand a statement of the aggregate number of shares demanding appraisal from the surviving company.[92] A dissenter might seek this information to confirm the existence of other dissenters who, for example, can help spread the costs of prosecuting the appraisal case. If the dissenter does not like the results of the information supplied by the company, it has a statutory right to withdraw its dissent and accept the merger consideration.[93]

C. The Increasingly Competitive World of Appraisal Litigation

The manner in which appraisal litigation proceeds also appears to be changing in ways that may indicate increasing competition among appraisal petitioners. Dissenting shareholders have 120 days following the merger's effective date to file a petition in court demanding the judicial appraisal.[94] That 120-day period can often be a time for negotiation, and the parties may settle their dispute before ever filing a claim. Figure 5 shows a kernel density plot[95] of filing times from the effective date of the merger for two appraisal petitions challenging two sets of mergers: (1) those from 2004 through 2010, shown in black and (2) those from 2011 through 2013, shown in gray.

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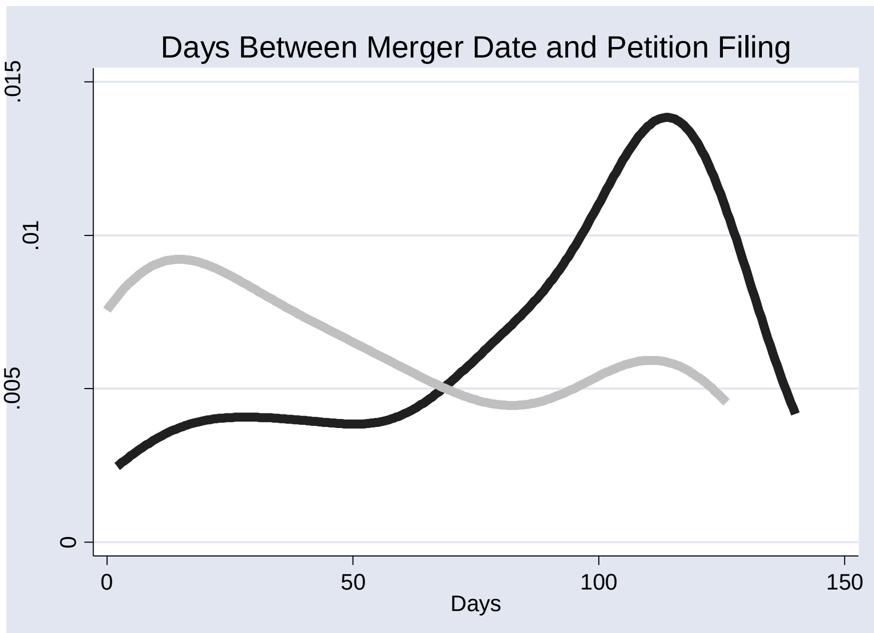
92. DEL. CODE ANN. tit. 8, § 262(e) (2015).

93. *Id*.

94. *Id*.

95. A kernel density plot is essentially a smoothed histogram, treating each observed instance as representing a larger unobserved population.

FIGURE 5



The black line suggests that petitioners commonly took the entire 120 days to negotiate over their disputes before filing in the 2004 through 2010 period. The gray line shows the lag between the merger and the filing from 2011 through 2013, and reveals that parties are filing their petitions much faster, more often not bothering to go through an initial round of settlement discussions before filing. We can only speculate on the causes of this, but one explanation may indeed be increasing competition among shareholders dissenting on the same transaction. One of the advantages of filing is that it compels the surviving company to identify publicly all other shareholders who have preserved the right to seek appraisal.[96] Doing so may make it harder for other dissenting shareholders to strike a separate bargain without including the filing shareholder. Filing faster may also provide an advantage in selecting lead counsel and managing the claims. The new filing pattern may also indicate that petitioners do not believe that claims are likely to settle without substantial litigation activity, and they may be anxious to proceed to discovery. In any event, we tentatively

96. DEL. CODE ANN. tit. 8, § 262(f) (2015).

interpret this shift as a sign that appraisal arbitrage is becoming more competitive.

D. What Explains the Rise in Appraisal Arbitrage?

We lack a compelling explanation for the rise in appraisal arbitrage identified here. We can, however, confidently dismiss two theories that have sometimes been offered by defense-side lawyers to explain this increase.

The first theory that has often been floated is that a 2007 Chancery decision called In re *Appraisal of Transkaryotic Therapies*[97] opened the floodgates for appraisal litigation.[98] The *Transkaryotic* opinion arose from an extremely large appraisal proceeding involving nearly half a billion dollars in foregone merger consideration.[99] Many of the shareholders seeking appraisal had acquired their stock after the record date for voting in the merger, but before the actual vote on the merger.[100] The court held that holders of shares acquired during that period were eligible to pursue appraisal, despite the inability of the petitioners to show how the shares had been voted, so long as the total number of shares seeking appraisal did not exceed the total number of "no" votes plus abstentions.[101] According to defense attorneys, appraisal arbitrageurs "are taking advantage of the flexibility of *Transkaryotic*."[102]

The trouble with this explanation is that the *Transkaryotic* holding—in addition to coming out nearly four years before the recent surge in appraisal activity—created only a marginal increase in the window of time

97. No. Civ.A. 1554-CC, 2007 WL 1378345, at *1 (Del. Ch. 2007).

98. *See, e.g.*, Trevor S. Norwitz, *Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses*, CLS BLUE SKY BLOG (Feb. 2, 2010), http://clsbluesky.law.columbia.edu/2015/02/10/delaware-legislature-should-act-to-curb-appraisal-arbitrage-abuses (claiming appraisal arbitrage was "spawned by *Transkaryotic*"); Daniel E. Wolf et al., *Appraisal Rights—The Next Frontier in Deal Litigation?*, KIRKLAND & ELLIS (May 1, 2013), http://www.kirkland.com/siteFiles/Publications/MAUpdate_050113.pdf (describing the *Transkaryotic* decision as significant factor in the rise of appraisal litigation).

99. *In re Transkaryotic*, at *1 (noting merger consideration of $37 per share and nearly 11 million shares seeking appraisal).

100. *Id.* (noting that approximately 8 million out of 11 million shares were purchased after the record date).

101. *Id.* at *4. More precisely, since the record holder of the relevant shares in *Transakaryotic* was Cede & Co. (as is the case for most publicly traded shares), the plaintiffs simply needed to show that Cede & Co. itself held more shares that had voted "no" or abstained than the number of shares for which appraisal was being sought. *Id*. at *5 ("Only the record holder possesses and may perfect appraisal rights. The statute simply does not allow consideration of the beneficial owner in this context.").

102. Weiss, *supra* note 87.

during which would-be appraisal petitioners may buy stock. Weeks or months typically pass between the announcement of a transaction and the record date, and stock acquired in that period has always been available for appraisal. A company's preliminary proxy statement, of course, may disclose new information that would make an appraisal claim more attractive, and the *Transkaryotic* ruling allows potential investors more time to consider the proxy contents. By the same token, the *Transkaryotic* ruling also ensures that companies cannot set the record date opportunistically to preclude appraisal claims. The more fundamental problem with relying on the *Transkaryotic* decision to explain the rise in appraisal claims is that *Transkaryotic* is only relevant in a transaction structure that contemplates a shareholder vote, and many do not. In a tender offer followed by a Section 251(h) merger, a short-form merger, or a merger approved by written consent of a majority of holders, no shareholder vote is required and thus the *Transkaryotic* ruling can have had no impact. These types of transactions constitute a substantial portion of M&A activity, and an even larger proportion of appraisal targets.

To investigate the possible role of *Transkaryotic*, we separated out transactions that were affected by the ruling and those that were not, and examined the change in appraisal litigation for each group. Our data show that the rise in appraisal activity appears strongest *outside* of the transaction structure affected by *Transkaryotic*. The Chancery Court issued the *Transkaryotic* decision in the summer of 2008. During the period from 2004 to 2007, stockholders filed appraisal petitions in approximately 5% of transactions structured as a tender offer and approximately 5% of those structured as a standard merger with a shareholder vote subject to the *Transkaryotic* rule. If the *Transkaryotic* ruling mattered, we would expect to see that transactions affected by the ruling would be more likely to involve an appraisal petition. We find the opposite. In the post-*Transkaryotic* era, from 2009 to 2013, stockholders dissented in approximately 9% of transactions subject to *Transkaryotic*. By contrast, in tender offer deals—which were entirely unaffected by the ruling in *Transkaryotic*—the appraisal rate was 13%. These numbers suggest that whatever legal changes were wrought by the *Transkaryotic* decision do not appear to have moved the needle on appraisal activity.

The second explanation sometimes offered is centered on the interest rates available to appraisal petitioners. Appraisal petitioners are entitled to interest on amounts recovered in their petitions from the effective date of the merger. Delaware amended its appraisal statute in 2007[103] to set the interest rate equal to the federal funds rate plus five percent, compounded quarterly.[104] Some lawyers have suggested that in an era of historically low interest rates, the interest rate available to appraisal petitioners has attracted investors to appraisal.[105] The apparent theory is that an investor could park money in an appraisal claim, and even if the court found the merger price to represent fair value, the investor would receive an attractive return. Vice Chancellor Glasscock, too, has voiced a "concern about whether the interest rate that the Legislature has set encourages these types of appraisal cases."[106]

In our view, the statutory interest rate cannot account for the rise in appraisal activity. As an initial matter, the timing does not line up: interest rates dropped precipitously in 2009, two years before the sharp rise in appraisal activity. More fundamentally, it is unlikely that a five percent premium over the federal funds rate would represent an attractive return under the circumstances, given the substantial risks associated with an appraisal proceeding. Appraisal petitioners function as unsecured creditors of the surviving company, holding a claim of uncertain value to be determined by litigation. While the statutory rate no doubt is better than what petitioners could get in a money market account, it likely undercompensates them for the risk of their position. The appraisal interest rate surely defrays some of the risk, particularly compared to other conventional measures of interest in legal scenarios. But petitioners are exposed not only to the credit risk of the surviving company, but also to the financial risk associated with the trial. Petitioners are only entitled to demand an award of interest if they take their claims all the way to trial, which typically takes well over a year and carries with it the risk that the appraised value could be less than the foregone merger consideration. The idea that sophisticated investors are pouring hundreds of millions of

103. *See* 76 Laws 1998, ch. 145 §§ 11–17, eff. July 17, 2007.

104. *See* DEL. CODE ANN. tit. 8, § 262(h) ("Unless the Court in its discretion determines otherwise for good cause shown, interest from the effective date of the merger through the date of the payment of the judgment shall be compounded quarterly and shall accrue at 5% over the Federal Reserve discount rate . . . .").

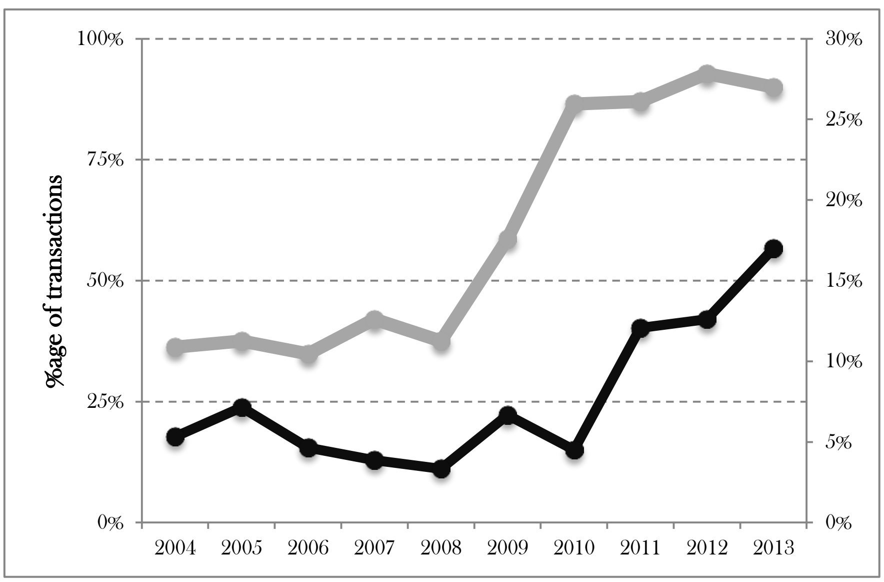
105. *See* Daniel E. Wolf, *Appraisal Rights—The Next Frontier in Deal Litigation?*, HARVARD CORPORATE GOVERNANCE BLOG (May 16, 2013, 9:30 AM) ("In today's ultra-low interest rate setting, the accumulating interest payments represent, if not an intriguing stand-alone investment opportunity, at least a meaningful offset to the extended period of illiquidity and litigation costs imposed on the dissenting shareholders for the duration of the proceedings.").

106. Transcript of Scheduling Conference at 18, *In re* ISN Software Corp. Appraisal Litig. (Sept. 23, 2013).

dollars into risky appraisal proceedings to chase above-market interest rates simply is not credible.

Yet another potential explanation for the rise of appraisal litigation is that it is simply part of the roughly contemporaneous trend in merger litigation. As others have shown, fiduciary class actions challenging mergers have recently become ubiquitous, touching over 90% of transactions above $100 million.[107] Our own data on fiduciary challenges to mergers—which cover only appraisal-eligible transactions—confirm this same phenomenon. In 2004, 36% of transactions attracted a fiduciary challenge; by 2013, 90% of transactions did. Figure 6 shows the trend in fiduciary litigation from 2004 to 2013 in gray and plotted on the left axis, and it shows the trend in appraisal litigation over the same period in black and plotted on the right axis.

FIGURE 6: THE RISE OF FIDUCIARY AND APPRAISAL LITIGATION, 2004–2013



107. *See* Matthew D. Cain & Steven M. Davidoff, *Takeover Litigation in 2012* (Feb. 1, 2013), *available at* http://ssrn.com/abstract=2216727 (finding that ninety-two percent of all transactions with a value greater than $100 million experienced litigation in 2012). *See also* Robert M. Daines & Olga Koumrian, *Shareholder Litigation Involving Mergers and Acquisitions*, CORNERSTONE RESEARCH (Feb. 2013 Update), *available at* www.cornerstone.com/files/upload/Cornerstone_Research_Shareholder_Litigation_Involving_M_and_A_Feb_2013.pdf (making similar findings).

Fiduciary litigation rose sharply in 2009, and since 2010, stockholders have challenged more than eighty-five percent of transactions. The rise in appraisal litigation did not start until 2011, two years after the litigation rate rose in fiduciary litigation. It certainly could be the case that there is some connection between the rise in the two types of litigation, given that they both involve legal action relating to mergers. Beyond these superficial similarities, however, there is no reason to conclude any connection between the two types of litigation. The parties who appear to be driving appraisal arbitrage—the sophisticated investors we described above—have little connection to fiduciary litigation and historically have had no interest in it. There are thus no grounds to suspect that the rise in appraisal activity has anything to do with the rise of fiduciary litigation.

In the end, we can identify no single causative factor to account for the rise in appraisal arbitrage. We suspect that it may simply be a case of a few investors who, somewhat by accident, found themselves considering appraisal as a method for salvaging an investment following a bad merger, became intrigued by the opportunity, and explored it further. As word spread of their success, others mimicked the strategy. Indeed, the Transkaryotic transaction itself—and not the judicial opinion that grew out of it—may have functioned as a catalyst for interest in appraisal. Among the class of dissenting shareholders in *Transkaryotic* were some of the most sophisticated entities on Wall Street, including various Carl Icahn affiliates, SAC Capital Advisors, and Millennium Management.[108] Transkaryotic was acquired by Shire Plc for $37 per share.[109] Appraisal cases that settle are not made public because unlike standard shareholder litigation they do not bind non-signatories.[110] But Shire is a public company and had to disclose developments in the litigation in its periodic SEC reports. Shire announced the settlement of the *Transkaryotic* claims in November 2008,[111] and it disclosed that the settlement "paid the same price of $37 per share originally offered to all TKT shareholders at the time of the July 2005 merger, plus interest."[112] This account of the

108. *See* Petitioners' Answering Brief in Oppositionn to Respondents' Motion for Partial Summary Judgment, *In re* Appraisal of Transkaryotic Therapies, Inc., 2006 WL 4790526 (Del. Ch. 2006) (listing entities seeking appraisal).

109. *See In re Transkaryotic*, 2007 WL 1378345, at *1.

110. *See* Siegel, *supra* note 50, at 84, n.17 (noting that "[t]here is no way to document the number of appraisal settlements.").

111. *See* Press Release, Shire Plc., Shire Successfully Settles Former TKT Shareholder (Nov. 12, 2008), *available at* http://www.sec.gov/Archives/edgar/data/936402/000095010308002790/dp11808_ex9901.htm.

112. Shire Plc., Annual Report (Form 10-K) (Feb. 27, 2009).

Transkaryotic settlement frequently appears in subsequent retellings of the case.[113]

This description of the settlement, however, obscures its significance. First of all, paying interest in a settlement is puzzling: a settling acquirer is under no obligation to include interest in the settlement, and, in any event, this case was filed before Delaware adopted the statutory interest rate discussed above. Moreover, from the petitioners' perspective, the label attached to the settlement funds is unimportant—a dollar is a dollar, whether it is part of the "settlement price" or the "interest" on the settlement price. Shire only disclosed the aggregate interest award,[114] but by dividing this amount by the number of shares seeking appraisal it is possible to determine the per share figure for the entire settlement: precisely $50 per share. Thus, the amount of the "interest" award appears to have been reverse-engineered to achieve a pre-determined (and favorable) per-share settlement price. The net result was that the petitioners recovered a thirty-five percent premium on what would remain the largest appraisal claim in history until the Dell case in 2013. The successful result in *Transkaryotic*, though it was partially concealed, might in fact be a major part of what has sparked interest in appraisal.

III. DOES APPRAISAL TARGET THE RIGHT TRANSACTIONS?

Given the increasing incidence of appraisal litigation, and the sharply increasing amounts at stake, examining the policy implications of appraisal becomes a matter of some urgency. This Part and the next begin this examination. 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 petitioners target deals where the merger premium is low and where controlling stockholders are taking the company private.

113. *See* Geis, *supra* note 34, at 1639–40 (2011) ("[D]espite the favorable summary judgment ruling, petitioners in *Transkaryotic* eventually settled their claim for the initial $37 merger consideration (plus interest), thereby throwing their claims of purported price inadequacy into question."). *See also* Weiss, *supra* note 87 ("The case was eventually settled for $37 a share, the same price paid in the merger, plus interest.").

114. *See* Shire Plc., Annual Report (Form 10-K) (Feb. 27, 2009) (disclosing "interest" of $147.6 million on a "settlement" of $419.9 million).

A. The Unique Structure of Appraisal Litigation

At least superficially, there is some reason to fear that appraisal litigation—as a species of shareholder litigation—will share some of the well-known pathologies of shareholder litigation. In other types of shareholder litigation—like derivative suits or class actions alleging violations of fiduciary duties in mergers—the actual plaintiff is largely irrelevant. The plaintiffs' attorneys face all of the meaningful incentives in such litigation,[115] and the agency problem between the attorneys and the class of shareholders can oftentimes be severe.[116] Plaintiffs in shareholder litigation generally have only nominal control over their attorneys,[117] and the attorneys typically have de facto control over all litigation decisions, including the decision to settle and the terms on which the settlement will take place. The danger, then, is that attorneys will (1) bring non-meritorious claims in hopes of settling quickly for a generous award of fees—essentially a nuisance payment—and (2) settle meritorious claims for less than the discounted settlement value because they can be bought off by the defendants in settlement. Both outcomes are bad for shareholders, and potentially for allocative efficiency. As a result, a large literature exists questioning the extent to which the merits matter in shareholder actions.[118]

Most recently and most relevantly, we performed a study assessing the merits of fiduciary duty class actions challenging merger transactions.[119] In a merger transaction, the chief concern to shareholders will generally be the amount of the merger consideration.[120] If the merits mattered in merger litigation, we would expect there to be an inverse relationship between the

115. *See, e.g.*, Brian J.M. Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, U.C. DAVIS L. REV. 137, 151 (2010) ("This type of litigation is highly susceptible to agency costs because the interests of counsel will not always align with the interests of their purported clients, the shareholders."); Thompson & Thomas, *supra* note 77, at 148 ("[T]he entrepreneurial attorney's interests can diverge from those of the clients. If class counsel have tremendous discretion to run the litigation, they may do so in a manner that maximizes their benefit, even at the expense of the interests of their putative clients.").

116. *See* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency*, 54 U. CHI. L. REV. 877, 883 (1987) ("It is no secret that substantial conflicts of interest between attorney and client can arise in class action litigation. In the language of economics, this is an 'agency cost' problem.") (footnote omitted).

117. *See id*. at 884–86.

118. For summaries of this voluminous literature, see Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465 (2004); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587 (2006); Korsmo & Myers, *supra* note 15.

119. Korsmo & Myers, *supra* note 15.

120. *See id*. at 854.

size of the merger premium and the likelihood of a class action being filed.[121] In fact, we found that there was only a very weak correlation between the merger premium[122] and the likelihood of a fiduciary duty class action.[123] Instead, the strongest predictor of a fiduciary duty class action was the deal size,[124] suggesting that plaintiffs' attorneys are primarily seeking to maximize the nuisance value of suits by going after deep pockets and large transactions.[125]

If a similar dynamic were at work in appraisal litigation—which, of course, also targets merger transactions—the increase in appraisal activity would be cause for alarm. The structure of appraisal litigation, however, is such that this is far less likely than for other forms of shareholder litigation. Two features distinguish appraisal. First, as detailed above, there are no class claims in appraisal.[126] This means that an attorney cannot make an arrangement with a small shareholder (one who owns a single share, at the extreme) and seek to represent the entire class of shareholders.[127] It also means that the potential recovery is limited by the size of the plaintiff's holdings. In addition, the presence of a genuine plaintiff with a meaningful economic stake makes a collusive settlement between the petitioner's attorney and the defendant corporation

121. *See id.* at 835.

122. In assessing the size of the merger premium, we controlled for deal size, industry, and year of the transaction. *Id*. at 872.

123. *See* Korsmo & Myers, *supra* note 15, at 877

124. *Id.* at 874.

125. *Id*. at 836.

126. *See, e.g.*, Alabama By-Products Corp. v. Cede & Co., 657 A.2d 254, 260 n.10 (Del. 1995) ("In an appraisal proceeding, however, shareholders enter the appraisal class by complying with the statutory formalities required to perfect their appraisal rights. Thus, shareholders seeking appraisal 'opt in' to a class, invariably before suit is even filed, rather than 'opt out.'"); 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 3, at 267 n.6 ("[T]he appraisal remedy differs from the procedural rules applicable to the class action, which assume that investors who do not 'opt out' desire to be represented."); Aronstam, Balotti, & Rehbock, *supra* note 45, at 547 ("[T]he appraisal statute creates an "opt-in" class for minority shareholders as opposed to the "opt-out" default mechanism of class action lawsuits. Thus, only shareholders specifically electing to opt in will be able to benefit from a judicial determination diverging from the corporation's initial valuation.") (footnotes omitted); Thompson, *supra* note 31, at 41 ("No provision is made for a class action or other means that would permit shareholders in a common situation to share an attorney and other expenses of litigation easily.") (footnote omitted); *see, e.g.*, Fried & Ganor, *supra* note 45, at 1004 n.105 ("In Delaware, shareholders seeking appraisal are barred from using class action suits. Because each shareholder must pursue his own individual claim, shareholders lose the important economic benefits of class actions, which spread the costs of litigation and facilitate contingency financing.").

127. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3 (1991) ("[P]laintiffs' class and derivative attorneys function essentially as entrepreneurs who bear a substantial amount of the litigation risk and exercise nearly plenary control over all important decisions in the lawsuit.").

impossible.[128] Second, Delaware's appraisal statute does not provide for the allocation of plaintiffs' attorneys' fees to the defendant. As a result, the attorney's only route to a fee is, again, through an actual plaintiff.[129]

Furthermore, the sole issue at stake in an appraisal action is the fair value of the plaintiff's shares. This distinction is crucial for at least two reasons. First, the single-issue nature of the claim precludes the typical shareholder litigation phenomenon of collusive "disclosure only" settlements whereby the defendants pay a sizeable cash fee to the plaintiffs' attorneys, while providing only non-monetary window dressing to the shareholders themselves.[130] An appraisal case can only settle for cash. Second, the narrow focus of appraisal litigation reduces the nuisance value of an appraisal petition. Nuisance suits may be profitable whenever defendants are risk-averse or face asymmetric litigation costs.[131] While

128. *See id.* at 5 ("The named plaintiff [in a fiduciary class action] does little—indeed, usually does nothing—to monitor the attorney in order to ensure that representation is competent and zealous, or to align the interests of the attorney with those of the class or corporation.").

129. The Delaware appraisal statute envisions two types of litigation expenses: 1) the court costs of the proceeding itself, including the cost of a court-appointed appraiser; and 2) attorney and expert witness fees. The statute provides that the costs of the proceeding may be allocated to the parties as determined by the court, but "makes no mention of judicial discretion to allocate one party's expert and attorney expenses to its opponent." Siegel, *supra* note 50, at 241.

The Delaware courts customarily allocate court costs to the defendant absent bad faith on the part of the plaintiff. *See, e.g.*, Tri-Continental Corp. v. Battye, 74 A.2d 71, 77 (Del. 1950) (same); Meade v. Pac. Gamble Robinson Co., 58 A.2d 415, 418 (Del. 1948) (allocating court costs to the defendant absent bad faith); *In re* Appraisal of Shell Oil Co., No. 8080, 1990 Del. Ch. LEXIS 199, at *103 (Del. Ch. Dec. 11, 1990) (citing section 262(j) and assessing court costs against the defendant); Lehman v. Nat'l Union Electric Co., No. 4964, 1980 Del. Ch. LEXIS 490, at *3-4 (Del. Ch. Nov. 5, 1980) (finding that the plaintiff's good faith belief in the merits of his claim, even though unreasonable, was enough to justify allocating court costs to the defendant). The Delaware courts have, however, interpreted the statute to not allow the shifting of the plaintiff's attorney and expert witness fees to the defendants under most circumstances. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 684 A.2d 289, 301 (Del. 1996) ("In the absence of an equitable exception, the plaintiff in an appraisal proceeding should bear the burden of paying its own expert witnesses and attorneys."); Pinson v. Campbell-Taggart, Inc., 1989 WL 17438, at *1109-10 (Del. Ch. 1989) ("By its own terms the [appraisal] statute does not authorize the Court to tax a petitioning stockholder's attorneys' fees and other litigation expenses against the surviving corporation. Those expenses are recoverable only by a *pro rata* apportionment against the value of the shares entitled to an appraisal.") (citation omitted). The Delaware courts have recognized an equitable exception to the rule that the plaintiff always bears her own attorney's and expert's fees, however, this exception is narrow, and will not apply in the run of cases. Mary Siegel describes Delaware courts as giving the equitable exception a "narrow construction," applying "upon evidence of a party's egregious conduct." Siegel, *supra* note 50, at 241–42. We have located only one appraisal case where the court applied the equitable exception to assign the plaintiff's attorney and expert costs to the defendant. *See* Montgomery Cellular Holding Co., Inc. v. Dobler, 880 A.2d 206, 228–29 (Del. 2005) (finding that the destruction of evidence, failure to respond to discovery request, use of "fatally flawed" expert testimony, and the CEO's lying under oath justified allocating all of the plaintiff's costs to the defendant).

130. *See supra* note 5.

131. As Janet Cooper Alexander summarized the economic arguments, "high litigation costs and uncertainty about trial outcomes can lead to the settlement of frivolous suits." Janet Cooper Alexander,

calculating fair value is far from easy, the single-issue nature of the claim renders the proceeding relatively straightforward, and the scope of discovery is limited to materials bearing on the company's value. To be sure, where one party seeks to use the merger price itself as evidence of fair value, somewhat more sweeping discovery into the process that led to that price may be necessary. But compared to other forms of shareholder litigation, the proceeding is relatively simple and thus inexpensive, reducing the nuisance value of a claim.[132]

The litigation risk faced by the parties is also far more symmetric in appraisal litigation than in other forms of shareholder litigation. Aggregate shareholder litigation creates the possibility of catastrophic damages or an injunction. Damages in appraisal are limited to the fair value of the actual petitioner's shares. Moreover, the petitioner has real skin in the game, as well. Not only may filing a petition entail substantial upfront cost, courts in appraisal actions can—and occasionally do[133]—determine the fair value of the plaintiff's shares to be *less* than the merger consideration.[134] In contrast, fiduciary duty class action plaintiffs have typically already received the merger consideration and face no financial downside, giving

Do The Merits Matter?, 43 STAN. L. REV. at 502 n.10 (1991). *See also* Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, J. LEGAL. STUD. 437 (1988); John C. Coffee, Jr., *Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is Not Working*, 42 MD. L. REV. 215 (1983); Jill E. Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533 (1997); D. Rosenberg & S. Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L. REV. L. & ECON. 3 (1985).

132. There is also reason to believe that litigation costs will be more symmetric, greatly reducing the *in terrorem* value of an appraisal petition. The open-ended nature and scienter aspects of fraud or fiduciary duty claims makes it easy for plaintiffs to justify sweeping discovery requests for, say, all e-mails from dozens of top executives. These requests impose crushing and asymmetric costs on defendants, who may then find it cheaper to simply pay a nuisance settlement. Such "fishing expeditions" will less often be justifiable in an appraisal proceeding, where the sole merits issue is the fair value of the company. Likewise, the parties will generally face similar costs in hiring experts to conduct valuations and testify at trial. The lack of aggregate litigation also reduces litigation cost asymmetries in that plaintiffs are not able to spread costs across the class of all shareholders. *See* Korsmo & Myers, *supra* note 15.

133. Courts in Delaware do not treat the merger price as a floor in appraisal valuations. In our examination of appraisal opinions, 5 of the 40 opinions (twelve-and-a-half percent) gave the appraisal petitioners a lower price than they would have received in the merger. The lowest gave the petitioner an award that was 19.8% lower than the merger price. Thus, while appraisal petitioners might face an attractive expected return, it comes with considerable risk—both sides have something to lose. As noted *supra* at 38, the appraisal petitioner essentially becomes an unsecured creditor of the acquirer, with no set time frame for getting his money back and a substantial chance of ultimately being entitled to less than he would have received in the merger.

134. *See* Siegel, *supra* note 50, at 104 ("[S]hareholders in appraisal actions risk the possibility of receiving less than the transaction price.").

fiduciary litigation a costless option value that is absent in appraisal actions.[135]

Furthermore, the distorting effects of insurance play less of a role in appraisal. For most types of shareholder litigation, the potential for a nuisance settlement is heightened by the ubiquity of liability insurance for directors and officers. Such insurance policies will pay some or all of the costs of a settlement, so long as the defendants are not found culpable at trial.[136] As a result, defendants face a strong incentive to settle weak claims rather than run a small risk of personal liability. In an appraisal proceeding, any recovery simply comes from the acquirer, and the culpability and personal liability of the target company's board are not at issue.

In sum, the agency problem—ubiquitous in aggregate shareholder litigation—is absent from appraisal litigation, and the parties to an appraisal proceeding face far more symmetric costs and risks from litigation, greatly reducing the *in terrorem* value of nuisance suits. There is thus strong reason to believe that appraisal litigation will be more meritorious, on average, than other forms of shareholder litigation.[137]

B. An Empirical Examination of the Merits of Appraisal Litigation

In evaluating whether the merits matter, we seek to determine how mergers are selected for appraisal litigation. Are plaintiffs targeting deals where there is reason to believe the merger consideration was inadequate? Or are they simply seeking deep pockets that may be willing to settle for

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135. *Id*.

136. *See, e.g.*, Alexander, *supra* note 131, at 550 (arguing that "[t]he existence and operation of insurance and indemnification may be the most important factor in creating a system of settlements that do not reflect the merits."); Choi, *supra* note 118, at 1469 (noting that "many companies have liability insurance policies for their directors and officers, many of which will not pay if the directors or officers are found culpable at trial . . . Rather than face this prospect (even if unlikely), directors and officers will often settle, relying on the [D&O] liability insurers to pay most, if not all, of the settlement award."); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J. L. ECON. & ORG. 55, 57 (1991) ("[A]ll states permit corporations to purchase D&O insurance for their executives, and policies can cover losses that cannot be indemnified. Policies routinely exempt losses from adjudication of dishonesty, but if a claim is settled, courts prohibit insurers from seeking an adjudication of guilt and thereby avoiding the claim's payment."); *see also Securities Litigation Reform: Hearings Before the Subcomm. on Telecomm. Fin. of the Comm. on Energy Commerce*, 103d Cong. 1 (1994) (statement of Vincent E. O'Brien) (claiming that 96% of securities class action settlements are within the D&O insurance coverage limits, with the insurance usually the lone source of the settlement proceeds).

137. The reasons for thinking the merits will matter in appraisal are, in fact, so strong that we used appraisal litigation as a benchmark of merit against which to contrast apparently non-merits-related fiduciary duty challenges to merger transactions. *See* Korsmo & Myers, *supra* note 15.

nuisance value? Davidoff and Cain, for example, find that nearly 95% of all mergers with a deal size greater than $100 million result in some form of shareholder litigation.[138]

If this dynamic were also at work in appraisal actions, we would expect to see large merger transactions to be disproportionately targeted for appraisal petitions, and for the adequacy of the merger price to have little or no predictive power.[139] Until recently, an empirical investigation of this question has been impossible, due to a lack of data on the characteristics of appraisal litigation.[140] Using our hand-collected data set,[141] however, it is possible to examine the selection of merger transactions by appraisal petitioners.

Out of 1168 appraisal-eligible transactions for which litigation data was available, 683 attracted at least one fiduciary class action.[142] By contrast, only 87 transactions involved a counseled appraisal petition, with an additional seven transactions attracting only pro se petitions.[143] Table 2 presents the general pattern of litigation.

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138. Davidoff and Cain, for example, find that nearly all mergers with a deal size greater than $100 million result in some form of shareholder litigation. *See* Cain & Davidoff, *supra* note 107 (finding that 92% of all transactions with a value greater than $100 million experienced litigation in 2012). Similarly, Curtis and Morley recently studied excessive-fee litigation in the mutual fund industry. *See* Quinn Curtis & John Morley, *An Empirical Study of Mutual Fund Excessive Fee Litigation: Do the Merits Matter?* (working paper) (2012), *available at* http://ssrn.com/abstract=1852652. They found that the size of the fee charged by a mutual fund was not a statistically significant predictor of the incidence of litigation. The single strongest predictor was simply the value of the assets under management of the relevant mutual fund family—large, rich fund families attract litigation. They interpret this result to suggest that the filing of excessive-fee litigation is largely driven by the search for deep pockets, rather than by the charging high fees. *Id*.

139. There may be some reason to expect larger deals to attract more appraisal action, in that a larger corporation is likely to have more minority shareholders with a large enough stake to potentially justify the costs of an appraisal action. Nonetheless, we would expect the size of the merger premium to be the most predictive single variable.

140. A version of some of the findings presented here are also presented in Korsmo & Myers, *supra* note 14.

141. We compiled a set of transactions from the Thomson One database of merger transactions with Delaware-incorporated, public company targets that closed between 2004 and the end of 2013, a period corresponding to the appraisal cases we collected from the Delaware dockets. We restricted our sample of transactions to those where appraisal was available. For this same universe of transactions, we also collected data on the incidence of classic fiduciary class action litigation and the outcomes of that litigation. Our resulting dataset thus includes all transactions involving public corporations incorporated in Delaware for which a shareholder could have mounted a fiduciary challenge, an appraisal proceeding, or both. For each transaction, we then determined whether shareholders pursued either or both. This allows us to compare the selection of merger transactions for challenge via different types of shareholder litigation. For a more complete description of the data on fiduciary duty class actions, see Korsmo & Myers, *supra* note 15.

142. *Id*. at 868.

143. *Id*.

TABLE 2
INCIDENCE OF FIDUCIARY CLAIMS AND APPRAISAL CLAIMS

		Fiduciary class action		
		No	*Yes*	*Total*
Appraisal (counseled)	*No*	470	612	1082
	Yes	15	71	86
	Total	485	683	1168

A major difficulty in determining whether the merits matter in much shareholder litigation—involving issues of scienter and breach of fiduciary duty, for example—is that the merits are generally not easy to evaluate. The only issue in an appraisal action, however, is the fair value of the plaintiffs' shares, and the sole remedy is accordingly very straightforward—cash in exchange for the shares.[144] As we have argued elsewhere,[145] per share cash recovery is likely to be the only truly meaningful relief—and thus the best measure of the merits—even in non-appraisal merger litigation. This simplicity offers a rare opportunity to assess the merits of a claim. The merits of appraisal actions are easy to perceive.[146]

In evaluating how appraisal petitioners select disputes for litigation, we examined two principal metrics. The first represents the size of the transaction,[147] which we do not consider directly relevant to the merits.

144. *See supra* note 63.

145. *See* Korsmo and Myers, *supra* note 15.

146. The notion of "merit" or "frivolousness" in litigation is more slippery than it may first appear. *See* Robert G. Bone, *Modeling Frivolous Suits*, 145 U. PA. L. REV. 519, 529–33 (1997) (considering and rejecting a number of common definitions of "frivolous litigation"). We will speak, somewhat loosely, of a suit being "merits-related" when either the decision to bring the suit or the disposition of the suit are more related to the expected damages at trial than to other factors, such as the ability to inflict litigation costs on the defendant and thus extract a settlement. An advantage of the approach used here is that we measure the relative influence of merit-related variables and non-merit related variables on the decision to bring suit, rather than arbitrarily defining some cut-off for "frivolous" litigation (i.e., all suits settled in less than one year; all suits settled for less than $2 million). *See* Korsmo & Myers, *supra* note 15.

147. Ideally, we would use the size of the acquiring firm, rather than that of the target firm, as the measure of "deep pockets." It is, after all, the acquiring firm that will pay any judgment. Unfortunately, using the size of the acquiring firm is not possible. Many of the acquiring firms are not

The second represents the adequacy of the merger consideration, which is relevant to the merits. We examine these two metrics below. A large merger premium should suggest a weak appraisal claim and a small merger premium should suggest a strong merger claim, all else being equal. By contrast, we would expect there to be little or no relationship between the sheer size of a transaction and the merit of a claim.[148]

1. *The Unimportance of Transaction Size*

To examine the effect of deal size on the likelihood of appraisal, we used two measures of the value of the transaction: (1) "enterprise value" (the total merger consideration); and (2) "equity value" (the amount of merger consideration allocated to the shareholders). Both are calculated in constant 2013 dollars. Table 3 reports the mean and median sizes of both measures of transaction size across various categories of transactions.

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publicly traded, and it is often not possible to obtain reliable data about private acquirers. Nor is it possible to simply restrict our analysis to petitions where the acquirer is public and reliable data is available, as this would lead to a highly skewed sample. Private acquirers tend to disproportionately include financial buyers, such as private equity firms, where there are unlikely to be large synergistic values. As a result, excluding non-public acquirers would skew our sample toward strategic mergers with potentially large synergies. Because synergistic values are excluded from the calculation of fair value, such transactions are likely to pose abnormally high risk to would-be appraisal petitioners. *See, e.g.*, *In re* Trados Inc. S'holder Litig., 73 A.3d 17, 74 (Del. Ch. 2013) (noting that in appraisal, valuations must "back out any synergies"); Gearreald v. Just Care, Inc., 2012 WL 1569818, *3 (Del. Ch. 2012) ("Determining the value of a 'going concern' requires the Court to exclude and synergistic value. . . ."); Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd., 847 A.2d 340, 356 (Del. Ch. 2004) ("[T]his court must endeavor to exclude from any appraisal award the amount of any value that the selling company's shareholders would receive because a buyer intends to operate the subject company, not as a stand-alone going concern, but as a part of a larger enterprise, from which synergistic gains can be extracted.").

Transaction size thus acts as a proxy for acquirer size. While a large firm can acquire a small firm, a small firm will generally not acquire a large firm. We therefore expect that transaction size will be strongly correlated with acquirer size. To test this intuition, we examined the transactions for which the size of the acquirer was available, and found a positive, statistically significant relationship between transaction size and acquirer size. *See* Korsmo & Myers, *supra* note 15, at 884.

148. While transaction size should not be directly related to the chance of success on the merits—it is likely to be at least somewhat related to the expected recovery at trial in a fiduciary class action, which is related to the "merits," as we use the term. *See supra* note 147. Transaction size might be at least weakly related to the merits in class actions in that it will be correlated to the size of the class and thus the potential damages at trial. In an appraisal claim, however, any relationship should be weaker still. Because there is no class in appraisal, the potential damages at trial are limited by the number of shares owned by the petitioner, not the size of the transaction. The only potential merit-related relationship between transaction size and the incidence of appraisal is that larger transactions may have more shareholders with a large enough position to make appraisal worthwhile. *See* J. Travis Laster, *The Appraisal Remedy in Third Party Deals*, 18 INSIGHTS, Apr. 2004, at 4 (suggesting a $500,000 threshold for a worthwhile appraisal claim—$620,000 adjusted for inflation to 2013 dollars).

TABLE 3
COMPARISON OF TRANSACTION SIZE IN APPRAISAL CASES, IN MILLIONS OF 2013 DOLLARS

	Equity value		*Enterprise value*	
	mean	*median*	*mean*	*median*
No appraisal	$1918.6	$457.8	$2,694.3	$482.7
All appraisal	2,942.5	381.6	3,042.9	555.7
Pro se appraisal	21,086.9	1344.0	20,993.4	1303.7
Counseled appraisal	1465.6	446.3	1581.8	505.5

Transactions attracting appraisal are larger, on both measures of size, than transactions not attracting appraisal.[149] When we consider only those appraisal actions filed by plaintiffs represented by counsel, however, the difference in deal size disappears altogether. Indeed, transactions attracting counseled appraisal actions are actually *smaller* than the deals that did not generate a counseled appraisal action.[150]

The focus of our analysis is on the more economically significant counseled appraisal petitions, which are far more likely to be sensitive to the incentive structure created by legal rules. For counseled petitions, the difference in transaction size between deals that attracted appraisal petitions and those that did not is not statistically significant, measured either in constant dollars or in the logarithm of constant dollars. This lack of a strong relationship between transaction size and counseled appraisal can be seen visually. Figure 7 shows a kernel density plot of transactions that attracted counseled appraisal petitions in gray and those transactions that did not in black.

149. None of these differences in size are statistically significant at any conventional level.

150. The difference in transaction size between transactions with counseled petitions and pro se petitions is significant at least at the five-percent level, across both measures of size and also when looking at log dollars. We speculate that large deals attract greater publicity, thus coming to the attention of small shareholders who may not act as strictly rational economic actors.

FIGURE 7
DENSITY PLOT OF TRANSACTIONS ATTRACTING COUNSELED APPRAISAL PETITION (GRAY), BY THE LOGARITHM OF EQUITY SIZE

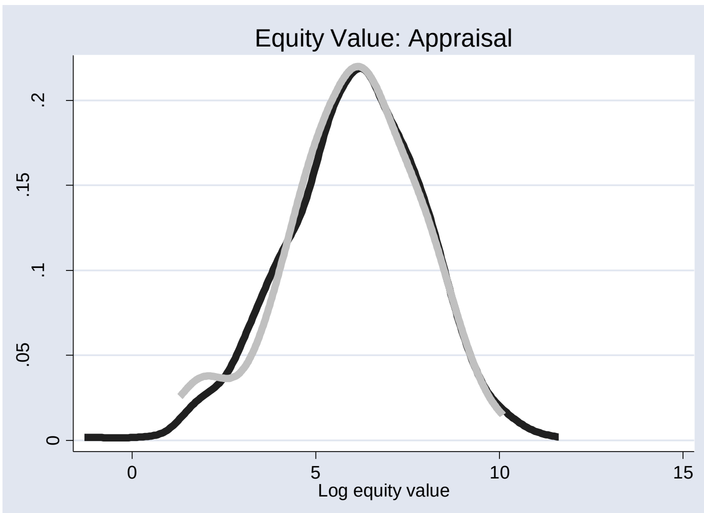


Figure 7 illustrates that those transactions that attracted counseled appraisal petitions are nearly identical in equity value to those that did not. A plot using enterprise value rather than equity value looks similar.

2. The Importance of the Merger Price

We also examined the merger premium, which we obtained from the Thomson One merger database.[151] The raw size of the merger premium for any given deal is, however, not a particularly satisfactory measure of the adequacy of the merger consideration (and, thus, the merits of the claim). Average merger premia vary widely across industries and across time, with average premia being much higher in the hot deal market of 2007, for example, than in the cold market of 2009. Furthermore, as we might

151. In a recent paper, Quinn Curtis and John Morley exploit a similar feature of mutual fund excessive fee litigation to evaluate whether the merits matter in such cases. In such cases, the only issue is the appropriateness of the funds' fees, which are directly observable and comparable. *See* Curtis & Morley, *supra* note 138. They find that the strongest predictor of whether a mutual fund would be targeted by such a claim was not the size of the fees charged, but rather the size of the assets under management by the targeted fund's family. They suggest that this may indicate that such litigation is triggered less by a meritorious claim, and more by the presence of deep pockets. *See id.*

expect, larger deals tend to involve smaller premia as measured in percentage terms.

In order to take these factors into account, we computed an "expected" merger premium based on the most salient variables: the size of the target company,[152] the year of the transaction, and the target company's industry. We then use the residual premium—the difference between the expected premium and the actual premium—as our proxy for the merits of the underlying legal claim.[153] The size of the residual premium should be negatively correlated with the merits of a claim: a positive residual premium implies a weaker claim, while a large negative residual premium ought to suggest a stronger claim, all else being equal.

We computed residual premia based on three measures of actual premium: the one-day premium, the one-week premium, and the four-week premium. We were able to determine these figures for 88 deals that attracted appraisal actions—6 pro se and 82 counseled—and 1014 deals that did not. Across all three measures, we find that the deals that attracted appraisal actions have lower residual premia, as shown in Table 4.

TABLE 4
COMPARISON OF MERGER PREMIA RESIDUALS IN APPRAISAL CASES

	1-day premium		*1-week premium*		*4-week premium*	
	mean	*median*	*mean*	*median*	*mean*	*median*
No appraisal	2.1%	-3.2%	2.8%	-2.9%	2.9%	-2.9%
All appraisal	-15.0%	-16.0	-15.7	-12.7	-18.4	-20.6
Pro se appraisal	-9.5	-2.0	-11.9	-0.3	-12.1	-3.0
Counseled appraisal	-15.4	-16.1	-16.0	-14.0	-18.9	-21.3

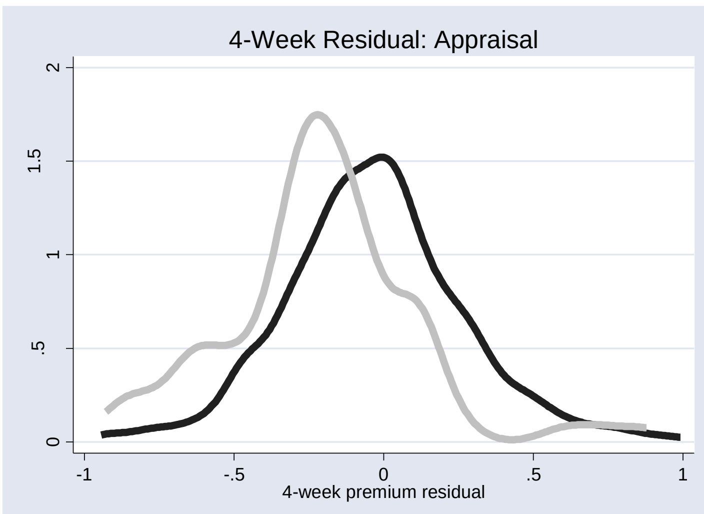
The appraisal petitions target deals with highly negative residual premia, and the differences in residual premia between transactions with appraisal and those without are all statistically significant beyond the 1% level. A kernel density plot showing the likelihood of attracting counseled

152. In order to avoid circularity, we use the market value of the target company four weeks prior to the merger announcement as the measure of the target's size. By using this measure, we avoid the problem of having the target company's market value being distorted by the proposed terms of the merger.

153. The procedure used here is similar to that employed by Morley and Curtis in their analysis of excessive fee litigation targeting mutual funds. *See* Morley & Curtis, *supra* note 138. Rather than simply using the raw size of the fee charged by the relevant mutual fund as their measure of merit for excessive fee litigation, they first calculate an average fee for funds with a similar investment style, and then subtract that average from the individual fund's actual fee. The result is what they call the "Style-Demeaned Expense Ratio." *See id.* at 20.

appraisal petitions by the four-week residual premium dramatically illustrates the difference.

FIGURE 8
TRANSACTION PREMIA RESIDUALS FOR TRANSACTIONS WITH COUNSELED APPRAISAL (GRAY), BY FOUR-WEEK RESIDUAL PREMIA



The gray line plots the residual premia for transactions that attracted a counseled appraisal petition, while the black line shows the same for transactions not attracting counseled petitions. The consistent pattern across the three measures is that appraisal litigation involves transactions with strongly negative residual premia.

As hypothesized, appraisal petitioners appear to target transactions with, all else equal, lower merger premia. While we lack an exogenous shock that would allow us to draw more firm causal inferences, the result certainly suggests that appraisal petitions are being brought with due regard to the merits. Furthermore, counseled appraisal petitioners do not appear to simply target large transactions, suggesting they are not merely looking for deep pockets and nuisance-value settlements.

We use two other methods of examining more searchingly the empirical determinants of appraisal proceedings. The first is to construct a logistic regression model, identifying the factors that predict whether or not a transaction will face an appraisal petition. Our dependent variable is a dummy that takes the value of 1 if the transaction faced a counselled appraisal petition and 0 otherwise. Our transaction dataset again includes

93 transactions that attracted at least one appraisal petition, 86 of which were counseled. We use as independent variables the log of transaction value, the residual premium, and variables for going private transactions and financial buyers. Our results appear in Panel A in the Appendix. Under all specifications, our measures of deal premium residual are strongly significant, and the sign of the coefficient is always negative, meaning that appraisal petitioners are more likely to target deals with lower merger premia. In addition, the going private variable is positive and strongly significant in all specifications, suggesting appraisal petitioners target going private transactions, where conflicts of interest are most likely to be acute. We estimate the effects of these variables on the incidence of appraisal litigation. A one standard deviation decrease in the one-week residual premium implies an increase of between 3.3% and 8.8% in the predicted probability of an appraisal petition. Similarly, a going-private transaction implies an increase in the likelihood of a petition of between 2.2% and 14.3%. All of the other variables—including, notably, transaction size—have no impact on the likelihood of an appraisal petition that is statistically distinguishable from zero.

Our second empirical approach goes beyond treating appraisal as a binary yes-or-no question. Instead, we analyze how many shares actually sought appraisal. For each transaction, we computed the percentage of equity value that sought appraisal, rounding to the nearest percentage integer. Of the 1168 appraisal eligible transactions, 48 had 1% or more of shareholders seek appraisal. The firms in each transaction that sought appraisal are shown in the following table:

Percentage of shareholders seeking appraisal, by transactions	
Percentage of shareholders seeking appraisal (rounded to nearest integer)	*Firms*
0	1120
1	20
2	4
3	6
4	2
5	4
6	2
7	1
8	3
9	1
11	1
12	1
15	1
17	1
31	1
Total	**1168**

We used these numbers as our dependent variables for a poisson regression, using the same independent variables noted above. The results of this regression appear in Panel B of the Appendix. As in our logistic regressions, the sign of the coefficient here for premium is negative under all specifications, and in each case it is statistically significant at the 1% level. Transaction size is statistically significant only under some specifications, and only when equity value is the measure of transaction size. While this suggests some role for transaction size, it appears to be a small one. A one standard deviation reduction in the one-day premium residual, for example, has an effect ten times as strong on the percentage of shares seeking appraisal as a one standard deviation increase in equity value. In sum, not only was an appraisal petition more likely to be filed as the residual premium decreased, but the percentage of shares seeking appraisal also tended to go up as the residual premium became more negative. By contrast, the incidence of appraisal was not predicted by the size of the transaction, and the intensity was only weakly affected.

As we demonstrate above, however, appraisal activity has increased dramatically in recent years. A natural question, then, is whether the metrics of litigation merit also changed dramatically as appraisal became more widespread in recent years. To test this possibility, we performed separate analyses restricted to the approximately 300 transactions that closed from 2011 through 2013, and found that our results did not change. All of the measures of residual premium still have a negative and statistically significant relationship on the incidence of appraisal: it is still the case that if the premium is lower, appraisal is more likely. Similarly, appraisal is still more likely in the presence of a going-private transaction.

Taken together, these results suggest that the merits *do* tend to matter in appraisal litigation, and that the rise of litigation arbitrage has not changed this picture. This stands in contrast to the fiduciary class action litigation involving the same universe of appraisal-eligible mergers. In another paper, we show that for fiduciary class actions, deal size is the strongest predictor of litigation, with far greater predictive power than the size of the merger premium.[154] While these results do not prove that appraisal arbitrage is a positive development, it does at least suggest that appraisal is not simply a new frontier of nuisance litigation. The policy implications of these findings are developed in the next two Parts.

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154. *See* Korsmo & Myers, *supra* note 15.

IV. THE SOCIAL UTILITY OF THE APPRAISAL REMEDY AND APPRAISAL ARBITRAGE

Given the sharp increase in appraisal litigation and the rise of appraisal arbitrage, it is heartening to see that the merits matter in the decision to bring an appraisal petition and that petitioners are targeting deals where there is reason to think the merger consideration is inadequate. This suggests that appraisal is working, at least in some respects, in a socially useful way. At the very least, our findings allay the fear that—as one commentator has colorfully put it—appraisal will simply become "a back-end cesspool for strike suits."[155] Nonetheless, appraisal defendants have attempted to paint the new brand of appraisal arbitrage as an ominous and unwelcome "abuse" that courts and policymakers should frown upon.[156] Thus, it is worth considering more broadly the social utility of the appraisal arbitrage.

The potentially positive role for appraisal is relatively straightforward. Just as the market for corporate control can serve as a check on agency costs from managerial shirking,[157] appraisal rights can serve as a back-end check on abuses by corporate managers, controlling shareholders, or other insiders in merger transactions.

The idea of a market for corporate control as a governance mechanism is well-known.[158] If a firm's managers shirk or otherwise mismanage the firm badly enough, the firm's stock will go down in price. If the price falls enough, outside arbitrageurs can buy a controlling stake in the firm at the depressed price, replace the old management with competent new managers, and profit from the subsequent increase in stock price. Appreciating the risk that they could be ousted in such a fashion, managers have an incentive to avoid shirking in the first place. The substantial transaction costs involved in a takeover often render it a governance

155. Geis, *supra* note 34, at 1664.

156. *See supra* note 24.

157. *See* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 73–75 (2008).

158. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 112 (1996); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1173–74 (1981); Gregg A. Jarrell, James A. Brickley & Jeffry M. Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 51 (1988); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 29–31 (1983); Jonathan R. Macey, *Auction Theory, MBOs and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85, 96–98 (1990); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965).

mechanism of last resort, but the possibility nonetheless serves as an important market check on managerial abuse and neglect.

Similarly, a robust market for appraisal arbitrage could serve as an effective back-end market check on expropriation from minority shareholders in merger transactions. When a merger takes place at a fair price, appraisal arbitrage will not be attractive to outside investors on the merits. If, however, a merger is agreed to at a price far enough below fair value—measured in conventional financial terms—appraisal arbitrageurs will have an incentive to accumulate a position and seek appraisal. In so doing, the arbitrageur will serve as a check on low-ball merger agreements and freeze-outs.[159]

Protecting minority shareholders is good not only for minority shareholders, but also—in the long run—for controlling shareholders, entrepreneurs, and the economy at large. To the extent that minority shareholders are protected against mistreatment, they will be willing to pay more for their shares in the first place. A governance mechanism that reduces the risk of expropriation faced by minority shareholders will thus reduce the cost of accessing equity capital for companies and increase the allocative efficiency of capital markets as a whole.[160]

Crucially, however, for appraisal to act as an effective back-end check on low mergers, a deep and active appraisal arbitrage market is necessary. In the absence of robust appraisal arbitrage, collective action and free-riding problems would likely render the threat of appraisal proceedings an ineffective deterrent to wrongdoing. By buying up large positions after the announcement of a transaction, thus allowing them to spread the fixed costs of bringing an appraisal claim over a broad share base, arbitrageurs can bring meritorious claims that would otherwise be cost-prohibitive for dispersed minority shareholders. Arbitrageurs can also bring their expertise as repeat players to bear to further reduce the frictions that might otherwise prevent appraisal from being an effective governance mechanism. Appraisal arbitrage thus solves the same collective action

159. Geis, *supra* note 34, at 1662 ("[J]ust like the traditional market for corporate control dampens the shareholder-manager agency cost problem, a robust back-end market for appraisal rights might protect against the majority shareholder expropriation problem.").

160. *See generally* Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 880; Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL. STUD. 251 (1977). *See also* Geis, *supra* note 34, at 1657 ("[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.") (footnote omitted).

problems that aggregate litigation seeks to solve, but without generating a serious agency problem in the process.

Potential criticisms of appraisal arbitrage, while superficially plausible, are either inconsistent with the empirical evidence or otherwise fail to withstand scrutiny. The most basic fear, of course, is that appraisal arbitrage will—like other forms of shareholder litigation—turn into a swamp of nuisance litigation, with the possible twist that the main beneficiaries are opportunistic financiers rather than opportunistic attorneys. So far, at least,[161] the empirical evidence provides no support for this fear.[162]

A related but somewhat more sophisticated concern is that acquirers will come to view the risk of appraisal as essentially a tax that raises the costs of acquiring a company, and reduce the amount they are willing to bid for the company accordingly. As a result, minority shareholders who do not seek appraisal would receive less than they would have in a world with no appraisal. The net result would be a kind of price discrimination: unsophisticated or unmotivated shareholders would receive the lower deal price, while sophisticated and motivated shareholders who seek appraisal would receive a somewhat higher price. In such a world, society as a whole would come out worse, net of transaction costs.[163]

This argument neglects two important considerations, however. First, acquirers have it in their power to render the expected cost of any "appraisal tax" negligible. As an initial matter, if they simply price the deal fairly, such that the cost of pursuing appraisal is unlikely to be justified by the potential recovery at trial, acquirers will face only nuisance suits, which—as explained above[164]—appear to be unlikely. Acquirers also can protect themselves contractually by including in the merger agreement a provision allowing them to terminate the agreement if more than a certain number of shares demand appraisal.[165]

Second, and perhaps more relevant, any substantial price discrimination effect can only persist in the absence of a developed appraisal arbitrage market. In a developed appraisal market, appraisal arbitrageurs will seek to accumulate a position in the target company following the announcement of a transaction, and will continue to

161. We expect to continue to collect data on appraisal litigation, and update our analysis annually.

162. *See supra* Part III.B.

163. A version of this argument was made by Mahoney and Weinstein in the 1990s. *See* Mahoney & Weinstein, *supra* note 5, at 242.

164. *See supra* text accompanying notes 125–36.

165. *See id*. at 242.

purchase shares until the market price has been driven to the risk-adjusted expected present value of an appraisal claim. Indeed, the threat of this phenomenon could operate as an *ex ante* price floor in merger negotiations.

Minority shareholders would thus share in the expected gains from appraisal without having to file a petition themselves,[166] just as the benefits from the market for corporate control accrue to ordinary shareholders. Indeed, minority shareholders could be better off by sharing in these gains than if they had sought appraisal themselves because professional arbitrageurs, as sophisticated repeat players, may be able to reduce overall costs in pressing claims or achieve better results in appraisal than individual investors could on their own.

Another criticism that might be made of appraisal is that the remedy is ultimately circular.[167] If the merger price is "low" in a transaction, then the acquirer is capturing excess value and the target is leaving value on the table. Although this phenomenon may sound worrisome at first, shareholders who are diversified across potential acquirers and potential targets would not actually end up harmed by it. A diversified stockholder could expect to profit as much as she suffers from any mispricing of mergers—sometimes suffering from a lowball merger price on the target side, and sometimes gaining a windfall on the acquirer side. As such, any attempt to reallocate the merger proceeds would just shift value from her left hand to her right, minus the costs of the proceeding itself. The costs of such a system would thus function as pure deadweight loss.

The basic fault with this argument is that it wrongly assumes that a public investor could achieve a portfolio that is sufficiently exposed to the acquirers of public companies. In our data set, one-third of the transactions involved an acquirer that was a private entity—a private equity fund, a dedicated investment vehicle, or a closely-held corporation. When public companies are sold to these entities at a discount, the value is captured entirely by the private entity and completely lost to public stockholders. Because they cannot generally invest in these types of vehicles, public stockholders thus cannot diversify away the risk of mispricing in mergers.

166. In several of the cases involving repeat petitioners, we observed substantial trading above the merger price following the announcement of the deal. It is possible that this trading represented more traditional merger arbitrageurs speculating on the possibility of a topping bid, but it is also possible that this represented appraisal arbitrageurs bidding up the price of shares and in so doing paying existing minority shareholders a portion of the expected gain.

167. *See* Amanda M. Rose & Richard Squire, *Intraportfolio Litigation*, 105 NW. U. L. REV. 1679 (2011) (on circularity in the context of securities and corporate litigation).

Thus, the circularity argument—potent for other forms of shareholder litigation—does not apply to appraisal.

The most fundamental objection to appraisal is that the courts simply are not equipped to perform accurate valuations.[168] On this view, it is unrealistic to expect legal proceedings to do a better job than competitive markets at valuing companies. Allowing courts to declare the fair value of a company where there has been no showing of any process-based wrongdoing apparently flies in the face of the usual strong presumption—in Delaware, at least—that competitive markets are the best arbiters of economic value. The valuations that courts derive in appraisal proceedings have, on occasion, attracted ridicule from practitioners and academic observers. Courts have sometimes awarded three or more times the merger consideration to dissenting shareholders,[169] leading commentators to decry the "casino-like aspect of the appraisal process"[170] and lament that courts' "misunderstandings have led to windfalls for dissenting shareholders."[171] There has been little systematic examination, however, of what courts have done in appraisal cases, even in reported opinions.[172]

To get a sense of what a shareholder might reasonably expect in appraisal, we analyzed data on all appraisal opinions between the watershed case of *Weinberger v. UOP, Inc.*,[173] and roughly the beginning

168. On occasion, the judges of the Delaware Chancery Court have themselves expressed frustration with their role. *See, e.g.*, In re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG, memo. Op. at *1 (Del. Ch. Jan. 30, 2015) ("I have commented elsewhere on the difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company in light of an auction sale, aided by experts offering wildly different opinions on value."); Huff Fund Inv. P'ship v. CKx, Inc., 2013 WL 5878807, at *1 (Del. Ch. Nov. 1, 2013).

169. *See, e.g.*, Borruso v. Communications Telesystems International, 753 A.2d 451 (Del. Ch. 1999) (awarding a 3027% premium to a dissenting stockholder of a private company).

170. James C. Morphy, *Doing Away With Appraisal in Public Deals*, 26 DEL. LAW. 30 (2008). *See also* Michael P. Dooley, *Rules, Standards, and the Model Business Corporation Act*, 74 LAW & CONTEMP. PROBS. 45, 53 (2011) (noting that appraisal awards are sometimes "two to three times the merger consideration, thereby turning appraisal into something of a lottery") (footnote omitted).

171. William J. Carney & Mark Heimendinger, *Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums*, 152 U. PA. L. REV. 845, 847 (2003).

172. *Compare* Feng Chen, Kenton K. Yee & Yong Keun Yoo, *Robustness of Judicial Decisions to Valuation-Method Innovation: An Exploratory Empirical Study*, 37 J. BUS. FIN. & ACCT. 1094 (2010) (purporting to examine appraisal cases but in fact mixes all sorts of judicial valuations beyond appraisal), *with* Laster, *supra* note 133, at 29 (suggesting around 400% average return for appraisal petitioners, which is consistent with our findings).

173. 457 A.2d 701 (Del. 1983). Prior to *Weinberger*, Delaware courts—pursuant to statute—used the so-called "Delaware Block Method" to value shares in an appraisal. *Id*. The Delaware Block Method entirely eschewed forward-looking evaluations, focusing on trailing indicators like capitalized trailing earnings, book value, and liquidation value of assets. *See* Piemonte v. New Boston Garden Corp., 387 N.E. 2d 1145, 1148 (Mass. 1979) (detailing Delaware Block Method of valuation). In its refusal to consider forward-looking projections, the Delaware Block Method came to be seen as out of step with modern financial theory, and in the seminal 1983 decision in *Weinberger v. UOP*, the

of our data set described above, during which time there were 44 reported appraisal opinions in Delaware.[174] Across 40 opinions that disclose both (1) the merger consideration and (2) the final premium awarded in the appraisal proceedings, the median award is a 50.2% premium over the merger price. The mean award is 330% over the merger price, but this statistic is heavily skewed by three very large awards of over 30 times the merger consideration.[175] The range from the 25th to the 75th percentile was 8.0% to 149% premium over the merger consideration. Thus, judges did not hesitate to award petitioners amounts in appraisal that were well beyond the merger consideration. Of course, these cases are over ten years old and involve mostly non-public companies, so they should be interpreted with caution. One might question why, in many of these cases, if these companies were truly as valuable as the courts found, a higher bidder did not materialize.

We are not insensitive to this criticism, but there are reasons to think it misses the mark. First, as an empirical matter, if courts were habitually over-valuing shares in appraisal we would expect the pattern of appraisal litigation to more closely resemble that of fiduciary duty class actions, with petitions routinely filed without much regard for the merits. This is not, in fact, what we observe. Appraisal activity is strongly associated with abnormally low deal premia.[176]

More fundamentally, a great many merger transactions take place without a true "market test" in the form of a competitive auction. Formally, the procedure by which a merger is negotiated is not strictly relevant in an appraisal proceeding.[177] In practice, however, many appraisal proceedings involve transactions where there is reason to doubt the probity of the process. Most obviously, when an existing majority shareholder takes a company private or otherwise freezes out the minority shareholders, the potential for abusive expropriation is plain. Indeed, we found that such going-private transactions were significantly more likely

Delaware Supreme Court revitalized the appraisal remedy by allowing the use of forward-looking valuation methods. 457 A. 2d 701 (Del. 1983).

174. R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *Delaware Appraisal Cases—Valuation Methods*, *in* THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS (3d ed. Supp. 2013) (starting place was Table 9-1). We supplemented the information collected from that treatise with information obtained by reviewing court documents, news reports, and SEC filings.

175. These very large percentages increases stem from the fact that the original merger consideration in these cases was very nearly zero.

176. *See supra* Part III.B. It remains possible that courts routinely *under*value shares in appraisal, which is more difficult to disprove.

177. *See* Golden Telecom, Inc. v. Global GTLP, 11 A.3d 214, 217–18 (Del. 2010).

to face an appraisal petition.[178] In addition, we were struck by the number of transactions where the merger price was actually *below* the market price prior to the announcement—sometimes substantially below. Of 1168 appraisal-eligible transactions between 2004 and 2013, 4.5% of them had a negotiated merger price that was *below* the market price one day prior to announcement. While it can certainly be the case that a price below the market price represents "fair value,"[179] it would be at least somewhat anomalous to insist that it is never appropriate to second-guess the judgment of the deal market, where the deal market has itself second-guessed the presumably much broader and more liquid stock market.

That is not to say that criticism of court-performed valuation is never valid. Where there has been a genuine market test, in the form of a free and fair auction for control of the company, it would be nothing but mischief to allow a shareholder to ask a court to second-guess the outcome. As we discuss more fully in the next section, it may be desirable to allow acquirers "safe harbor" from appraisal where they can show that a true market test has taken place.[180]

Nonetheless, where a market test is lacking, appraisal can serve as a valuable check on abusive transactions. If appraisal is to be effective in this role, however, rather than a series of one-off windfalls, appraisal arbitrage must play a crucial role. As such, it is a phenomenon that should be encouraged, rather than smothered in its crib.

V. POTENTIAL REFORMS

In this section, we explore two types of potential reforms. First we examine a variety of ways to reform appraisal in Delaware, and we adopt something of a Hippocratic approach. Appraisal appears to be working well now, and our primary goal is to avoid undermining it. Nevertheless, some reforms appear appropriate. We tentatively propose expanding appraisal to stock transactions while at the same time creating a safe harbor for transactions where there has been a genuine market test for

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178. Across our entire sample, 165 of our 1,167 (10%) transactions involved a going-private transaction. Of the going-private transactions, 15% attracted an appraisal petition, compared to only 6% of the other transactions. The difference using a chi-square is statistically significant beyond the 1% level.

179. One relatively common scenario where this may be the case is where news of a pending deal has reached the market but the deal price is not yet public, and the market overestimates the likely deal price.

180. *See infra* Part V.A.

control of the firm. The second type of reform we consider is how appraisal might serve as a model for other types of stockholder litigation.

A. Reforming Appraisal in Delaware

The fact that appraisal appears to be working relatively well suggests that radical reforms designed to substantially alter incentives are both unnecessary and unlikely to be beneficial. Two potential reforms that have occasionally been proposed stand out as particularly misguided. First, some have criticized the holding of *Transkaryotic*, arguing that appraisal petitioners should have to show that the actual shares they own were not voted in favor of the merger.[181] At present—given the way the vast majority of transactions are cleared by the Depository Trust Company and Cede[182]—it would generally be impossible for new purchasers to prove how the shares they own had been voted. As a result, this proposal would make appraisal arbitrage effectively impossible. Indeed, that is generally the point of the proposal. Because appraisal arbitrage is actually crucial to the effectiveness of appraisal as a governance mechanism, such a "reform" is unappealing.

Second, Professor Geis has recently proposed a reform designed to discourage "extortionate" appraisal claims.[183] He suggests that appraisal petitioners be required as part of the demand process to declare what they believe to be the "fair value" of the stock. They must at the same time write an embedded put option that would give the acquirer the right to sell the petitioners an additional share of stock for each share-seeking appraisal. The strike price is the fair value declared by the dissenter, and the shares sold under the put would also be part of the appraisal proceeding. The proposal is intended to give the dissenter an incentive to name an accurate price and is explicitly intended to increase the risk of bringing an appraisal proceeding in order to deter nuisance suits.[184] Geis, of course, wrote without a full picture on the merits of appraisal litigation. The empirical results presented here reveal that the existing incentives facing appraisal petitioners already encourage meritorious claims, thus rendering Geis's proposed changes unnecessary.

The goal of the proposal is to call the bluff of petitioners who demand too much. Respondents, however, already have a basic but formidable

181. *See supra* Part II.D.
182. *See* Geis, *supra* note 34, at 1650–52.
183. *See id.* at 1670–76.
184. *Id*. at 1676.

mechanism for doing so: refusing to settle and taking the case to trial. With a real petitioner facing the prospect of real litigation costs, proceeding to trial, while not without cost, is a comparatively direct way for respondents to battle nuisance claims.

Even on its own terms, however, the proposal is misguided. The appraisal petitioner operates at an informational disadvantage. Under current practice, a petitioner does not declare their estimate of the "fair value" until their pre-trial brief, after the benefit of discovery: reviewing documents, receiving interrogatories, and deposing relevant parties. Most fundamentally, it does not genuinely improve the incentive structure of appraisal. Merger transactions already involve one party—the acquirer—writing an implied put that gives the other party—the shareholder—the right to either exercise the put or go into appraisal. Geis's proposal simply switches the burden to the shareholder to name an accurate price at his peril, as an (unnecessary) measure for deterring strike suits, and even though the shareholder is almost certainly operating at a significant informational disadvantage. Appraisal, under this framework, might become so unpalatable as to be rendered a nullity.

This is not to say that Delaware's appraisal statute is a flawless gem in no need of polishing. But given that appraisal appears to be working relatively well, we believe that any changes should be approached with a measure of caution and should be aimed at refining appraisal rather than limiting it. We tentatively offer two suggestions for improvement, one of which would broaden the availability of appraisal somewhat and the other of which would limit it. First, the so-called "market-out" exception in the current statute makes no sense.[185] The usual rationale for the exception is that appraisal is unnecessary where shareholders have the option of simply selling their shares on the open market for what is presumably fair value.[186] The obvious problem with this rationale is that it envisions

185. *See supra* note 38, at 12.

186. *See, e.g.*, Jeff Goetz, *A Dissent Dampened by Timing: How the Stock Market Exception Systematically Deprives Public Shareholders of Fair Value*, 15 FORDHAM J. CORP. & FIN. L. 771, 787–88 (2010) ("[P]roponents argue, as Professor Manning did, that the market adequately values stock; valuation through appraisal is unnecessary because dissenting shareholders can sell their shares on the market for the appropriate price.") (internal citations omitted); David J. Ratway, *Delaware's Stock Market Exception to Appraisal Rights: Dissenting Minority Stockholders of Warner Communications, Inc. are "Market-Out" of Luck*, 28 U. TOL. L. REV. 179, 205 (1996) ("Proponents of the 'market-out' exception claim that with a publicly-traded stock, the stock market price is an accurate and fair valuation of the stock. Therefore, expensive judicial determination of the fair value would be redundant."); Michael R. Schwenk, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 681–82 (1994) ("If the shareholder can receive the fair value of his or her stock by selling it in the market, then there is no need for a judicial proceeding to determine this value.

minority shareholders selling their shares once the transaction has been announced, by which time the horse has already left the barn. Once dissenters can sell their shares, the fact of the merger—potentially at an unfair price—has already been incorporated into the market price.[187]

Perhaps aware of this difficulty, Delaware has crafted an exception to the market-out exception for when the shareholders receive as merger consideration anything other than shares in the surviving corporation or shares in another widely traded corporation.[188] Thus, public company appraisal in Delaware is largely limited to situations where shareholders are required to take cash as some portion of the merger consideration. This "exception to the exception," however, does little to solve the problem. Just because the stockholder ends up with marketable securities at the end of the day does not mean he is able to receive fair value for his original shares.

To take an extreme example, consider stockholders of Company A, whose stock is trading at $100 per share. Suppose the board of Company A agrees to merge with some acquirer, and under the merger each Company A stockholder will receive one share of Company B stock for each Company A share. Suppose further that Company B stock is trading for $50 per share. A minority shareholder in Company A would be left with shares in Company B, worth only half of what his original shares were worth, but he would be unable to pursue appraisal as the statute is currently constituted. The fact that the consideration the shareholder received was in the form of liquid securities would be of little consolation; cash is liquid, too.

Because the adequacy of the consideration paid in a merger does not, at the end of the day, depend on the form of that consideration, neither should the availability of the appraisal remedy. Thus, the first reform we suggest is that the form of merger consideration should be irrelevant to eligibility for appraisal. Indeed, for similar reasons we also suggest that the sale of all assets ought to trigger appraisal rights that can be exercised against the purchaser of the assets, as under the MBCA.

It has already been set with the best source of information regarding values: a competitive market."); Wertheimer, *supra* note 31, at 633.

187. *See* Goetz, *supra* note 186, at 794 ("[S]ince most shareholders that might wish to dissent from the transaction learn about the transaction when the rest of the market does—at the time of the public announcement, they can only sell their shares after that announcement. . . . Consequently, dissenting shareholders will only be able to sell their interests in the company after the merger's value has become incorporated into the company's share price.") (footnote omitted).

188. DEL. CODE ANN. tit. 8, § 262 (b)(2) (2015).

Our second proposed reform is to allow acquirers a safe harbor from appraisal claims where they can demonstrate that the merger price was subjected to a genuine market test. As we noted above, where a free and fair auction has taken place, it makes little sense to allow a law-trained chancellor—even the experts on the Delaware Court of Chancery—to second-guess the price set by the market. In a recent opinion in an appraisal case,[189] Vice Chancellor Glasscock drew an analogy to reviewing a real estate transaction that had been conducted at arm's length. He suggested that "[a] law-trained judge . . . would have no reason to second-guess the market price absent demonstration of self-dealing or a flawed sales process."[190] After observing that he was "faced with a similar situation in this much more complex venue of the sale of a corporate enterprise," he lamented that the "statute and interpreting case law direct that I not rely presumptively on the price achieved by exposing the company to the market."[191]

Vice Chancellor Glasscock is right to lament; appraisal makes little sense where there has been a true market test. Satisfying one of the various *Revlon*-type tests, however, is not necessarily a market test. We would allow acquirers a safe harbor only where such a genuine market test has occurred. Perhaps the most obvious way to do so is to require petitioners to show that a market test was lacking. There is reason to think this would be sub-optimal, however. Making the process and the motivations of the parties relevant to the petitioner's case would potentially expand the scope of legitimate discovery demands upon the defendant. This may result in precisely the kind of large, asymmetric litigation costs that could fuel settlement of nuisance claims.[192] Turning every appraisal action into a mini-*Revlon* claim is not in anyone's interests. A better solution would be to maintain the formal irrelevance of deal process to the petitioner's case but allow the defendants the option of mooting the claim by demonstrating that a true market test had been performed.

The difficulty is in defining our safe harbor. Borrowing directly from any of the doctrines that apply to mergers in the fiduciary context—like *Revlon* or *In re MFW*—would result in something far too permissive; we are not inclined to expand the safe harbor far beyond a genuine auction for control of the company. In our view, for example, the power vested in an independent board committee or a majority of the minority shareholders to

189. Huff Fund Inv. P'ship v. CKx Inc., C.A. No. 6844-VCG, memo. op. (Del. Ch. Nov. 1, 2013).
190. *Id*. at *2.
191. *Id*. at *2-3.
192. *See supra* Part III.A.

"say no" to a transaction would not be sufficient. These mechanisms set up, at best, a Hobson's choice for existing shareholders, and it is precisely in these scenarios where appraisal is useful.

At a minimum, we believe that to qualify for a safe harbor against appraisal, the process should have to satisfy the requirements of Section 5.15 of the American Law Institute's 1994 Principles of Corporate Governance, regarding interested director mergers.[193] Section 5.15(b) would require (1) public disclosure of a proposed transaction; (2) that potential competing bidders be provided with relevant information concerning the target and given a reasonable opportunity to submit a competing bid; and (3) after complying with (1) and (2), a majority of disinterested directors and minority shareholders must approve.[194]

The ALI would allow use of various lock-up provisions, including commitments to pay a termination fee to cover bidder expenses.[195] While lock-ups will often be appropriate, and even beneficial to shareholders, we would not be inclined to extend the safe harbor this far. Even standard lock-up provisions like termination fees and matching rights have the potential to harm minority shareholders by discouraging competing bidders. We are here addressing only a safe harbor where none before existed, not a standard for liability. Thus, we can safely set a very high bar for what will constitute a genuine market test. The potential for mischief even with common lock-ups is great enough that appraisal will at least sometimes be justified. As such, it seems appropriate to offer management and potential acquirers a choice. They may use lock-up provisions and face a possible appraisal claim, which is, after all, the status quo. Or they may forego deal protection and take advantage of the safe harbor. Which option is more advantageous will likely be highly context-specific.

B. Appraisal as a Model for Shareholder Litigation

Beyond these modest reforms to what already appears to be a well-functioning appraisal remedy, it is worth asking what aspects of appraisal might usefully serve as templates for reforming the profoundly dysfunctional system of fiduciary duty class actions. Elsewhere, we have

193. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.15 (1994).

194. *Id*. Incidentally, the ALI suggested that appraisal rights need not arise if these procedures are followed. *See id*. § 7.21 cmt. c(3), at 306 ("Given that § 5.15(b) supplies an adequate market test, there is no need to extend a judicial remedy through appraisal when this test is satisfied.").

195. *Id.* § 5.15 cmt. c(3), at 369.

proposed several fairly straightforward reforms.[196] These range from lead plaintiff provisions akin to those found in the PSLRA,[197] to reforms to D&O insurance,[198] to switching from an opt-out to an opt-in class structure.[199]

We also made some tentative suggestions regarding eliminating the contemporaneous ownership requirement from fiduciary duty class actions.[200] In light of our findings above regarding the expansion of appraisal arbitrage, it seems appropriate to expand somewhat upon this notion. As of now, appraisal is unique among stockholder litigation in its opt-in class and lack of any contemporaneous ownership requirement. While the structure of standard aggregate stockholder litigation is that a small holder can speak on behalf of millions of non-present investors, with the risk that the process may be hijacked by plaintiffs' attorneys, in appraisal the petitioner must put his money where his mouth is.

As currently structured, the universe of potential lead plaintiffs is limited to shareholders who happened to own their shares when the transaction was announced.[201] While this universe may include large institutional investors with the resources and economic incentives to serve as effective monitors on class counsel, they are also likely to be diversified investors with little expertise or interest in pursuing litigation.[202] Eliminating the contemporaneous ownership requirement in derivative

196. *See* Korsmo & Myers, *supra* note 15.

197. *Id.* at 832 n.10; *see also* 15 U.S.C. § 78u-4(a)(2)(B) (2012).

198. *See* Korsmo & Myers, *supra* note 15, at 891.

199. *Id*.

200. *Id*.

201. *See* Dieter v. Prime Computer, Inc., 681 A.2d 1068, 1072–73 (Del. Ch. 1996) (holding that an after-acquiring stockholder was disqualified from serving as class representative). *See also* A. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 13.25 (3d ed. 2011) (citing Leighton v. Lewis, 577 A.2d 753 (Del. 1990)) ("[A] stockholder who purchases shares of stock after the announcement of the challenged merger should not be permitted to maintain a class action challenging the merger since he is not truly a member of the class."). Although precluded from service as lead plaintiff, after-acquiring stockholders are nevertheless often eligible to receive any benefits of the class action settlement because settlement classes are commonly defined to include transferees. *See In re* Prodigy Commc'n Corp. S'holders Litig., 2002 WL 1767543, at *4 (Del. Ch. July 26, 2002) ("[W]hen a claim is asserted on behalf of a class of stockholders challenging the fairness of the terms of a proposed transaction under Delaware law, the class will ordinarily consist of those persons who held shares as of the date the transaction was announced and their transferees, successors and assigns."). Due to the extreme rarity of monetary recovery, however, inclusion in the recovery class without an ability to influence the litigation is of limited practical utility.

202. Professors Cox and Thomas find that most institutional investors fail to even file to get their share of class action settlements. *See* James D. Cox & Randall S. Thomas, *Leaving Money on the Table: Do Institutional Investors Fair to File Claims in Securities Class Actions?*, 80 WASH. U. L.Q. 855 (2002).

litigation and securities litigation would allow specialized institutional investors—such as those we find pursuing appraisal arbitrage—to seek out strong legal claims, and seek to accumulate a large position for pursuing litigation. In so doing, they would solve the collective action problems that otherwise plague shareholder litigation without simultaneously creating a serious agency problem, and would further both the deterrence and compensation functions of such litigation.

While this reform may seem radical, it was actually suggested in 2008 by no less than now-Vice Chancellor J. Travis Laster.[203] Laster proposed that derivative plaintiffs simply be required to "(1) hold stock at the time of the lawsuit and (2) not voluntarily divest the stock during the lawsuit."[204] He identifies the contemporaneous ownership rule as having originally been created to "prevent corporations from manufacturing diversity jurisdiction for claims against third parties,"[205] a problem that "obviously does not afflict the *state* courts of Delaware, whose jurisdiction does not turn on diversity of citizenship."[206] Since that time, however, the alleged justification for the rule has morphed into the supposed necessity of preventing the alleged "evil" of an individual purchasing shares with the purpose of bringing suit.[207]

As Laster notes, however, the nature of this "evil" is not entirely clear. The "evil" is often described, without further analysis, as purchasing stock "with litigious motives."[208] But after-purchasers of stock are not "strangers" to the dispute as under the old doctrines of champerty or maintenance, in that the purchase of shares "necessarily gives the acquirer an equitable interest in the underlying corporation."[209] An after-purchaser has the same continuing interest in the corporation as any other shareholder. As Laster concludes, "[a] plaintiff who can effectively vindicate corporate rights should not be prevented from conferring

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203. J. Travis Laster, *Goodbye to the Contemporaneous Ownership Requirement*, 33 DEL. J. CORP. L. 673 (2008).

204. *Id*. at 673.

205. *Id*. at 678 (citing Rosenthal v. Burry Biscuit Corp., 60 A.2d 106, 111 n.4 (Del. Ch. 1948)).

206. Laster, *supra* note 203, at 679.

207. *See id*.; Schoon v. Smith, 953 A.2d 196, 203 (Del. 2008) (claiming that the rule was intended "solely to prevent what has been considered an evil, namely, the purchasing of shares in order to maintain a derivative action designed to attack a transaction which occurred prior to the purchase of the stock.") (footnote omitted); Ala. By-Prods. Corp. v. Cede & Co., 657 A.2d 254, 264 n.12 (Del. 1995) (describing the policy against suits by "an individual [who] purchases stock in a corporation with purely litigious motives.").

208. *See, e.g.*, *Ala. By-Prods. Corp*., 657 A.2d at 264 n.12; Screiber v. Bryan, 396 A.2d 512, 516 (Del. Ch. 1978).

209. Laster, *supra* note 203, at 683.

benefits" on the corporation or its shareholders "simply because the wrong occurred before the plaintiff purchased its shares."[210]

Nor is it plausible to consider the contemporaneous ownership requirement as an effective control on meritless strike suits. As we have shown elsewhere, the prevalence of meritless merger litigation could hardly become worse.[211] More likely, a professional investor being willing to invest a substantial sum in the expectation of bringing suit would represent a signal of merit. As Laster noted, "a stockholder purchasing shares with 'litigious motives' might be expected to have identified a relatively strong claim so as to make it worthwhile to expend funds both to purchase the shares and to bring the case."[212] Our findings regarding appraisal litigation strongly support Laster's intuition. Far from barring claims by after-purchasers, the Delaware courts should presume that such plaintiffs will function as the best monitors of a class action, and they should view with great suspicion any suit so weak that no investor was willing to invest substantial resources in pursuing it.

CONCLUSION

Until now, the academic consensus has been that appraisal litigation is a peripheral sideshow. This view, which may have been accurate as recently as 2009, must now be radically revised. Appraisal litigation is undergoing a period of rapid growth, characterized by a new breed of sophisticated repeat petitioners.

Given the well-known pathologies of shareholder litigation, the increase in appraisal litigation might be regarded with some degree of apprehension. We show, however, that far from representing a new frontier in vexatious litigation, appraisal litigation is a unique form of shareholder litigation where the merits are highly relevant to the decision to bring suit. The structure of appraisal litigation is such that petitioners are able to reap the benefits of bringing a meritorious claim and are likely to suffer consequences from bringing a non-meritorious claim. Our data bear out these theoretical conclusions.

More importantly, the growth of appraisal promises to bring genuine benefits to shareholders in general, both in terms of providing real deterrence against management and controlling shareholder opportunism and negligence and in terms of providing meaningful compensation where

210. *Id*. at 684.
211. *See* Korsmo & Myers, *supra* note 15.
212. Laster, *supra* note 203, at 689.

such behavior persists. By purchasing shares after the announcement of an opportunistic transaction with the intention of pursuing appraisal, appraisal arbitrageurs share the compensation achieved through appraisal even with those minority shareholders who do not pursue appraisal themselves.

APPENDIX

Panel A: Logistic Regression: Dependent variable is the filing of a counselled appraisal petition

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)					0.0492	0.0846	0.0901	0.11
						-0.0705	-0.07	-0709	-0.0721
	Enterprise value (log)	0.0369	0.0526	0.061	0.0781				
		-0.0688	-0.0681	-0.069	-0.0695				
Premium residuals	1-day	-1.708***	-1.687***			-1.630***	-1.658***		
		-0.44	-0.443			-0.436	-0.442		
	1-week			-1.669***				-1.645***	
				-0.433				-0.433	
	4-week				-1.631***				-1.620***
					-0.405				-0.41
Going private			1.018***	1.030***	0.990***		1.015***	1.025***	0.984***
			-0.291	-0.293	-0.293		-0.292	-0.294	-0.294
Financial buyer			0.212	0.203	0.153		0.224	0.216	0.167
			-0.269	-0.271	-0.272		-0.269	-0.271	-0.273
Constant		-2.869***	-3.238***	-3.291***	-3.400***	-2.942***	-3.439***	-3.474***	-3.599***
		-0.464	-0.473	-0.481	-0.485	-0.469	-0.488	-0.495	-0.504
Observations		1090	1090	1086	1094	1098	1098	1094	1102

Panel B: Poisson Regression: Dependent variable is the integer percentage of equity value dissenting in appraisal

VARIABLES		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Size	Equity value (log)					0.0453	0.113***	0.0732*	0.108***
						-0.0388	-0.0389	-0.0382	-0.0392
	Enterprise value (log)	0.0312	0.0359	0.0184	0.0463				
		-0.0373	-0.0368	-0.0363	-0.0367				
Premium residuals	1-day	-2.768***	-2.335***			-2.591***	-2.474***		
		-0.209	-0.19			-0.217	-0.219		
	1-week			-1.985***				-2.034***	
				-0.188				-0.21	
	4-week				-2.014***				-2.104***
					-0.18				-0.205
Going private			0.968***	1.008***	0.959***		1.004***	1.014***	0.965***
			-0.14	-0.141	-0.141		-0.142	-0.143	-0.142
Financial buyer			0.735***	0.730***	0.672***		0.749***	0.742***	0.687***
			-0.137	-0.14	-0.139		-0.138	-0.14	-0.139
Constant		-1.964***	-2.450***	-2.287***	-2.484***	-2.024***	-2.959***	-2.636	-2.882***
		-0.255	-0.257	-0.252	-0.258	-0.264	-0.284	-0.273	-0.284
Observations		1090	1090	1086	1094	1098	1098	1094	1102

*** p<0.01, ** p<0.05, * p<0.1