

## AN APPRAISAL PUZZLE

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### INTRODUCTION

In the spring of 2005, a biotech company named Transkaryotic Therapies (TKT) decided to sell itself to Shire Pharmaceuticals Group (Shire).<sup>1</sup> Shire agreed to pay \$37 for each share of TKT, representing a 44% premium over the prior month's average price.<sup>2</sup> Under Delaware General Corporation Law (DGCL), the deal required approval by a majority

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<sup>1</sup> *In re Appraisal of Transkaryotic Therapies, Inc.*, No. Civ.A. 1554-CC, 2007 WL 1378345, at \*1 (Del. Ch. May 2, 2007). The transaction received even more attention for a related lawsuit exploring the appropriate scope of state-law disclosure obligations in *In re Transkaryotic Therapies, Inc.*, 954 A.2d 346 (Del. Ch. 2008).

<sup>2</sup> *Transkaryotic Therapies*, 2007 WL 1378345, at \*1.

of TKT's voting shareholders.<sup>3</sup> Thus, the next obvious question was: Who owned the shares?

This was not as easy to determine as one might expect: contrary to our common sense expectations, public companies do not keep a long list of their shareholders hidden away in an underground vault or an encrypted database file. The technical answer was that TKT, like almost all other publicly held companies, recorded an obscure firm named Cede & Company (Cede) as the registered owner for most of its stock.<sup>4</sup> But Cede, better known by the name of its affiliate, the Depository Trust Corporation (DTC), is not some trillion-dollar hedge fund; it only holds the shares as a clearinghouse to help buyers and sellers execute trades efficiently.<sup>5</sup>

In the Transkaryotic merger, then, presumably the parties with a real economic interest, the beneficial owners, would tell Cede how to vote their shares. In the end, Cede voted approximately 12.9 million shares in favor of the merger, approximately 9.9 million shares against the merger, and withheld votes on roughly 7 million shares.<sup>6</sup> This, combined with a favorable vote for the shares not held by Cede, ultimately amounted to 52% support for the merger—just enough to approve the deal.<sup>7</sup>

Yet, as you might suspect by the close vote, not everyone was pleased with the \$37 offer price. A group of twelve beneficial owners, holding nearly 11 million shares, decided to file an appraisal claim.<sup>8</sup> Appraisal laws, in a nutshell, allow shareholders to sue for the “fair value” of their shares (as determined through judicial proceedings) when they object to a merger or related fundamental transaction.<sup>9</sup> But the procedural

<sup>3</sup> DEL. CODE ANN. tit. 8, § 251(c) (2010).

<sup>4</sup> In this case, Cede held roughly 29.7 million shares of the 35.6 million total shares of TKT eligible to vote (about 83%). Opening Brief in Support of Respondent's Motion for Partial Summary Judgment at 4, *Transkaryotic Therapies*, 2007 WL 1378345 (No. 1554-N), 2006 WL 4775227, at \*4.

<sup>5</sup> See Marcel Kahan & Edward Rock, *The Hanging Chads of Corporate Voting*, 96 GEO. L.J. 1227, 1237–38 (2008).

<sup>6</sup> *Transkaryotic Therapies*, 2007 WL 1378345, at \*1. The practice of withholding votes might be done at the specific request of the beneficial owners or, more commonly, because the owner never returns voting instructions. See Kahan & Rock, *supra* note 5, at 1249–51. In this transaction, 47,416 shares requested abstention and 6,943,962 shares ignored the ballot. Opening Brief in Support of Respondent's Motion for Partial Summary Judgment, *supra* note 4.

<sup>7</sup> *Transkaryotic Therapies*, 2007 WL 1378345, at \*1.

<sup>8</sup> *Id.*

<sup>9</sup> See Paul G. Mahoney & Mark Weinstein, *The Appraisal Remedy and Merger Premiums*, 1 AM. L. & ECON. REV. 239, 239 (1999). Triggering mechanisms for appraisal rights differ by jurisdiction. *Id.* at 239, 243. Every state grants appraisal rights for statutory merger transactions, many offer the remedy when a firm sells “substantially all of the corporation's assets,” and a majority offer the rights during corporate charter amendments. See Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 9 (1995). Likewise, the extent to which appraisal is available for shareholders of an acquiring firm differs by jurisdiction. See *id.* at 14–15.

requirements to perfect an appraisal claim are Byzantine,<sup>10</sup> and here a crucial issue surfaced. Under Delaware law, an owner forfeits appraisal rights if she votes in favor of the merger.<sup>11</sup> How, then, had this dissenting dozen voted their shares?

The answer was easy for a quarter of the dissenting shares. The petitioners had owned this stock on the record date—when the firm’s books were frozen in order to identify which shareholders received voting rights—and they told Cede to vote these shares against the merger.<sup>12</sup> But the dissenters purchased the balance of their equity stake, approximately 8 million shares, after the record date, though before the date of the shareholders’ meeting where the votes were tallied.<sup>13</sup> This meant that they did not have the right to vote these shares; that privilege remained with the selling beneficial owners.<sup>14</sup> So which of the shares held by Cede did the petitioners buy: some of the 12.9 million shares that eventually voted in favor of the merger, or some of the 16.9 million shares that abstained or voted against the deal? If the former, then petitioners failed to perfect their appraisal remedy and it was destroyed. If the latter, then the claim could proceed.

As this Article will demonstrate, it is impossible to answer this question in a conclusive and meaningful way. Indeed, under current exchange settlement practices the inquiry makes little sense. Cede merely holds a large pool of undifferentiated shares and does not specifically trace stock certificates to beneficial owners. There is no possible way to know which group of shares the petitioners bought or, therefore, how the stock ultimately purchased by the petitioners was voted by the previous owners.

The Chancery Court, while clearly aware of this mess,<sup>15</sup> finessed the problem in a summary judgment opinion. It relied on precedent and a literal reading of the Delaware appraisal statute to maintain that the “holder of record” had to abstain or vote against the merger in order to perfect appraisal rights.<sup>16</sup> In this case, then, the standard was met. Cede was the record holder, and it had voted (or withheld) nearly 17 million shares against the deal. The petitioners were now seeking to exercise appraisal

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<sup>10</sup> See Mahoney & Weinstein, *supra* note 9, at 240; see also *infra* Part I.B (tracing the basic mechanics for filing an appraisal claim in Delaware).

<sup>11</sup> DEL. CODE ANN. tit. 8, § 262(a) (2010).

<sup>12</sup> *Transkaryotic Therapies*, 2007 WL 1378345, at \*1.

<sup>13</sup> *Id.*

<sup>14</sup> See *id.* There is some precedent for a buyer to reclaim merger voting rights by obtaining irrevocable proxies from a selling shareholder, but as I discuss *infra* note 113, these proxy transfers are exceptionally difficult to track and implement.

<sup>15</sup> See *Transkaryotic Therapies*, 2007 WL 1378345, at \*2–5.

<sup>16</sup> *Id.* at \*3 (quoting § 262) (internal quotation mark omitted). This language reflects 1967 amendments to section 262. Prior to that, the statute simply stated that appraisal rights were available for “stockholders.” See Joseph Evan Calio, *New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding*, 32 AM. BUS. L.J. 1, 15 n.52 (1994).

rights for 12 million shares through Cede, the same record owner. That was enough for the court. In other words, who cares if the beneficial owners seeking appraisal were not the beneficial owners that had cast the votes? As long as there were enough “qualified” nonpositive votes to cover the petitioners’ claims, then appraisal rights were still available.<sup>17</sup>

This literalistic holding may have been the most sensible thing for the court to do under the circumstances.<sup>18</sup> But *Transkaryotic* raises the ante on appraisal in a way that was certainly never contemplated by the statute’s drafters. What happens if a very high percentage of after-bought shares seek appraisal when only a handful of shares actually vote against the deal? Can everyone pursue the claim? Should the rights be prorated? Does Cede now assume the responsibility of figuring this out? Should new legal “look-through” standards be developed? In short, we have a tricky new appraisal puzzle.

Furthermore, this mystery of mistaken identity is important because it impacts the balance of power between majority and minority shareholders.<sup>19</sup> For instance, it is possible that a robust market for appraisal rights will develop, analogous to the market for corporate control that allegedly disciplines otherwise entrenched managers with the threat of an external takeover.<sup>20</sup>

Indeed, *Transkaryotic* illustrates this exact point. There was some intrigue surrounding the timing of the sell-out because the directors struck this deal right before the firm was due to receive test results for a promising

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<sup>17</sup> See *Transkaryotic Therapies*, 2007 WL 1378345, at \*4 (“Cede, the record holder, properly perfected appraisal rights under § 262. As a result, Cede may exercise appraisal rights for all 10,972,650 contested shares.”).

<sup>18</sup> Title 8, section 262(a) of the DGCL expressly defines the shareholder eligible for appraisal as “a holder of record of stock in a corporation.” § 262(a). Case law confirms the court’s view by insisting that the record owner must bring appraisal claims on behalf of beneficial owners. See, e.g., *Olivetti Underwood Corp. v. Jacques Coe & Co.*, 217 A.2d 683, 687 (Del. 1966) (finding that in appraisal proceedings, “the relationship between, and the rights and obligations of, a registered stockholder and his beneficial owner are not relevant issues”); *Salt Dome Oil Corp. v. Schenck*, 41 A.2d 583, 589 (Del. 1945) (“[A corporation] may rightfully look to the corporate books as the sole evidence of membership.”).

<sup>19</sup> The governance tension between majority and minority shareholders is starting to receive significant attention in academic literature. See, e.g., Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008); Guhan Subramanian, *Fixing Freezeouts*, 115 YALE L.J. 2, 7 (2005) (identifying “social welfare costs” of the current statutory regime, including the possibility of exploiting the freezeout merger doctrine to the detriment of minority shareholders). This is not to say, of course, that these issues were ignored in earlier times. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 306 (1939) (describing “dominant or controlling stockholder[s] or group[s] of stockholders” as fiduciaries); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 719–20 (Del. 1971) (articulating fiduciary standards of review for controlling majority shareholders).

<sup>20</sup> See sources cited *infra* note 155.

new drug.<sup>21</sup> The test results came back overwhelmingly positive, before the date of the merger vote<sup>22</sup>—a fact which undoubtedly caused some shareholders to grumble at the \$37 offer price. Was this a situation where the buyer had somehow gotten wind of the good news and sought to expropriate value from TKT shareholders?<sup>23</sup>

The stench attracted some new characters, including the well-known shareholder activist Carl Icahn.<sup>24</sup> These new purchasers quickly assembled large ownership blocks.<sup>25</sup> Though they bemoaned the inability to vote against the merger (as the record date had passed), these activists promised to pursue after-announcement appraisal lawsuits as a way to obtain full value for the shares,<sup>26</sup> thus giving rise to the identity puzzle presented by the case. Similarly, ownership ambiguity and any resulting amplification of appraisal rights might be seen as a positive development for protecting against abusive freezeout mergers by allowing dissenters to gather the scale needed to pursue meaningful appraisal claims.<sup>27</sup> Channeled appropriately, this would be a cause for celebration.

But there is also a risk that appraisal statutes will become warped far beyond their intended purpose, turning into a new vehicle for meritless strike suits rather than an effective tool for corporate governance. Majority holders or synergistic outside buyers may shun sensible deals if merger announcements routinely bring a new appraisal tax.<sup>28</sup> Indeed, despite the favorable summary judgment ruling, petitioners in *Transkaryotic* eventually settled their claim for the initial \$37 merger consideration (plus interest),

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<sup>21</sup> See Tom Gardner, *When Shareholders Attack*, MOTLEY FOOL (July 22, 2005), <http://www.fool.com/investing/small-cap/2005/07/22/when-shareholders-attack.aspx> (describing the general intrigue, along with the CEO's instant resignation in protest of the board's decision).

<sup>22</sup> *Id.*

<sup>23</sup> Apparently Shire's CEO was also caught crowing about the extraordinary deal he was able to get on the Transkaryotic acquisition. *Id.*

<sup>24</sup> See Phil Milford, *Icahn's High River Sues Shire over 2005 Purchase*, BLOOMBERG (Mar. 27, 2007, 4:01 PM), [http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiHYVX9bM\\_ao](http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiHYVX9bM_ao); Robert Steyer, *Transkaryotic Gets Enough Shareholder Support*, THE STREET (July 27, 2005, 1:59 PM), <http://www.thestreet.com/story/10235094/1/transkaryotic-gets-enough-shareholder-support.html>.

<sup>25</sup> Steyer, *supra* note 24 (noting that Porter Orlin LLC and Millenco LP pledged to seek "appraisal rights for their combined holdings of 16.1%").

<sup>26</sup> *Id.*

<sup>27</sup> The assembly of large back-end positions is also necessary because appraisal statutes do not typically allow for class action litigation. See Thompson, *supra* note 9, at 41.

<sup>28</sup> To be sure, there is a contractual countermeasure that potential buyers might implement: including an appraisal condition giving them an out if, say, 15% or more of the shares seek appraisal rights. As I discuss *infra* Part III.A, this may protect buyers from incurring litigation costs, but there will still be social welfare losses if buyers abandon synergistic mergers.

thereby throwing their claims of purported price inadequacy into question.<sup>29</sup> How, then, should we unpack the effects of this problem?

This Article describes the appraisal identity puzzle, analyzes the theoretical implications for the majority–minority governance relationship, and evaluates some normative responses. There are several possible approaches, ranging from doing nothing to pervasively rewiring the systems that support equity exchange. My recommended response, however, is to use these developments as a springboard for pursuing intermediate reforms focused on modifying the procedures for perfecting appraisal rights and determining share value.

We should start by assuming that these developments have made it easier for dissenting investors, including post-record date purchasers, to pursue appraisal claims when they are dissatisfied with a buyout offer or freezeout merger pricing.<sup>30</sup> Accepting—perhaps even embracing—this wider path to appraisal, we should then add new rules that deter dissenters from launching strike suits or holding out for unreasonably high prices. Specifically, dissenting shareholders (at any stage in the merger timeline) should be required to write the controlling shareholder an embedded option, coupled with a requested fair price, in order to perfect the appraisal claim. Obviously, if the controlling shareholder is willing to raise the price to this requested amount, then the matter is finished. The embedded option would allow the controlling shareholder to *sell* new shares to the dissenter at the same price that the dissenter requested under appraisal proceedings. This would effectively require dissenters to put their money where their mouth is—allowing the pursuit of appraisal in cases where a dissenter truly believes that the price is inadequate but scaring off disingenuous claims with the possibility that the dissenter would be forced to buy at the inflated price demand. Said differently, we would make it easier to initiate claims while parsing the actual legal entitlement of appraisal more finely through the use of embedded options.<sup>31</sup>

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<sup>29</sup> Press Release, Shire plc, Shire Successfully Settles Former TKT Shareholder Appraisal Rights Litigation (Nov. 5, 2008), available at <http://www.shire.com/shireplc/uploads/press/TKTappraisalrights05Nov08.pdf>.

<sup>30</sup> I will conduct most of the analysis in this Article through the lens of freezeout merger transactions because more conventional mergers can be structured in many states to avoid triggering appraisal rights. With freezeout mergers, however, dissenting shareholders will usually have an opportunity to obtain appraisal, either during the initial transaction or during a follow-on short form merger. This is also consistent with recent empirical studies of the appraisal case law, which show how these disputes increasingly arise during freezeout transactions. *See, e.g.*, Thompson, *supra* note 9, at 9–10.

<sup>31</sup> The notion of constructing intermediate legal entitlements via embedded options or other means has received increasing attention in the legal commentary. *See, e.g.*, Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703, 743–44 (1996); Lee Anne Fennell, *Revealing Options*, 118 HARV. L. REV. 1399, 1433–44 (2005).

This proposal may seem complicated, but an example should help to illustrate. Simplify the facts of *Transkaryotic* to assume that a single 60% shareholder is conducting a freezeout merger at \$37 per share. Louis Latecomer buys a 15% block, after the record date but before the vote, and seeks appraisal. Following the precedent of the actual case, Latecomer is free to pursue appraisal (assuming at least 15% of the shares abstain or vote “no”) even though he personally votes no shares. But now, under the modified appraisal proceedings, Latecomer must name a fair price for his shares and attach an embedded option to perfect the claim. Say he chooses \$50. The controller then has a choice: (1) pay Latecomer the higher price, (2) exercise the embedded put option to *sell* Latecomer 15% of the shares at \$50, or (3) litigate. If \$50 is really a fair price, then Latecomer should have little reason to object (after all, he named the price of the option). If, on the other hand, Latecomer has overreached with an excessively high price, then he will regret buying shares at \$50. Indeed, the mere threat of the controller exercising this embedded option should deter Latecomer from mounting a strike suit in the first place. In short, this proposal draws upon relatively simple principles of mechanism design to provide a better balance between expropriation and holdout. It accepts the easier path to appraisal rights paved by *Transkaryotic* but tempers the incentives to make outrageous claims.

I have organized the Article as follows. Part I describes the appraisal remedy, focusing in particular on its interplay with modern securities voting and settlement practices. Part II dumps out the puzzle by considering the appraisal identity problem from a variety of angles, including the likely effects on majority–minority shareholder governance. Part III finishes by considering several normative solutions, including my recommended strategy of modified appraisal procedures. A brief conclusion summarizes the arguments.

## I. THE LAW OF APPRAISAL

### A. Background

Appraisal statutes<sup>32</sup> permit minority shareholders to dissent against a merger (or related fundamental change)<sup>33</sup> and receive the judicially

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<sup>32</sup> For representative statutes, see DEL. CODE ANN. tit. 8, § 262 (2010); MODEL BUS. CORP. ACT § 13.02 (2008).

<sup>33</sup> As mentioned, the availability of appraisal differs by jurisdiction. *See supra* note 9. For example, Delaware does not grant appraisal rights to minority shareholders during an asset sale. *See* DEL. CODE ANN. tit. 8, § 262. Other jurisdictions, such as those following the Model Business Corporation Act, do award these rights to shareholders of the selling firm. MODEL BUS. CORP. ACT § 13.02(a)(3). This inconsistent approach has been known to cause some deal-gaming, where merger planners try to sidestep the availability of appraisal rights through jurisdiction shopping and recharacterization of the buyer and seller. *See, e.g.,* Farris v. Glen Alden Corp., 143 A.2d 25, 27–28, 31 (Pa. 1958) (finding that the transaction was structured as a minnow-swallows-whale asset purchase of

determined fair value of their shares. The doctrine mushroomed in the early 1900s,<sup>34</sup> when state lawmakers granted appraisal rights to shareholders—apparently in exchange for an easing of merger voting requirements.<sup>35</sup> Prior to this change, a corporation was generally prohibited from consummating a fundamental transaction, like a merger, without the unanimous consent of shareholders.<sup>36</sup> This meant, of course, that any single shareholder could block the deal, and the expansion of shareholder rosters during this time period raised serious holdout problems; for example, gadfly shareholders might demand side payments before granting approval.<sup>37</sup> The legislative response was to replace unanimity with majority or supermajority voting requirements.<sup>38</sup> But this, in turn, led to concerns that majority owners could

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the Delaware firm to avoid appraisal rights for both buying and selling shareholders). The court rejected this structure under the “de facto merger” doctrine, but this doctrine was later reversed in Pennsylvania. *See Terry v. Penn Cent. Corp.*, 668 F.2d 188, 192–93 (3d Cir. 1981) (rejecting the de facto merger doctrine in light of legislative amendments to the corporation laws of Pennsylvania).

<sup>34</sup> *See* MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* § 7.1, at 75 (1976). Rudimentary appraisal rights apparently existed in Pennsylvania and Ohio as far back as the mid-1800s. *Id.*

<sup>35</sup> *E.g.*, Thompson, *supra* note 9, at 11–14 (“Appraisal statutes are often presented as having been enacted in tandem with statutes authoring consolidation or merger by less than unanimous vote.”); Barry M. Wertheimer, *The Shareholders’ Appraisal Remedy and How Courts Determine Fair Value*, 47 *DUKE L.J.* 613, 614, 619 (1998) (“The origin of the appraisal remedy typically is tied to the move in corporate law . . . away from a requirement of unanimous shareholder consent.”).

<sup>36</sup> *See* Thompson, *supra* note 9, at 11–15; Wertheimer, *supra* note 35, at 618–19. The unanimous vote requirement presented obvious holdout problems. *See* Thompson, *supra* note 9, at 12–13; *see also* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 *AM. B. FOUND. RES. J.* 69, 80–82 (“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.”). Thus, state legislatures began to replace the unanimity requirement with more modest voting hurdles in the early 1900s. *See id.* at 86–90 (describing the elimination of unanimous shareholder voting requirements for some corporate transactions). Appraisal statutes were enacted, in turn, to provide shareholders with an escape hatch from consolidation deals they considered unwise. *See* Wertheimer, *supra* note 35, at 619; *see also* Joseph L. Weiner, *Payment of Dissenting Stockholders*, 27 *COLUM. L. REV.* 547, 547–48 & n.7 (1927) (cataloging over twenty states that enacted the appraisal remedy by 1927). It is worth noting, however, that appraisal statutes were not always enacted in concert with the removal of unanimous shareholder voting requirements. *See* Wertheimer, *supra* note 35, at 619 n.29. In some cases, appraisal measures lagged the franchise amendments by ten or twenty years, Thompson, *supra* note 9, at 14–15, casting some doubt on the direct connection between these two developments. *See* Mahoney & Weinstein, *supra* note 9, at 243.

<sup>37</sup> *See* Thompson, *supra* note 9, at 12–13.

<sup>38</sup> *See* Carney, *supra* note 36, 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 . . . .”); Wertheimer, *supra* note 35, at 619. *Compare* MODEL BUS. CORP. ACT §§ 11.03(e), 12.02(e) (2008) (imposing majority rule for proposed transactions), *with* VA. CODE ANN. § 13.1-718(E) (2010) (requiring two-thirds of shareholders to vote in favor of proposed merger transactions).

trample over the interests of minority shareholders—say, by merging with firms engaged in risky or objectionable activity.<sup>39</sup>

Over the ensuing decades, appraisal rights were therefore enacted in most jurisdictions as an emergency exit from majority rule.<sup>40</sup> A merger could move forward with less-than-unanimous approvals, but minority owners had an escape if they disliked the shift in direction.

Unfortunately, most appraisal statutes were riddled with legal loopholes, and managers began to exploit these weaknesses to avoid appraisal litigation.<sup>41</sup> This, combined with a variety of complicated procedural prerequisites,<sup>42</sup> soon caused the appraisal remedy to fall out of academic favor. The most vocal critic was undoubtedly Bayless Manning, a professor at Yale Law School who launched his influential evaluation of the remedy in 1962.<sup>43</sup> Other commentators similarly derided appraisal as riddled with “substantial defects”<sup>44</sup> or a “remedy of desperation.”<sup>45</sup>

In more recent years, however, the appraisal remedy has been rehabilitated as a defense against abusive freezeout mergers by majority shareholders.<sup>46</sup> These transactions—which made the move to mainstream legitimacy in the 1950s and 1960s<sup>47</sup>—allow majority owners to merge two firms into a separate, wholly-owned company by cashing out minority shareholders and taking 100% ownership of the new entity. Assuming effective board control, it is easy to secure the necessary approvals: the

<sup>39</sup> Thompson, *supra* note 9, at 12–13.

<sup>40</sup> *Id.* at 16–17.

<sup>41</sup> One example is the use of an asset sale transaction. Though the economic result mirrors that of a statutory merger, asset sales do not trigger appraisal rights in Delaware. *See, e.g.,* Hariton v. Arco Elecs., Inc., 188 A.2d 123 (Del. 1963). Another example is the use of triangular mergers, where the acquirer conducts its merger through a shell subsidiary in order to take away buyer-side appraisal rights. *See* Terry v. Penn Cent. Corp., 668 F.2d 188 (3d Cir. 1981) (assessing this type of deal structure and concluding that the shareholders of the buying firm do not get appraisal rights because they were not entitled to vote on the merger).

<sup>42</sup> *See infra* Part I.B.

<sup>43</sup> Bayless Manning, *The Shareholder’s Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962). Manning’s criticism bites broadly, but his central concern is that firm managers can often negate appraisal rights simply by repositioning the deal as an asset sale, reverse merger, or some other form-over-substance alchemy. *Id.*

<sup>44</sup> Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 830 (1984).

<sup>45</sup> Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 85 (1969).

<sup>46</sup> Thompson, *supra* note 9. Thompson’s analysis of appraisal cases demonstrates that the focus had clearly shifted to freezeout transactions by 1995. *Id.*

<sup>47</sup> *See* Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 648 (1981). Florida first permitted freezeout mergers in the 1920s, *id.* at 632, but it was not until lawmakers revised the DGCL and the Model Business Corporation Act that these transactions became widely accepted, *see* Subramanian, *supra* note 19, at 8–9.

majority shareholder asks both boards to support the deal and, by definition, holds the equity stake needed to vote the transaction through at both firms.<sup>48</sup>

While freezeout mergers can promote efficient and desirable outcomes,<sup>49</sup> they also forge a powerful weapon for majority shareholders interested in taking advantage of minority owners.<sup>50</sup> Indeed, it should be easy to see how a greedy majority controller can underprice the deal to instantly steal value from all other owners. By analogy, I could get a pretty good deal on your car if I chose the price at which you sign over the pink slip.

Lawmakers are aware of this problem, of course, and the seminal Delaware case of *Weinberger v. UOP, Inc.* sought to mitigate the threat of abusive freezeouts with renewed appraisal rights.<sup>51</sup> Among other reforms, *Weinberger* established appraisal as a primary legal framework for checking abusive freezeouts.<sup>52</sup> It also replaced an overly formalistic and outdated judicial valuation methodology with a more flexible and realistic approach.<sup>53</sup> These reforms, perhaps combined with an increase in freezeout mergers, soon led to a new wave of appraisal proceedings.<sup>54</sup> In these cases, however, appraisal is rarely invoked as an exit strategy for minority shareholders disturbed by the firm's move into a new line of business.

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<sup>48</sup> These deals were obviously not possible in the earlier era of unanimous shareholder consent, as every minority holder retained a veto over the freezeout. Moreover, active boards have recently increased the complexity of some freezeout negotiations, as the special committees assigned to evaluate a deal will sometimes resist the transaction in an attempt to squeeze out a higher price.

<sup>49</sup> *But see* Subramanian, *supra* note 19, at 43–44 (describing how existing law may discourage efficiency and cost savings from going-private transactions and other potential synergies from related deals).

<sup>50</sup> *See id.* at 31–38.

<sup>51</sup> 457 A.2d 701 (Del. 1983).

<sup>52</sup> *Id.* at 704, 715; *see also* George S. Geis, *Internal Poison Pills*, 84 N.Y.U. L. REV. 1169, 1190–92 (2009) (“[T]he court promoted appraisal as the appropriate remedy for unhappy minority shareholders.”). Other legal tools that discourage abusive freezeouts include disclosure obligations and fiduciary duty lawsuits. *Id.* at 1180–86.

<sup>53</sup> Prior to *Weinberger*, the courts had adopted the “Delaware block” method of valuation: a weighted average of pre-merger market value, capitalized earnings value, and net asset value. *Weinberger*, 457 A.2d at 712. The rule had the advantage of relative methodological certainty but was ultimately damned with the disadvantage of awarding judgments that bore little resemblance to financial reality. *See* Geis, *supra* note 52, at 1190 n.94 (noting that the *Weinberger* change “should be welcomed as promoting accuracy through modern finance”). *Weinberger* broke apart the Delaware block with a more current legal standard, stating that courts should instead accept “any legitimate valuation methodology used by the financial community.” *Id.* at 1190 n.94 (citing *Weinberger*, 457 A.2d at 713).

<sup>54</sup> The revival of appraisal is easily demonstrated by comparing the work of Joel Seligman with that of Robert Thompson. In 1984, Professor Seligman examined the reported state cases on appraisal for the decade prior to *Weinberger*; he found just nineteen reported decisions. *See* Seligman, *supra* note 44, at 829–30 & n.3. Professor Thompson, conducting a similar empirical analysis for the post-*Weinberger* decade, discovered that the number of appraisal cases had jumped to 103. Thompson, *supra* note 9, at 25. Furthermore, over 80% of these latter cases involved freezeout mergers. *Id.* at 25–26.

Rather, it has become a governance “trump card” to counter the threat of majority expropriation via freezeout.<sup>55</sup>

### B. Mechanics

The appraisal remedy is complicated, and shareholders have to navigate a variety of hurdles to perfect their claims.<sup>56</sup> Furthermore, the rules of the game change frequently<sup>57</sup> and can differ considerably among jurisdictions.<sup>58</sup> A full comparison is beyond the scope of this Article but it is worth tracing the basic mechanics for filing a Delaware claim, governed by section 262 of the DGCL. There are two general sets of hurdles: one set relates to standing, or the availability of appraisal for a given transaction and investor. The other set of hurdles relates to affirmative duties that shareholders must take to perfect appraisal claims when they do enjoy standing. Clearing all obstacles brings the case to a judicial determination of fair value.

To obtain standing,<sup>59</sup> a petitioner must satisfy three requirements. First, the disputed transaction must qualify for appraisal (i.e., the shares are being acquired through a statutory merger, short form merger, or other covered transaction).<sup>60</sup> This inquiry is sometimes gamed; as mentioned above, firms can employ creative deal structures to avoid appraisal claims during conventional mergers.<sup>61</sup> Objecting shareholders will usually have a chance to assert appraisal, however, if they are being forced out through a freezeout merger.<sup>62</sup> Second, the petitioner must be a *record* stockholder

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<sup>55</sup> The problems related to majority expropriation are discussed further *infra* Part II.C.

<sup>56</sup> See *infra* notes 59–70 and accompanying text.

<sup>57</sup> For example, Delaware has amended its statute approximately thirty-five times. The most recent amendments include 77 Del. Laws 4 §§ 12–13 (2009), 76 Del. Laws 203 §§ 11–16 (2007), 73 Del. Laws 231 § 21 (2001), 71 Del. Laws 873 §§ 49–52 (1998), 71 Del. Laws 233 § 15 (1997), 70 Del. Laws 777 § 22 (1996), 70 Del. Laws 711 §§ 2–3 (1996), 70 Del. Laws 186 § 1 (1995), 70 Del. Laws 121 § 16 (1995), 69 Del. Laws 523 §§ 1–9 (1994), 69 Del. Laws 54–55 § 10 (1993). For a listing of twenty-three earlier amendments to the statute (since adoption in 1899), see Calio, *supra* note 16, at 13 n.46.

<sup>58</sup> Compare MODEL BUS. CORP. ACT § 13.02(a) (2008) (differing from Delaware on appraisal triggers, the timing of appraisal payment, allocation of court costs, and application of the market-out exception), with 15 PA. CONST. STAT. ANN. § 1578 (West 1995) (containing similar differences from Delaware). For a helpful analysis of the differences between the DGCL and the Model Business Corporation Act, see Mary Siegel, *An Appraisal of the Model Business Corporation Act's Appraisal Rights Provisions*, 74 LAW & CONTEMP. PROBS. 231 (2011).

<sup>59</sup> I use “standing” only to denote the availability of appraisal rights; it should not be confused with procedural or constitutional concepts of standing.

<sup>60</sup> DEL. CODE ANN. tit. 8, § 262(b) (2010).

<sup>61</sup> See *supra* notes 33, 41.

<sup>62</sup> This is true because a majority controller typically uses a freezeout merger to capture 100% ownership of the firm—either through a long-form statutory merger or through a tender offer followed by a short form merger. Appraisal is available to the dissenter in either case. For a more detailed description of the differences (both strategic and legal) between statutory merger and tender offer freezeouts, see Geis, *supra* note 52, at 1182–85; Subramanian, *supra* note 19, at 7–8.

who owns the shares when an appraisal demand is made and holds this position continuously through the effective date of the merger.<sup>63</sup> This requirement to act through a record holder has been strictly interpreted in Delaware, and some beneficial owners—who typically instruct their record holder to assert appraisal on their behalf—have even lost their appraisal rights when the record holder fails to take action.<sup>64</sup> Third, the petitioner must avoid a “market-out exception,” which revokes appraisal rights when the merger consideration consists of reasonably liquid equity securities—stock listed on a national securities exchange or held by more than 2000 record owners.<sup>65</sup> The justification here is that appraisal proceedings are a waste of time if dissenters preserve their equity position while still enjoying an exit option via public sale. Importantly, however, dissenters maintain appraisal rights in Delaware when cash is used for the merger consideration—even if the shares trade publicly prior to the transaction.<sup>66</sup>

After meeting the standing requirements, the petitioner faces a second flight of hurdles. This time she must take several affirmative steps to perfect the appraisal claim. First, the petitioner must deliver a written appraisal demand (again conducted through the record holder) to the corporation, prior to the merger vote.<sup>67</sup> The demand is a simple statement containing the stockholder’s identity and a notification that she intends to

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<sup>63</sup> § 262(a).

<sup>64</sup> See, e.g., *Bandell v. TC/GP, Inc.*, No. 247, 1995, 1996 WL 69789, at \*1 (Del. Jan. 26, 1996) (dismissing petition for appraisal filed by a beneficial owner when the record owner was not a party to the petition and beneficial owner did not present evidence establishing his status as record owner—even though the record owner had “submitted a pre-merger demand for appraisal” on behalf of the beneficial owner); *In re Enstar Corp. v. Senouf*, 535 A.2d 1351, 1355–56 (Del. 1987) (denying appraisal rights to a beneficial owner who filed a direct appraisal demand instead of working through the record holder); *Edgerly v. Hechinger*, No. C.A. 16138-NC, 1998 WL 671241, at \*3 (Del. Ch. Aug. 27, 1998) (dismissing appraisal action filed by a beneficial owner against the company where a broker filed a demand for appraisal because the broker was not the record holder and the broker failed to instruct the record holder to demand appraisal); *Tabbi v. Pollution Control Indus., Inc.*, 508 A.2d 867, 871–73 (Del. Ch. 1986) (denying appraisal rights to persons who were not record shareholders on the merger date). This strict approach is apparently justified as providing greater certainty and fairness for the firm managers. A recent case, however, throws some uncertainty on the Delaware Chancery Court’s willingness to adhere to a literal reading of this requirement. See *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010) (looking through the record holder to the actions of lower intermediaries in a non-appraisal context). On appeal, the Delaware Supreme Court reversed in part and labeled this part of the opinion as dicta without precedential effect. See *Crown EMAC Partners v. Kurz*, 992 A.2d 377, 398 (Del. 2010). The Model Business Corporations Act is less formal, allowing beneficial owners to seek appraisal rights without the consent of a record owner. MODEL BUS. CORP. ACT § 13.03 (2008).

<sup>65</sup> DEL. CODE ANN. tit. 8, § 262(b)(1).

<sup>66</sup> *Id.* § 262(b)(2).

<sup>67</sup> *Id.* § 262(d)(1). Again, only a record holder may pursue appraisal rights. *Id.* The exact mechanics are slightly more complicated. If the transaction qualifies for appraisal rights, then the firm must notify shareholders of appraisal rights at least twenty days prior to the shareholders’ meeting. *Id.* Dissenting stockholders must then deliver their appraisal demand to the firm prior to the vote on the merger. *Id.*

pursue appraisal for a given number of shares.<sup>68</sup> This may seem like a bureaucratic formality, but it is an independent requirement: a proxy or vote against the merger will not satisfy the written demand requirement.<sup>69</sup> Second, the petitioner must vote against the merger or abstain from the vote.<sup>70</sup> Finally, she must file a petition requesting appraisal proceedings with the Delaware Chancery Court within 120 days of the effective merger date.<sup>71</sup> Importantly, each dissenting shareholder must file her own lawsuit in Delaware; there are no provisions that automatically require litigants to share legal expenses via class action proceedings.<sup>72</sup>

If every requirement is satisfied, the lawsuit can proceed, and a court will determine and award the fair value of the stock to the dissenter. Each side submits a valuation and bears the burden of proving claims by a preponderance of the evidence.<sup>73</sup> If no one meets this burden, as is commonly the case, the court will step in and use its own judgment to determine fair value.<sup>74</sup> Unfortunately for the petitioners, it is possible for courts to award a *lower* price for the stock than the merger consideration provided.<sup>75</sup> Also, time is rarely on the petitioner's side: it can take years to determine the fair value of disputed stock.<sup>76</sup> During this period the dissenter may not close out her position, receives no dividends, and forfeits subsequent capital gains,<sup>77</sup> though a recent amendment does award the

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<sup>68</sup> *Id.*

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* § 262(a). It is also worth noting that this requirement is a central factor in the identity puzzle discussed in this Article. As described *infra* Part II.A, it can often be difficult to determine how a previous owner voted when shares are purchased after the record date but prior to the merger vote. For all practical purposes, however, a petitioner may be able to sidestep this unfavorable voting requirement much of the time under the recent *Transkaryotic* precedent. See *supra* notes 12–17 and accompanying text.

<sup>71</sup> § 262(e). A dissenting shareholder is also free, however, to change her mind and accept the merger terms as long as she does so within sixty days of the effective merger date. *Id.*

<sup>72</sup> *Id.*; see also *id.* § 262(j) (providing that any shareholder *may* specifically request a judicial order to share appraisal expenses among all shareholders who opted into a proceeding).

<sup>73</sup> See, e.g., *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513, 520 (Del. 1999).

<sup>74</sup> There are many examples of judicial adjustments to appraisal valuation models. See, e.g., *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 498–99 (Del. Ch. 2010); *Cede & Co. v. Technicolor, Inc.*, Civ. A. No. 7129, 1990 WL 161084, at \*8 (Del. Ch. Oct. 19, 1990).

<sup>75</sup> See *Berger v. Pubco Corp.*, 976 A.2d 132, 141–42 (Del. 2009); *Gilliland v. Motorola, Inc.*, 873 A.2d 305, 309 (Del. Ch. 2005).

<sup>76</sup> See, e.g., Jesse A. Finkelstein & Russell C. Silberglied, *Technicolor IV: Appraisal Valuation in a Two-Step Merger*, 52 BUS. LAW. 801 (1997) (describing the long saga of appraisal litigation prompted by the acquisition of Technicolor).

<sup>77</sup> Delaware does have a limited sharing rule that allows dissenters to claim “elements of future value . . . known or susceptible of proof as of the date of the merger and not the product of speculation.” See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983). To this extent, private information available at the merger date but not yet translating into price gains may be included in recovery models. This rule has, however, faced some criticism from commentators. See, e.g., Lawrence A. Hamermesh &

petitioner meaningful interest payments on any ultimate judgment.<sup>78</sup> Perhaps worse than this long path to judgment, however, is the unpredictable and costly battle of the experts, typically modified by some judicial tinkering, that forms the basis for the ultimate fair price valuation.<sup>79</sup>

### C. *Quasi-Appraisal*

Before turning to the identity puzzle, it is helpful to discuss one last riff on the appraisal theme. As mentioned above, appraisal serves as the primary legal countermeasure to abusive freezeout mergers.<sup>80</sup> Indeed, in a short form merger—where minority holders can be cashed out without a vote if the controller owns at least 90% of the firm<sup>81</sup>—Delaware courts have recently stated that appraisal is the *exclusive* remedy for disgruntled shareholders.<sup>82</sup> But this assumes that the firm does not engage in fraud or illegality and that the firm discloses the facts necessary for a dissenter to decide whether to accept the deal or to seek appraisal.<sup>83</sup> What happens if the controller lies or leaves out important information related to the deal or the firm’s economic prospects? It is difficult to unscramble the eggs here, because, under the DGCL, a short form merger becomes effective *before* any disclosures are made to minority shareholders.<sup>84</sup>

The judicial response has been to craft something called “quasi-appraisal”: a legal valuation process that<sup>85</sup> attempts to “mirror as best as possible the statutory appraisal remedy”<sup>86</sup> when minority holders are hindered from exercising their traditional rights.<sup>87</sup> Yet working out the

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Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. CORP. L. 119 (2005).

<sup>78</sup> Historically, interest payments on appraisal judgments were messy, with petitioners sometimes receiving only simple interest. See Thompson, *supra* note 9, at 42 & n.182. In 2007, however, the Delaware statute was modified to pay the Federal Reserve Discount Rate plus 5%, compounded quarterly, for the period running from the date of the merger through the payment of the judgment (though the court reserves the discretion to use a different rate). See 76 Del. Laws 203 § 14 (2007) (codified as amended at DEL. CODE ANN. tit. 8, § 262(h) (2010)).

<sup>79</sup> See, e.g., Finkelstein & Silberglied, *supra* note 76 (illustrating both the challenges of performing appraisal valuation and the judicial judgment required to assess competing claims in a notorious appraisal saga). In this context, one additional benefit of my proposed revisions to the appraisal process might be faster and more certain relief for meritorious claims. See *infra* Part III.C.

<sup>80</sup> See *supra* note 52 and accompanying text.

<sup>81</sup> See DEL. CODE ANN. tit. 8, § 253 (describing short form mergers).

<sup>82</sup> See *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 248 (Del. 2001).

<sup>83</sup> *Id.*

<sup>84</sup> See § 253; *Berger v. Pubco Corp.*, 976 A.2d 132, 134–35 (Del. 2009) (providing the requirements of the “short form merger statute” under section 253 of the DGCL).

<sup>85</sup> See *Gilliland v. Motorola, Inc.*, 873 A.2d 305, 311 (Del. Ch. 2005) (describing the origins of quasi-appraisal).

<sup>86</sup> *Berger*, 976 A.2d at 137.

<sup>87</sup> *Gilliland*, 873 A.2d at 311.

details of quasi-appraisal has proved tricky.<sup>88</sup> Obviously, if there has been fraud or a nondisclosure problem with the short form merger materials, then the firm should be required to correct this deficiency. And the actual litigants will have their usual battle of the experts to determine whether the freezeout price was fair. But should all minority shareholders be eligible for a judgment if the consideration is indeed found wanting, or should the remedy be available only to those who opt in to a lawsuit? And should the dissenters be required to repay the firm (perhaps even placing some of the already-paid funds from the freezeout into escrow during litigation) if the court's determination of fair value falls below the deal price? After all, in a normal appraisal proceeding, petitioners do face the risk of receiving less than the merger consideration.<sup>89</sup>

In the recent case of *Berger v. Pubco Corp.*,<sup>90</sup> the Delaware Supreme Court wrestled with these exact issues. Citing “considerations of utility and fairness,”<sup>91</sup> the court held that all minority shareholders would automatically become members of a class that was eligible to receive any resulting increase in price through quasi-appraisal.<sup>92</sup> Furthermore, the minority holders were not obligated to escrow any portion of the merger consideration.<sup>93</sup> The upshot of this decision, then, is that the quasi-appraisal road looks much smoother than the appraisal road—and the litigation risk accompanying short form mergers has likely increased.<sup>94</sup> But because the quasi-appraisal door opens only through fraud or faulty disclosures, the real effect is likely to be longer and more complete information releases at the time of the freezeout.

For our purposes, however, quasi-appraisal is interesting for a different reason. In *Berger*, the Delaware Supreme Court recognized the practical need to toss out the formal requirement that beneficial shareholders act through the record owners:

[T]he court will not require beneficial or “street name” owners to “demand”

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<sup>88</sup> See *Berger*, 976 A.2d 132.

<sup>89</sup> *Gilliland*, 873 A.2d at 309. This is true because some courts may ultimately determine that the fair value of the stock is less than the merger consideration. If so, a petitioner will receive this lower amount (adjusted for interest) and cannot take the earlier deal that was offered. Other minority shareholders who simply cashed their checks and did not pursue an appraisal claim are, of course, unaffected by this subsequent judicial determination of a lower fair price for the stock.

<sup>90</sup> 976 A.2d 132.

<sup>91</sup> *Id.* at 142.

<sup>92</sup> *Id.* at 143.

<sup>93</sup> *Id.* at 144. This decision reversed the earlier *Gilliland* case, which required that minority shareholders both opt in and establish an escrow account replicating the traditional appraisal requirements. See *Gilliland*, 873 A.2d at 313.

<sup>94</sup> This is true because an automatic class plus no escrow requirements make it much easier for plaintiffs to gain the scale needed to pursue the claim. Recall that normal appraisal proceedings do not typically allow for class action proceedings; rather, a qualifying shareholder must take affirmative action to join a demand suit. See DEL. CODE ANN. tit. 8, § 262(d)–(e).

quasi-appraisal through their record holder. The court is concerned that, given the substantial passage of time since the merger, it would be difficult for stockholders to secure the cooperation of the former record holders or nominees needed to perfect demand in accordance with the statute. Instead, stockholders seeking [quasi-appraisal] will need to provide only proof of beneficial ownership of [their] shares on the merger date.<sup>95</sup>

This is an intriguing approach, especially given Delaware's strict view on the need for shareholders to act through a record holder during traditional appraisal proceedings. It also hints at the difficulties involved in reconciling anachronistic appraisal laws with the realities of modern securities exchange. To understand these complexities, we must now trace two important developments in the financial markets.

#### D. Developments

First, settlement and clearing procedures for stock trades have become much more complex—to the point where some parts of the appraisal remedy make little sense. Second, temporal delays are leading to a decoupling of vested franchise rights and economic ownership—a phenomenon that has been called “empty voting” in the corporate law literature.<sup>96</sup> Taken together, these events, along with the recent Delaware holding in *Transkaryotic*, have opened the door to a significant amplification of appraisal economics.

1. *Modern Stock Settlement and Clearing Procedures.*—When lawmakers first enacted appraisal rights a hundred years ago, investors lived in a paper world. Numbered stock certificates were typically passed from buyer to seller like the deed to a house or title to a car.<sup>97</sup> This soon raised a problem, however, because shares of IBM and other large companies trade hands much more frequently than old Cutlass Supremes.<sup>98</sup> Starting in the 1960s, the system began to buckle under the immense volume of stock trading on the NYSE and other exchanges.<sup>99</sup> It got so bad that, for a time, the markets were closed every Wednesday so the unruly piles of certificates could be inspected for authenticity, organized, and forwarded to the correct owners.<sup>100</sup>

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<sup>95</sup> *Berger*, 976 A.2d at 141 (second alteration in original) (quoting *Gilliland*, 873 A.2d at 313).

<sup>96</sup> See *infra* note 116 and accompanying text.

<sup>97</sup> See WILLIAM T. DENTZER, JR., *THE DEPOSITORY TRUST COMPANY: DTC'S FORMATIVE YEARS AND CREATION OF THE DEPOSITORY TRUST & CLEARING CORPORATION (DTCC)* 1–2 (2008) (noting the problems caused by the “paperwork crisis”); Kahan & Rock, *supra* note 5, at 1237 & n.48 (same).

<sup>98</sup> See DENTZER, *supra* note 97, at 1–6.

<sup>99</sup> *Id.* at 1; Kahan & Rock, *supra* note 5, at 1237 n.48.

<sup>100</sup> See DENTZER, *supra* note 97, at 1; *History of New York Stock Exchange Holidays*, NYSE.COM, <http://www.nyse.com/pdfs/closings.pdf> (Jan. 2011) (describing periodic closings due to “back office work load” and Wednesday closings from June to December of 1968).

This would not do, and eventually traders settled on a fix. A central entity was set up to replace the network of messengers scurrying across the back alleys of Wall Street with stock certificates and cashier's checks.<sup>101</sup> This entity, the Depository Trust Company (DTC), began to serve as record owner for a huge majority of the shares.<sup>102</sup> Certificates were physically housed in DTC warehouses, and the name on the shares no longer changed with every sale: the DTC took record ownership in the nominee name, Cede & Co.<sup>103</sup> Instead of physically transferring stock certificates, the clearinghouse simply transferred beneficial ownership from seller to buyer, electronically, through bookkeeping changes.<sup>104</sup> Economically, everything seemed the same: beneficial owners continued to receive information on their holdings and could exercise shareholder rights either through their broker or through the DTC.<sup>105</sup> This setup was a kludge, but it worked. The DTC and its affiliated entities now settle and clear more than \$1.86 quadrillion in securities transactions and payments each year.<sup>106</sup>

This transformation of back-office exchange procedures, however, has also altered some fundamental features of corporate governance in a way that is only beginning to receive sustained attention.<sup>107</sup> It is now much harder, for example, to match most buyers and sellers to specifically identifiable certificates. Indeed, the DTC often does not even try: it holds most of its stock as unidentified "fungible bulk."<sup>108</sup> When I buy, say, 100 shares of Apple Computer, the DTC simply works with broker-dealers to debit and credit the right accounts. But it is meaningless to say that my shares were purchased from a specific seller when the average daily volume of Apple stock exceeds 33 million shares.

In most cases, this doesn't really matter. Who cares if my shares of Apple came from Steve Jobs or Bill Gates? Yet, as I will explain, this use of central record holders and anonymous exchange is partially responsible for rendering a key procedural requirement of appraisal statutes

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<sup>101</sup> DENTZER, *supra* note 97, at 11–16 (describing the formation of this central depository).

<sup>102</sup> *Id.* at 13. For public firms, approximately 70%–80% of shares are now held through the DTC and other nominees. Exchange Act Release No. 34,384, 06 SEC Docket 231, at 232 n.5 (Mar. 14, 1997).

<sup>103</sup> DENTZER, *supra* note 97, at 12.

<sup>104</sup> *Id.* at 13. This is a slight simplification, as there may be several layers of custodians between the DTC and the economic owner. See Kahan & Rock, *supra* note 5, at 1238–40. For excellent resources on the complicated plumbing that supports the settlement and clearing process, or the back-office exchange of securities following a sale, see generally VIRGINIA B. MORRIS & STUART Z. GOLDSTEIN, GUIDE TO CLEARANCE & SETTLEMENT: AN INTRODUCTION TO DTCC (2009); DAVID M. WEISS, AFTER THE TRADE IS MADE: PROCESSING SECURITIES TRANSACTIONS (2d rev. ed. 2006).

<sup>105</sup> See Kahan & Rock, *supra* note 5, at 1238–40.

<sup>106</sup> DENTZER, *supra* note 97, at x.

<sup>107</sup> See, e.g., Kahan & Rock, *supra* note 5, at 1248–49. For additional details on the series of complex corporate "voting pathologies" brought on by modern trading practices, see *id.* at 1248–70.

<sup>108</sup> *Id.* at 1239–40.

incoherent.<sup>109</sup> But first, consider another problem: how should firms assign and freeze voting rights in an ever-churning river of stock trades?

2. *Temporal Decoupling of Franchise Rights from Economic Interest.*—Our mental model of corporate governance envisions a steady body of shareholders who receive statements outlining the key issues on a forthcoming ballot, muster the information necessary to make sound decisions, and eventually cast their votes by proxy cards or at a shareholders' meeting.<sup>110</sup> In actuality, however, we do not live in such a stable world. Think back to Apple Computer. With roughly 15 million shares trading hands on the average day,<sup>111</sup> how can we ever freeze events long enough to send the ballot, deliberate, and cast votes? Time presses forward, and the linking of corporate voting rights to shares of stock raises administrative concerns different from those presented by our relatively stable political franchise of one person, one vote.<sup>112</sup>

The typical solution is to set a bright-line record date, at which time franchise rights attach to current owners even if they sell the shares before the day of the actual vote.<sup>113</sup> This gives a firm time to send out the ballots, distribute key data, and collect the votes. The same “snapshot” approach is taken with dividends: shareholders enjoy the right to receive payments and the shares trade ex-dividend long before checks are ever cut.<sup>114</sup> This system

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<sup>109</sup> See *infra* Part II.A.

<sup>110</sup> See generally STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* (2008) (describing the intricacies of corporate governance); JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* (2008) (detailing the fundamentals of corporate governance as an institution and suggesting the most effective mechanisms for corporate management).

<sup>111</sup> See, e.g., Edward Krudy, *Apple Shares Briefly Slump as Volume Spikes*, REUTERS (Feb. 10, 2011, 6:38 PM), <http://www.reuters.com/article/2011/02/10/us-apple-stock-drop-idUSTRE7196UG20110210>.

<sup>112</sup> However, notorious balloting scandals suggest that, even in politics, voting may not always be so simple. See, e.g., David Greenberg, *Was Nixon Robbed?*, SLATE (Oct. 16, 2000, 9:30 PM), [http://www.slate.com/articles/news\\_and\\_politics/history\\_lesson/2000/10/was\\_nixon\\_robbed.single.html](http://www.slate.com/articles/news_and_politics/history_lesson/2000/10/was_nixon_robbed.single.html) (describing the nasty fights surrounding the 1960 presidential election).

<sup>113</sup> The DGCL is illustrative. Under section 213(a), a record date not “more than 60 nor less than 10 days before the date of such meeting” establishes the roster of eligible voters. DEL. CODE ANN. tit. 8, § 213(a) (2010). There is some dispute over the extent to which an after-record-date purchaser may claw back the right to vote on the transaction by securing an irrevocable proxy from the selling shareholder in addition to economic ownership. To the extent that such vote clawbacks are available, this would suggest that the appraisal puzzle might be solved—at least clumsily—by requiring dissenting shareholders to secure these irrevocable proxies. It does not seem, however, that these clawbacks are common or easy to administer, and Delaware rejected such a solution (at least implicitly) in the *Transkaryotic* decision. See *In re Appraisal of Transkaryotic Therapies, Inc.*, No. Civ.A. 1554-CC, 2007 WL 1378345 (Del. Ch. May 2, 2007).

<sup>114</sup> See, e.g., RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, *PRINCIPLES OF CORPORATE FINANCE* 392–402 (10th ed. 2011).

seems to work fine for economic matters, as share prices simply drop to reflect the severance of a dividend from the stock.<sup>115</sup>

But delays between the vesting of voting rights on the record date and the time of the actual vote at the shareholders' meeting can introduce intractable complications for firms with rapid share turnover. A series of articles by Bernard Black and Henry Hu coins the term "empty voting" for situations where an actor retains franchise rights without economic interest.<sup>116</sup> When combined with the centralized settlement framework described above, empty voting throws a monkey wrench into appraisal statutes.<sup>117</sup> The easiest way to understand how significantly these developments confound appraisal is to return to *Transkaryotic*.

## II. DUMPING OUT THE IDENTITY PUZZLE

### A. Transkaryotic

The question in *Transkaryotic* can be stated simply: should we allow investors who purchase shares without a vote on the merger, because the record date has passed, to receive appraisal rights even though they did not personally comply with Delaware's procedural requirement to abstain or vote against the deal?<sup>118</sup> It should be clear by now that this problem arises only because of the confluence of modern settlement practices and the temporal decoupling of franchise rights from economic ownership. If, counterfactually, all shares were identified and tracked through a unique serial number, then it would be easy to look back at how each specifically identified share was actually voted to determine whether it was eligible for appraisal. In such a world, the *Transkaryotic* problem would not exist, even

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<sup>115</sup> *Id.*

<sup>116</sup> *E.g.*, Henry T.C. Hu & Bernard Black, *Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership*, 13 J. CORP. FIN. 343 (2007) [hereinafter Hu & Black, *Hedge Funds*]; Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2006) [hereinafter Hu & Black, *The New Vote Buying*]. The authors explore a variety of concerns related to empty voting and corporate governance, most of which are beyond the scope of this article. It is also important to note that empty voting can arise through other means as well, such as when shareholders use derivatives to hedge away the economic effects of ownership while retaining the franchise. *See, e.g.*, Shaun Martin & Frank Partnoy, *Encumbered Shares*, 2005 U. ILL. L. REV. 775.

<sup>117</sup> Hu and Black do briefly mention *Transkaryotic* in one of their articles—describing the possibility of hedging out economic ownership while maintaining an "empty appraisal" claim. *See* Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 723–24 (2008). Unlike Hu and Black, my analysis focuses on the impact of amplified appraisal claims through loosened voting requirements—and not on the possibility that economic ownership might also be hedged out while retaining appraisal rights. Of course, this phenomenon would also be curtailed by my modified appraisal proposal, as even an empty economic owner would face reduced incentives (through the embedded option requirement) to insist on outrageous appraisal terms. *See infra* Part III.C.

<sup>118</sup> This unfavorable voting requirement is discussed *supra* note 70 and accompanying text.

with our system of delayed franchise. Likewise, if there were no need to delay the vote—perhaps because of some technological advance allowing shareholders to instantaneously receive information and vote shares—then it would not matter that the DTC holds physical shares in fungible bulk. Like the quasi-appraisal proceedings discussed above,<sup>119</sup> beneficial shareholders could simply state how they *actually* voted on the merger.<sup>120</sup> The problem of linking a voting record to a generalized pool of shares only arises, then, with both of the developments described above.

Recall that the chancery court’s response in *Transkaryotic* was simply to look past the problem and concentrate on the record holder, Cede.<sup>121</sup> As long as enough shares qualify for appraisal—because Cede does not vote these shares for the deal—then appraisal claims can go forward by beneficial owners who, not having personally instructed Cede on the vote, otherwise comply with the legal requirements.<sup>122</sup> This solution is clearly consistent with the formal language of the statute.<sup>123</sup> It is also simple, practical, and in harmony with Delaware’s past focus on the record holder as exclusive agent for asserting appraisal claims.<sup>124</sup> But it raises the stakes of litigation significantly and opens the door to amplified appraisal claims. This development should also make us pause to ask whether there may be some better way to meet the underlying goal of managing governance tensions between majority and minority shareholders.

### B. Amplified Appraisal Claims

Imagine that you manage a hedge fund or a university endowment. Your coffers are dwindling, and you need a good way to eke out decent returns in these choppy economic times. Does anything suggest itself in light of *Transkaryotic*? One emerging possibility is to mount what I will call an “amplified appraisal strategy” to squeeze money from freezeout, or perhaps even conventional, mergers.

Here is how the game is played. You instruct your loyal staff to keep abreast of merger or takeover announcements related to Delaware firms (and possibly elsewhere if you think other jurisdictions will follow suit). Then, you monitor the buzz on each deal. If a transaction is awful, such

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<sup>119</sup> See *supra* Part I.C.

<sup>120</sup> Instantaneous voting would raise a different problem under Delaware appraisal law, however, as the statute requires a firm to notify shareholders of their right to pursue appraisal at least twenty days prior to the actual merger vote. DEL. CODE ANN. tit. 8, § 262. Stated differently, instantaneous voting makes little sense because shareholders need time to process and to evaluate the information related to the proposed transaction.

<sup>121</sup> *In re* Appraisal of Transkaryotic Therapies, Inc., No. Civ.A. 1554-CC, 2007 WL 1378345, at \*3–4 (Del. Ch. May 2, 2007).

<sup>122</sup> *Id.*

<sup>123</sup> Recall that section 262 of the DGCL focuses only on the record holder, without any mention of beneficial owners. § 262.

<sup>124</sup> See *supra* note 64 and accompanying text.

that a majority of shareholders will likely vote it down, you may as well put that deal aside. It does you no good, because appraisal rights will only attach if the merger goes through.<sup>125</sup> This is why freezeout mergers are attractive, as the probability of approval is great. Yet, perhaps ironically, you also want to avoid transactions that are highly attractive and likely to merit an overwhelmingly positive vote. There may not be enough shares to piggyback on down the road because every ‘yes’ vote negates appraisal rights.<sup>126</sup>

The fun starts, then, when you find a deal in that sweet middle ground between pessimism and popularity. Your hand is also stronger when you can reasonably claim that the merger undervalues the target: it is more difficult to argue inadequacy if a buyout offer doubles or triples recent share prices.<sup>127</sup> The next step is to assemble a meaningful minority position in the target firm, any time before the date of the shareholders’ meeting, to threaten an amplified appraisal claim. If, for example, you expect shareholders of a target firm to collectively vote 70% of the shares for the merger, then you can certainly buy 5%–10% of the stock and raise the threat of an appraisal claim. The firm may just pay you off to avoid the expense and the bad press of a sustained appraisal campaign. If not, then you still have enough of an economic position to make the appraisal suit plausible. In short, you have magnified your legal claim by buying into an appraisal class *ex post*, after voting rights are lost.<sup>128</sup>

In this manner, *Transkaryotic* finesses a key historical limitation of appraisal statutes. As described earlier, these rights were often unappealing because dissenting shareholders could not mount a class action lawsuit; each plaintiff had to finance the costs of litigation.<sup>129</sup> Unless the dissenter held a sizeable block of shares—or a majority owner was trying to cram down a particularly odorous deal—this effort was not worth it.<sup>130</sup> Now, however, strategic investors can buy shares up to the last minute without worrying about how to link specific stock to a negative vote by the sellers

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<sup>125</sup> § 262.

<sup>126</sup> *Id.* Due to voter apathy, however, this is unlikely to present much of a practical problem. Even in high-profile merger transactions, a sizeable percentage of shares are never voted. See *supra* note 110. Because the DGCL does not require the shares to be voted “no” to perfect appraisal—only that they not be voted “yes”—there is almost always a meaningful pool of qualified shares for appraisal speculators to draw upon. See *supra* note 70 and accompanying text.

<sup>127</sup> It is possible, however, that with a host of valuation methodologies, accommodating Delaware case law, and eager expert witnesses, an aggressive plaintiff may have room to argue for more. After all, if we put aside a “winner’s curse” theory and do not assume that acquirers tend to overpay, acquiring firms may frequently attempt to leave some room for profits from the deal.

<sup>128</sup> Moreover, with willing credit markets, it may be possible to buy these shares with heavy debt financing—a leveraged, amplified appraisal play, if you will.

<sup>129</sup> See *supra* note 72 and accompanying text.

<sup>130</sup> This is probably why early fears that appraisal rights would lead to strike suits did not seem to materialize. See, e.g., Manning, *supra* note 43, at 238 (warning that appraisal rights might cause minority shareholders to pursue false litigation).

retaining approval rights on the merger.<sup>131</sup> This development may not help the selling shareholders much, unless the possibility of an amplified appraisal upside is reflected in *their* sale price.<sup>132</sup> But it could fundamentally change the nature of appraisal from a weak protection for preexisting shareholders to a “live play” for post-announcement investors.<sup>133</sup> Any well-capitalized actor might now put enough skin in the game to make the costs of an appraisal claim, or the threat of incurring these costs if the firm will not accede to “greenmail,”<sup>134</sup> plausible.

Indeed, the appraisal puzzle may become amplified in an additional sense. The strategy is not that hard to comprehend. What happens if multiple groups of appraisal investors put in parallel claims, each seizing upon the same qualified shares of Cede to support their position? Imagine, for example, that a popular merger eventually receives a 90% approval vote.<sup>135</sup> Zero shares vote against the merger, and the other 10% of shares are simply not voted. Suppose also that, following common practice, half of the target shareholders sell their stock “on the news”—after the record date but before the shareholders’ meeting.<sup>136</sup> It is entirely possible that five different appraisal investors might each buy 10% of the stock, claiming it was “their” 10% that went unvoted by Cede. How could a Delaware court possibly deal with this? Certainly half of the shares cannot be eligible for

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<sup>131</sup> This is a meaningful change because the record date is often set many weeks prior to the actual vote, and new information will often emerge between the record date and the shareholders’ meeting. The emerging facts of *Transkaryotic* and the subsequent actions of Carl Icahn are a perfect example of this possibility. See *supra* notes 21–27 and accompanying text.

<sup>132</sup> This becomes a distinct possibility if multiple parties decide to pursue an amplified appraisal strategy and the share price is bid up to reflect the possibility of a higher appraisal valuation. This relates to the idea of amplified appraisal as a back-end check on the market for corporate control, discussed *infra* Part III.A. But the market’s tendency to incorporate information into prices as soon as possible means that the listing price may jump quickly to reflect future purchases used to amplify appraisal.

<sup>133</sup> To be sure, the acquiring firm may protect against this possibility by conditioning the merger agreement on receiving less than a certain percentage of appraisal claims. It is easy to write a contract granting the acquiring party an out if, say, more than 5% or 10% of shareholders seek appraisal rights. See Mahoney & Weinstein, *supra* note 9, at 242. These clauses were common historically, but seem to have died out in recent years. See *M&A Deal Commentary: Appraisal Arbitrage: Will It Become a New Hedge Fund Strategy?*, LATHAM & WATKINS (May 2007), [http://www.lw.com/upload/pubContent/\\_pdf/pub1883\\_1.pdf](http://www.lw.com/upload/pubContent/_pdf/pub1883_1.pdf).

<sup>134</sup> Greenmail is the repurchase of a private block of shares from a gadfly investor by the company for a premium over current prices. It is not a terribly effective entrenchment strategy (because another investor might reassemble an ownership toehold), but was deemed legally permissible in the well-known Delaware case of *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964).

<sup>135</sup> Such an overwhelming voter turnout is fantasy in today’s age of rational voter apathy, and it is unlikely that even the most popular mergers would garner such approval. This is especially true under the example’s assumption that many shareholders sell on the news—only the most dedicated corporate governance pundit will bother to cast votes for a merger of a firm she no longer owns.

<sup>136</sup> Shareholders frequently sell their stock to arbitrageurs after a merger is announced but before it is consummated. It is possible, of course, that they might sell prior to the record date—thus also transferring the vote—but this is less interesting for our purposes.

appraisal when the merger was approved by 90% of the stock. But no petition can be dismissed. The framework established by *Transkaryotic* makes each claim individually colorable, but collectively asinine.<sup>137</sup> Should the court invalidate all appraisal claims? Prorate them among the petitioners? Make Cede figure it out and deal with the consequences? There is no principled way to proceed.

The key question, of course, is whether amplified appraisal claims would, on balance, improve or distort the governance relationship between majority and minority shareholders. As is often the case, there are competing theoretical arguments.

### C. Reorienting the Majority–Minority Shareholder Relationship

Majority shareholders have many strategies for fleecing minority owners. They might, for example, exert influence over the board of directors to receive a plum management position or to secure favorable terms on a supply contract.<sup>138</sup> Or they might sell a block of shares to a third party at a price above prevailing market value to capitalize the future benefits of control.<sup>139</sup> But the most potent way for a majority owner to expropriate value is simply to conduct a freezeout merger and take 100% ownership of the firm.<sup>140</sup> Because the majority shareholder chooses the buyout price, every dollar below fair value flows directly from the minority owners' ledgers to that of the controlling shareholder. Without adequate regulatory safeguards, the controller also has power over the timing of the offer, essentially enjoying a perpetual call option on the entire firm.

For this reason, an 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.<sup>141</sup> A possible response, of course, is simply to splinter the majority ownership position into smaller holdings, thereby dissipating the risk of abusive freezeouts and driving up the total

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<sup>137</sup> The problem was only avoided in *Transkaryotic* because the collective demand for appraisal rights was still less than the eligible shares held by Cede (12 million shares versus 17 million shares). But the respondents astutely recognized this potential oversubscription problem and used it to argue against the court's ultimate decision to allow appraisal. Opening Brief in Support of Respondent's Motion for Partial Summary Judgment, *supra* note 4, at 1–2.

<sup>138</sup> See Ronald J. Gilson & Jeffrey N. Gordon, *Doctrines and Markets: Controlling Controlling Shareholders*, 152 U. PA. L. REV. 785, 787–88 (2003).

<sup>139</sup> See, e.g., *Zetlin v. Hanson Holdings, Inc.*, 397 N.E.2d 387, 388 (N.Y. 1979) (“[I]t has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price . . .”).

<sup>140</sup> See Gilson & Gordon, *supra* note 138.

<sup>141</sup> See, e.g., Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 880.

market capitalization of the firm. But this is a ham-fisted solution, especially because concentrated ownership may be quite beneficial—in some contexts—as a strategy for checking the agency cost problem between owners and managers.<sup>142</sup> Consequently, corporate law might play a meaningful role in enhancing firm value by policing freezeout mergers in a more nuanced and creative manner.

One legal approach is simply to prevent or limit a controlling shareholder's ability to conduct freezeout mergers. This was the strategy taken in Delaware for a short period of time: from 1977 to 1983, the court required majority owners to demonstrate that a freezeout merger would serve a "valid business purpose."<sup>143</sup> In other words, naked plots to take over the firm were forbidden. Yet this sort of standard is exceptionally difficult to administer, and the business purpose rule was quite sensibly abandoned<sup>144</sup> as it became clear that managers and their hired experts could easily fabricate *some* business purpose for the deal if that is what the law required.<sup>145</sup>

A second legal approach could require unanimous shareholder approval for freezeout mergers. After all, why should the majority controller have the right to set the price at which a minority owner must sell *his* property? But assigning this much power to minority shareholders can lead to a holdout problem whereby recalcitrant dissenters demand private tribute before blessing the merger. Not all freezeout transactions amount to legally sanctioned theft. It is important to recognize that there are

<sup>142</sup> This is discussed in the blockholder literature, which shows how a controlling shareholder can mitigate free-rider effects that undermine the monitoring of management. Simply stated, large owners will have greater incentives to prevent bad managerial decisions, and all shareholders can benefit from this vigilance. See, e.g., Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445 (1991).

<sup>143</sup> See *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032, 1037 (Del. 1979); *Tanzer v. Int'l Gen. Indus., Inc.*, 379 A.2d 1121, 1124–25 (Del. 1977); *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977).

<sup>144</sup> *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983) ("In view of the fairness test which has long been applicable to parent-subsidary mergers, the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any additional meaningful protection is afforded minority shareholders by the business purpose requirement . . . ." (citation omitted)).

<sup>145</sup> One simple possibility that comes to mind is that a going-private freezeout might allow firms to save the costs of making the ongoing disclosures required of public companies under federal securities laws. Or perhaps the transaction would "smooth governance tensions" and allow business decisions to be reached more efficiently. Humans are quite adept at offering a business justification for their decisions when this will benefit their personal accounts. This can be seen in another context by examining the legal requirements for expense reimbursements in corporate proxy contests: when the law requires competing slates of directors to invoke matters of policy (rather than just matters of personality) before personal reimbursement is permitted, these parties have an uncanny ability to justify their board aspirations in terms of business disputes. See, e.g., *Rosenfeld v. Fairchild Engine & Airplane Corp.*, 128 N.E.2d 291 (N.Y. 1955).

legitimate reasons to conduct these deals,<sup>146</sup> and excessive minority blocking power via an express veto may destroy social welfare by obstructing efficient results.<sup>147</sup> Furthermore, this prompts the question of what a shareholder's property rights in the stock really entail; one could make the case that elimination of the unanimous voting requirement for mergers in the early 1900s<sup>148</sup> should be understood as an important qualification to shareholder property rights.<sup>149</sup> In other words, investors buy shares subject to a wide variety of governance constraints, one of which is that mergers can be implemented by majority rule. Of course, this does not mean that such a framework must be frozen in time. Rather, the real question is what set of legal rules will foster the best outcomes.

The dilemma is plain. Overly permissive freezeout policies create a clear risk that majority owners will steal from the minority. But solving this problem through unanimous voting requirements only spawns a new risk that minority holders will blackmail sensible transactions. The legal challenge, of course, is how to balance these dual extremes of majority expropriation and minority holdup with a more nuanced set of rules. Alas, the task is not easy. Looking at the offer premium is rarely enough to separate the legitimate from the abusive. Even a seemingly generous freezeout proposal, far above yesterday's closing price, may under-compensate minority shareholders if the risk of an abusive transaction is already priced into the shares.<sup>150</sup> And for similar reasons, a dissenting minority owner upset at a seemingly generous offer may have legitimate valuation concerns instead of specious holdout aspirations.

In recent times, lawmakers have relied on three loosely related requirements to strike a balance between majority and minority interests. First, controllers have an obligation to provide various disclosures to minority shareholders during a freezeout transaction. These include reports on the purpose of the deal, recent information on the firm's financial performance, and a copy of the fairness opinion commissioned by management to help determine the offer price.<sup>151</sup> Second, minority owners can challenge freezeout transactions by initiating fiduciary duty lawsuits, though importantly the standard of review may differ significantly by deal

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<sup>146</sup> See Geis, *supra* note 52; Subramanian, *supra* note 19, at 39–45; Weiss, *supra* note 47, at 648–52.

<sup>147</sup> Subramanian, *supra* note 19, at 34.

<sup>148</sup> See *supra* notes 34–38 and accompanying text.

<sup>149</sup> *But see* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1080, 1082–83 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985) (upholding the legality of the poison pill and declaring that free alienability was not one of the sticks in the bundle of property rights comprising share ownership).

<sup>150</sup> This ignores, of course, the fact that the minority owner may have also been able to purchase the shares at a discount to fair value.

<sup>151</sup> See SEC Schedule 13E-3, Items 6–8, 13, 17 C.F.R. § 240.13e-100 (2007).

structure.<sup>152</sup> Finally, as we have seen, minority investors can pursue appraisal claims if they believe that the price of the deal is inadequate.

It is far from clear that this troika of legal protections gets the balance right. Some have argued that the framework is not terribly effective at shielding minority shareholders from abusive freezeouts.<sup>153</sup> Others question the inconsistent treatment of similar transactions or the lack of incentives to adopt fair governance standards related to the deal.<sup>154</sup> And while lawmakers in Delaware seem to have a good grasp on the competing considerations, current laws undoubtedly inject costly uncertainty into many freezeout transactions.

For our purposes, however, the key question is whether amplified appraisal claims under *Transkaryotic* represent a good or bad development for governing the complicated relationship between majority and minority shareholders. This is difficult to answer. The cynic might insist that this case opens the door for a new breed of wasteful strike suits that will further distort the merger process. The optimist will counter that renewed appraisal claims can serve as a force for good, analogous to the discipline on managers thought to be imposed through the market for corporate control,<sup>155</sup>

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<sup>152</sup> Specifically, a statutory merger freezeout is usually subjected to an “entire fairness review,” though the burden of proof can differ depending on whether the firm has formed a special committee to evaluate and negotiate the deal or conditioned the merger on an approval vote by a majority of the minority shareholders. See Geis, *supra* note 52, at 1182–86; Subramanian, *supra* note 19, at 16–17, 53. By contrast, Delaware courts have held that a noncoercive tender offer freezeout does not involve corporate self-dealing and, thus, is not subject to an entire fairness review. Rather, the transaction enjoys the protection of the “business judgment rule.” See *Solomon v. Pathe Commc’ns Corp.*, 672 A.2d 35, 39–40 (Del. 1996) (holding that a tender offer from majority to minority shareholders is not subject to entire fairness review); *In re Siliconix Inc. S’holders Litig.*, No. Civ. A. 18700, 2001 WL 716787, at \*6 (Del. Ch. June 19, 21, 2001) (declining to apply entire fairness review to a tender offer freezeout). A recent case suggests, however, that Delaware is rethinking this bifurcated approach and that we may soon see a unified standard of review for freezeout transactions, regardless of form. See *In re CNX Gas Corp. S’holders Litig.*, 4 A.3d 397, 406–07 (Del. Ch. 2010) (advocating a unified standard-of-review framework that would apply to both statutory merger and tender offer freezeouts).

<sup>153</sup> See, e.g., Thompson, *supra* note 9, at 4–6.

<sup>154</sup> See, e.g., Subramanian, *supra* note 19, at 58 (advocating legal reforms that harmonize the standard of review between statutory merger and tender offer freezeouts and provide incentives to use both a special deal committee and a majority of minority shareholder vote). Vice Chancellor Strine has expressed similar sentiments. See *In re Cox Commc’ns, Inc. S’holders Litig.*, 879 A.2d 604, 642–48 (Del. Ch. 2005) (describing the incongruous standards of judicial review for freezeouts, bemoaning that the court, in this case, is “not presented with an opportunity to evolve the common law in this area because the incentives . . . make a frontal challenge to the existing regime irrational for defendants,” and hinting at a desire to readdress this issue in a future case).

<sup>155</sup> The well-known logic here is that the threat of investors launching takeover bids on a firm will protect against managerial incompetence. See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 112 (1st paperback ed. 1996); Frank H. Easterbrook & Daniel R. Fischer, *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 & Jeffrey 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*,

by allowing activist shareholders to purchase shares and pursue large appraisal claims when a controller engages in an underpriced freezeout. How should we balance these competing claims? And is there another intermediate approach that might draw upon the benefits of broader participation in appraisal proceedings while also tempering the risk that appraisal statutes will morph into a tax, or even an outright barrier, against sensible freezeout transactions?

### III. PIECING TOGETHER A NORMATIVE RESPONSE

How should lawmakers react to the expansion of qualified appraisal rights brought on by ambiguities in the exchange infrastructure? I will consider three competing ideas. The first response is the simplest: do nothing. Indeed, we might even celebrate this development as a back-end market check on controller expropriation. The second response, by contrast, is much more difficult to implement. It involves the rewiring of our exchange infrastructure to remove ownership ambiguity and specifically to trace each share to a vote. The third response, my recommended approach, represents a legal compromise. Lawmakers would follow the *Transkaryotic* precedent, accepting that many more investors can qualify for appraisal rights. But the procedural requirements for asserting such a claim would be modified in a way that obligates dissenting shareholders to write an embedded option when initiating an appraisal demand. This embedded option would essentially require each dissenter to “put his money where his mouth is” and thereby impose economic disincentives against outrageous price demands. Yet there would be little cost to writing the option for blatant lowball freezeouts, allowing dissenters to comfortably seek appraisal. The balance of this Article discusses these three alternative approaches in turn, eventually recounting the inner workings of my suggested compromise in some detail.

#### A. Celebrate the Development as a Back-End Market Check on Controller Abuse

Start by considering a different problem in corporate law. One of the more vexing governance concerns involves misaligned incentives between firm managers and investors.<sup>156</sup> These agency costs can arise in many different forms, ranging from wasteful expenditures to excessive risk taking to managerial shirking—but they all sprout from a desire by those in control to take selfish actions at the expense of uninformed owners.<sup>157</sup> The

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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).

<sup>156</sup> See, e.g., MACEY, *supra* note 110, at 73–75.

<sup>157</sup> See, e.g., JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 16–17 (2006).

distortions are impossible to solve completely; only the most altruistic agent will *always* make the same decision as an underlying principal would for every given situation.<sup>158</sup> Yet one appealing strategy for mitigating this managerial agency cost problem comes through the notion that there is a market for corporate control.<sup>159</sup>

As the theory goes, public firms plagued by especially bad managers will suffer a decrease in stock price, reflecting the future effects of poor decisions. As the value of the firm plummets, this will attract outside investors who may be willing to buy the entire firm on the cheap, oust the scoundrels, install better managers, and profit from the entire affair when the stock price recovers. This solution also has the advantage of overcoming free-rider effects because the acquiring investor can make a tender offer for *all* of the stock.<sup>160</sup> There are legal barriers and other frictions to this market for corporate control, of course, but the ever-present risk of an unwelcome buyout undoubtedly curbs some managerial temptations to overreach.

In this same manner, we might view expanded appraisal rights as a back-end market check on controller abuses. When a controlling shareholder initiates a freezeout at a fair price, there is little reason for outside investors to buy into an appraisal claim and file a lawsuit. But if the controller hopes to expropriate value from minority shareholders through a cut-rate offer, outside investors will have incentives to purchase the shares and seek appraisal under *Transkaryotic*. The availability of this back-end market check should, in theory, expand the universe of monitors. Encouraging additional dissenters should also improve appraisal economics by allowing a petitioner to spread the fixed costs of mounting a claim over a larger base of minority shares.<sup>161</sup> In short, just 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.<sup>162</sup>

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<sup>158</sup> See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). The goal, then, for investors is to minimize these agency costs while recognizing that monitoring investments must also be taken into account when solving the cost function. *Id.* at 357.

<sup>159</sup> See *supra* note 155.

<sup>160</sup> The free-rider problem presents itself in shareholder monitoring efforts because all shareholders, even those not contributing to monitoring costs, benefit when managerial abuses are curtailed. This means that shareholders will usually lack collective incentives to fully invest in efficient monitoring. See, e.g., Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 433 n.21, 455 & n.88 (1985); Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49 (1982).

<sup>161</sup> In a sense, this development would allow a motivated and well-financed dissenter to economically circumvent the lack of availability of class action status for appraisal lawsuits.

<sup>162</sup> This tension can also be viewed as a strain of the agency cost problem because majority owners make decisions (i.e., how much to pay for the shares) that impact assets owned by another person (the minority shareholders).

Indeed, we might go further by completely eliminating the need to link late-purchased shares to a nonpositive merger vote. Under this looser standard, any party with standing<sup>163</sup> to seek appraisal could perfect his claim in Delaware simply by making a demand prior to the merger vote and then filing an appraisal lawsuit within 120 days of the deal's approval.<sup>164</sup> Thus, a future Carl Icahn might buy up *all* minority shares between the record date and the approval date of a freezeout and obtain full appraisal rights, even if some of those minority shares eventually vote for the deal. Obviously, such a rule would take this notion of a back-end market check on majority expropriation even further, though I doubt that such an extension is required. Indeed, I suspect that the practical effect of *Transkaryotic* is quite similar to whole-cloth elimination of the nonpositive voting requirement in the appraisal statute.<sup>165</sup>

It is tempting to stop the analysis here and applaud the *Transkaryotic* case as a giant leap toward this back-end market for disciplining freezeouts. But this is not the whole story, and one must ask how controlling shareholders and potential claimants will react to the expanded availability of appraisal.

One likely response is a move by majority owners away from transactions that trigger appraisal rights. It is usually impossible to completely avoid appraisal during a freezeout merger.<sup>166</sup> But controllers facing a risk of expanded claims may be willing to conduct a tender offer for most of the shares and simply forego the short form merger that triggers appraisal on the back end. To be sure, this would keep minority shareholders on the firm's books and thus would prevent the controller from taking 100% ownership of the firm (which may be a problem for going-private transactions or other freezeout rationales). Less-than-unanimous ownership might allow for continued majority expropriation, however, without any appraisal protection, as long as enough minority owners are willing to tender at the inadequate price.<sup>167</sup> Similarly, we might expect

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<sup>163</sup> I use the term standing, as defined *supra* note 59, to denote transactions that qualify for appraisal.

<sup>164</sup> See *supra* Part I.B.

<sup>165</sup> This is true because Cede is the record holder for so many shares and because shareholders selling shares between the record date and the shareholders' meeting have little incentive to vote. The combination of these effects tends to create a large pool of unvoted shares that any interested outside investor could use to qualify for appraisal. There is a theoretical difference, of course, turning on whether some shareholders will invest the time to vote in favor of a merger after they have sold their stock. This is ultimately an empirical question, and some shareholders may indeed cast all possible votes for a merger, even when they sell a portion of their shares on the news. Or, there may be other gaming strategies that arise with the possession of empty votes. See *supra* note 116. Common sense suggests that most former shareholders cannot be bothered to open ballots, let alone cast votes, for companies they no longer own.

<sup>166</sup> See *supra* note 62 and accompanying text.

<sup>167</sup> This is a strong assumption; perhaps the fact that some minority holders are willing to tender removes the need for appraisal protection. But remember that an inadequate price may not be

Machiavellian controllers to switch to alternative transaction forms—such as asset sales, generous self-dealing contracts, or other devices—to sidestep expanded appraisal, though these attempts might be foreclosed by fiduciary duty case law.<sup>168</sup>

A different, and perhaps more pernicious, problem arises if this back-end market check on controller abuse turns into a back-end cesspool for strike suits. It is costly to defend against appraisal claims<sup>169</sup> and a majority controller might rationally settle counterfeit requests to avoid litigation expense. If the path of appraisal continues to widen, these statutes could quickly morph into a heavy tax on sensible freezeout transactions. Amplified appraisal might become a fashionable greenmail strategy with post-announcement plaintiffs buying up chunks of stock, insisting that the unvoted shares were “the ones” they purchased and threatening to launch a drawn-out appraisal proceeding unless fat envelopes are passed across the table. As the risk of a 5% appraisal headache blooms to, say, 20% or 30%—even when most voters approve the merger—some majority shareholders may abandon synergistic transactions. This would be a very unfortunate outcome.

It is important to note that controlling shareholders have a contractual strategy for responding to any uncertainty created by expanded appraisal rights. They can draft a condition in the merger agreement allowing the transaction to be abandoned if, say, more than 10% or 20% of the shares demand appraisal.<sup>170</sup> Because dissenters must file notice prior to the shareholders’ meeting date (and therefore before the closing date of the merger), a controlling shareholder protected by this condition can simply walk away from transactions that attract significant appraisal nuisance claims. This contractual countermeasure could lead to some very interesting negotiation dynamics, as a controller could threaten to abandon a deal unless a minority plaintiff agreed to reduce the number of shares seeking appraisal or accept other terms. It would also protect controllers against especially egregious strike suits. But persistent dissenters may not abandon their claims, even when the deal contains an appraisal condition, and there will be social welfare losses if buyers abandon synergistic transactions or forego marginally sensible transactions after the cost of an

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immediately observable to minority shareholders if the threat of expropriation is already factored into current market prices. *See supra* notes 141–42 and accompanying text.

<sup>168</sup> To be sure, the availability of fiduciary duty lawsuits provides a strong check on obvious managerial abuses. But the typical firm is complex, and the resulting information asymmetries may make it difficult for some potential plaintiffs to uncover the abuse. Relatedly, the theory that a market for corporate control is needed as a check on managerial abuse is consistent with the belief that fiduciary duty case law is not always sufficient to align the interests of owners and managers.

<sup>169</sup> Typical defense costs include both legal fees and expert witness fees, and the problem is potentially compounded with multiple lawsuits. Further, as described *supra* note 76 and accompanying text, these proceedings can take years or even decades.

<sup>170</sup> *See, e.g., Mahoney & Weinstein, supra* note 9, at 242.

“appraisal settlement tax” is factored into the calculations. For these reasons, a do-nothing strategy is likely not the optimal response to Delaware’s expansion of appraisal rights.

*B. Reform Exchange Practices To Eliminate Ownership Ambiguity*

Imagine an old building with an electrical system that has not kept up with our modern need for multiple appliances in every room. But instead of ripping out the fuse box and installing a systemic solution, the owner snakes extension cords through every corner and closet. It works, but only just barely. And things get ugly when the hair dryer, the toaster, and the microwave all run at the same time. Our current system for clearing stock trades and for managing the accompanying transfer of voting rights operates in roughly the same manner. We have kludged together something that works, usually, though the failures are not normally as noticeable as those of our dilapidated fuse box.

This analogy raises the obvious question: Why should we plug in still another extension cord, grounded in legislative amendment or judicial opinion, to keep things plodding along? Wouldn’t it be better to redesign the back-end clearinghouse systems from the ground up in order to support a corporate governance model that easily links shareholders to voting rights?

In a perfect world we might abandon paper share certificates entirely, along with the complicated and multi-layered distinction between record- and beneficial-ownership status.<sup>171</sup> Every share of stock would trade electronically through existing brokers and exchanges. Importantly, however, the details of this electronic transfer would now include an encrypted code of numbers and letters specifically identifying *each share* that is exchanged. Similarly, market participants would have a unique identification code, perhaps assigned or facilitated by a broker upon the creation of trading accounts.<sup>172</sup> This information would be pooled centrally (ideally in real time, though batch processing might be an alternative), and could be accessed by an appropriate party with the right security clearance. Putting these two identification codes together would allow us to establish the exact chain of title for any single share of stock.<sup>173</sup> In other words,

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<sup>171</sup> See Kahan & Rock, *supra* note 5, at 1238–40.

<sup>172</sup> Interestingly, the SEC is apparently moving in this direction for large traders by establishing a reporting system with unique identification codes. See Press Release, SEC, SEC Proposes Larger Trader Reporting System (Apr. 14, 2010), <http://www.sec.gov/news/press/2010/2010-55.htm>.

<sup>173</sup> One way to do this might be to append each successive buyer’s identification code to the electronic signature record. For example, say stock AAPL234DFEWD342 is initially sold by Apple to customer 23453FDESSAD32, who then sells it to 5432FGDDGR4533, who sells it to FGRT78765GDED. The serial number for the stock might read: stock; owner; new owner; new owner (or AAPL234DFEWD342; 23453FDESSAD32; 5432FGDDGR4533; FGRT78765GDED). Undoubtedly, other schemes are possible.

recalling an earlier example, I *could* now determine whether the 100 shares of Apple stock I just purchased were sold to me by Bill Gates or by Steve Jobs.

In most cases this would not matter, and buyers would happily accept the economic rights that accompany each share without caring a jot about the serial number embedded somewhere in an electronic signature. The centralized availability and use of this information, however, could dramatically alter shareholder-voting practices. Firms undertaking a shareholder vote would still need to provide advance notification of an upcoming ballot so that shareholders would have enough time to muster information, evaluate competing proposals, and make up their minds about an issue. But there would be little need to set a record date far in advance of the vote. Rather, the firm could announce at, say, 4:00 PM EST on June 15 that all shareholders will have twenty-four hours to cast an electronic vote.<sup>174</sup> These votes would be gathered, signed with the string of serial numbers for each owner, checked against the central ownership database (to ensure that this owner really held the shares at 4:00 PM), and tallied accordingly. This may sound like fantasy, but much of the work could likely take place through software coding that could be ignored by the average investor. In a world where we can decode the human genome, organize vast volumes of Internet data, and program lifelike video games, it is at least worth entertaining such a project to rewire our exchange methods and clearing systems.

If successful, the obvious implication is that investors could continue to buy and sell stock up until the very moment designated for a vote. The temporal decoupling of governance rights and economic interest would be eliminated (or at least reduced significantly), as voting power would now remain attached to trades for a much longer period of time.

Furthermore, there should be less of a need to enlist brokers or proxy-solicitation firms to track down beneficial owners and distribute voting materials. In accordance with section 213(a) of the DGCL,<sup>175</sup> it would remain necessary to inform shareholders of an upcoming vote and to provide them with instructions on how to cast the ballot. But this might be accomplished with three overlapping strategies. First, upon announcement of an upcoming vote, all current shareholders could be sent this information—drawing upon contact information that is linked to each unique market participant identification code. Second, as shares trade between this announcement date and the day designated for the vote, new purchasers could be sent this same information (again using contact information linked to their customer identification code). Finally, all of the

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<sup>174</sup> Paper or electronic proxies might also be used for owners without online access or for long-term investors who will not change their positions and who want to vote earlier than the twenty-four hour window—though some additional processing would obviously be required.

<sup>175</sup> DEL. CODE ANN. tit. 8, § 213(a) (2010).

voting information could be uploaded to a central online repository (perhaps maintained by a leading proxy-solicitation firm), accessible by anyone who is concerned that they have fallen through the cracks.<sup>176</sup> Because every vote would be verified by checking the stock serial numbers and owner records against a master centralized database, there should be no need to worry about former owners or unrelated parties casting fraudulent votes. These would be rejected as invalid, and ballots might as well be made available to anyone.

For our purposes, rewired clearinghouses would provide a very clean solution to the appraisal identity problem. Dissenters would simply show that they did not vote any shares for the deal by presenting a voting confirmation report; or, alternatively, by asking for a reliable statement describing how all shares with their serial numbers were voted. Claimants could then proceed with the appraisal litigation as before. Importantly, buyers acquiring shares after the merger announcement, but before the vote, would no longer face a *Transkaryotic* problem because they *could* vote against the deal or abstain.<sup>177</sup> Similarly, there would be no need to worry whether a large record holder, such as Cede, cast enough nonpositive votes to support all claims. It would also be unnecessary to set rules for allocating qualified shares among multiple appraisal claimants, because share ownership would no longer be ambiguous.

In addition to solving the appraisal puzzle, efforts to rewire the exchange infrastructure would generate other positive governance effects. Indeed, many of these other results would likely prove more important than the resolution of appraisal ambiguities. For instance, we could gain confidence in the accuracy of shareholder votes on routine matters such as annual director elections and we could minimize the messy litigation that can arise when record holders make a mistake or fail to vote shares as instructed.<sup>178</sup>

Another very interesting side effect might be the ability to drive down the costs of engaging in a proxy contest through the creation of this centralized, real-time shareholder database. Under our current regime, it can be prohibitively expensive to pursue proxy contests that moot a

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<sup>176</sup> Though, this should not happen as long as the owner's contact information is current.

<sup>177</sup> Moreover, even if a record date is set in advance of the actual vote, the chain of title information for each share of stock would eliminate the *Transkaryotic* ambiguity: a court could simply observe how each share was actually voted by the previous owner and hold petitioners accountable for the consequences. Related to this, a purchasing shareholder who does care strongly about the vote might find it easier to obtain irrevocable proxies from a seller—a person who can now be identified with certainty.

<sup>178</sup> See, e.g., *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010) (documenting a voting breakdown where the record holder did not properly transfer voting rights to beneficial holders for a closely contested director election).

contentious issue or present rival slates of directors.<sup>179</sup> Some of this expense stems from the need to comply with detailed legal requirements governing proxy communications with shareholders.<sup>180</sup> But another category of expenses arises through the practical need to conduct a political campaign by hiring advisors (typically lawyers and proxy-solicitation firms) to track beneficial owners through labyrinths of intermediary owners and to lobby for marginal votes.<sup>181</sup> A centralized database of owners might alleviate the related identification and contact costs, thereby increasing the practical likelihood of using proxies for a wide variety of qualified governance concerns.<sup>182</sup>

Finally, this system might help deter some of the undesirable consequences of empty-share voting, when franchise rights are exercised without economic interest.<sup>183</sup> By linking votes to share ownership for a longer period of time, the regime would reduce the frequency of situations in which loose votes are available for sale or manipulation.<sup>184</sup> To be sure, rewiring the exchange infrastructure would only solve a small fraction of the problem. It might still be possible for an aspiring empty voter to buy and hold the actual shares, thereby retaining the vote, while hedging the economic risks of ownership through swaps or through other customized

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<sup>179</sup> See, e.g., Leo E. Strine, Jr., *Toward a True Corporate Republic: A Traditionalist Response to Bebchuk's Solution for Improving Corporate America*, 119 HARV. L. REV. 1759, 1767, 1771 (2006) (describing the high cost of proxy battles); Institutional Shareholder Services, *U.S. Proxy Voting Manual*, GOVERNANCE ANALYTICS, <http://governanceanalytics.com/content/menutop/content/subscription/usvmfiles/proxy-contests.html#AEN1282> (last visited Nov. 8, 2011) (“[A] proxy contest typically costs between \$1 million and \$15 million . . .”). To take one salient example, the proxy contest related to a merger between Hewlett-Packard Co. and Compaq Computer Corp. is estimated to have cost over \$200 million. Gary McWilliams & Pui-Wing Tam, *H-P Battle Raises Bar for Proxy Costs*, WALL ST. J., Mar. 26, 2002, at A4.

<sup>180</sup> The primary regulatory framework arises under section 14(a) of the Exchange Act of 1934, which prohibits parties from soliciting proxies (defined broadly) in violation of SEC rules. 17 C.F.R. § 240.14a-3 (2010). These rules also require anyone soliciting a proxy to prepare and distribute a proxy statement to shareholders. See *id.* § 240.14a-4 to -5.

<sup>181</sup> See, e.g., Kahan & Rock, *supra* note 5.

<sup>182</sup> Indeed, I would predict that one implication of easier access to shareholders would be a much greater emphasis on the federal laws that regulate the issues and requirements to secure proxy access for shareholder proposals. On this topic, see Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347 (2011).

<sup>183</sup> See Hu & Black, *Hedge Funds*, *supra* note 116 (describing the concerns with empty voting and especially the possibility that votes will be cast against the best interest of the firm for other reasons relating to private gain); Hu & Black *The New Vote Buying*, *supra* note 116 (same); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 160–62 (2009) (expressing concerns about voting by parties with no economic interest).

<sup>184</sup> The wisdom of allowing shareholder votes to be sold in public or private markets has been debated for some time now. Compare Bruce H. Kobayashi & Larry E. Ribstein, *Outsider Trading as an Incentive Device*, 40 U.C. DAVIS L. REV. 21 (2006) (discussing some potential economic benefits of permissive markets for votes), and Henry G. Manne, *Some Theoretical Aspects of Share Voting: An Essay in Honor of Adolf A. Berle*, 64 COLUM. L. REV. 1427 (1964) (advocating unrestricted vote selling), with Thompson & Edelman, *supra* note 183, at 162–66 (doubting the wisdom of vote sales).

derivative transactions,<sup>185</sup> so it would take much more to close down empty voting. These and other governance implications are worth exploring in more detail, but I will not do so in this Article.

Establishing a better method for settling stock trades would likely solve the appraisal puzzle and increase the accuracy of shareholder elections. But this is a long-term project—one that is unlikely to gain traction for some time.<sup>186</sup> The immediate challenge is technological: how to actually create the system described above (or some functional equivalent) at the scale needed to handle some 7.5 million or more shares every single trading day.<sup>187</sup> I suspect, though of course I cannot be certain, that something could be worked out with enough time and money. But this project would surely introduce unexpected side effects that would require a dedicated effort to solve. It would be a massive undertaking, requiring considerable resources, even in a world of skilled software programmers, powerful supercomputers, and cheap online storage.<sup>188</sup>

This brings us to the real question: Who has the incentives to undertake an infrastructure rewiring project, and how would they pay for everything? Many people would benefit from stock-clearing reforms: investors (through better governance and perhaps higher firm values), aspiring managers (through an ability to mount proxy contests), adjudicators (through clearer governance mechanisms), and perhaps those responsible for operating the new system (if they can command a reasonable profit for their services). But there is an obvious free-rider problem because once the clearinghouse is established, everyone can take the benefits without necessarily contributing funds for the completion of the efforts.

Furthermore, this project only makes sense when conducted as a “big bang” initiative. It does little good for a firm to embrace this half-heartedly,

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<sup>185</sup> This was the strategy employed in the now-famous Mylan/King merger, where a large shareholder in the target firm purchased shares in the acquiring firm so he could vote for the transaction on both sides in order to increase the odds of approval and thereby realize a large premium on his target shares. See Thompson & Edelman, *supra* note 183, at 153–54. In implementing this strategy, the shareholder hedged away his economic interest in the acquiring firm, calling into question whether his ability to vote was really in the best interest of the acquiring firm’s owners. *Id.*

<sup>186</sup> See Kahan & Rock, *supra* note 5, at 1280–81 (cautioning that necessary reforms require significant reorganization of the system, demand significant expenses, and promise uncertain results).

<sup>187</sup> Large exchanges measure a listed volume statistic: all shares traded in all markets for a given period of time. Daily listed volume can vary significantly, but some longer-term averages are informative. As of April 21, 2011, seventy-seven trading days had elapsed. During this time approximately 419 million shares traded on the NYSE, 63 million shares traded on the ARCA/AMEX, and 102 million shares traded on the NASDAQ. Adding these results yields total listed volume of 584 million shares—roughly 7.5 million shares per trading day. See *Daily Market Summary*, NYSE EURONEXT (Apr. 21, 2011), <http://www.nyse.com/financials/1108407157455.html>.

<sup>188</sup> It is worth noting that the SEC is seeking public comments on a wide number of these “proxy plumbing” issues, and it is possible that additional resources will be earmarked for a reform. See Concept Release on the U.S. Proxy System, Release Nos. 34-62495, IA-3052, IC-29340, 17 C.F.R. pts. 240, 270, 274, 275 (July 14, 2010), available at <http://www.sec.gov/rules/concept/2010/34-62495.pdf>.

say by stamping serial numbers on some of its shares and leaving the rest to trade as fungible bulk. Similarly, all active traders would require an identification code; everything breaks down with even a small minority of unidentified buyers.<sup>189</sup> It may be possible to establish pilot efforts or dual-system clearing,<sup>190</sup> but obviously a full-scale change would raise significant coordination challenges.

These free-rider and coordination problems raise a legitimate case for using government action to bankroll and establish the reforms.<sup>191</sup> But public money is not exactly flowing these days, and the current system seems to work, if crudely. It may be difficult to muster the political mandate necessary to take on this project. Moreover, public suspicion about the use of government funds to support capital market renovation efforts, along with the private incentives of some parties to maintain the status quo, combine to suggest that any such rewiring project will be controversial.<sup>192</sup>

This is not to say that these reforms are a bad idea. Indeed, there may be substantial social gains to such an effort.<sup>193</sup> But the mammoth complexity, cost, and coordination required by a greenfield approach suggest that we will not arrive easily at this destination. Accordingly, I am interested in the possibility of a nearer term legal compromise to manage the impact of asynchronous voting on the appraisal remedy.

### C. *Adjust Appraisal Rules as a Legal Compromise*

One of the more exciting developments in economic theory posits that incentive-molding rules can corral parties towards optimal social ends, strictly by appealing to their rational self-interest.<sup>194</sup> If these ideas can be put into practice, it may become possible for policymakers to promote better substantive outcomes while also reducing the transaction costs arising through adversarial legal proceedings.<sup>195</sup>

In the appraisal context, the challenge is to craft a legal entitlement that smokes out the fair price for a share of stock. We have seen how awarding too much power to a controlling shareholder can tempt expropriation, as the

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<sup>189</sup> Given the high frequency of trades and the close margins in some contested mergers (those ripe for the appraisal problem), even if a small percentage of traders do not have tracking IDs, the number of shares that get lost in the shuffle might exceed the vote margin.

<sup>190</sup> The notion here is that trades would continue as normal, but over time an electronic signature would be added to more and more trades. Eventually, the system could be “switched on,” run in parallel for some time to permit testing, and eventually take over as the exclusive trading method.

<sup>191</sup> The government incentives to fund such a project are another matter, however, though one might argue that efficiencies from better capital allocation and improved governance would be substantial. Such claims would be quite difficult to quantify.

<sup>192</sup> See Kahan & Rock, *supra* note 5, at 1278–79.

<sup>193</sup> See *supra* notes 171–85 and accompanying text.

<sup>194</sup> For an illustration of the possible social welfare benefits, see sources cited *supra* note 31.

<sup>195</sup> *Id.*

stock is sold for an inadequate price.<sup>196</sup> Conversely, granting broad property rights to minority shareholders through, say, unanimous voting requirements, can promote holdout problems and prompt demands for super-compensatory payments.<sup>197</sup> In a perfect world, we would divine the true value of each share and reward or punish each claimant as appropriate. But the high degree of uncertainty and judgment underlying any valuation exercise, combined with the pressures and biases of litigation, make this approach impossible.<sup>198</sup> Can we walk the tightrope between holdout and expropriation with a more nuanced legal entitlement?

The main idea requires separating the event of demanding a price from the knowledge about whether a claimant will be buying or selling at this stated figure. By tossing a veil of ignorance over the consequences of any price statement, policymakers can essentially force a claimant to put her money where her mouth is.<sup>199</sup> When freezeouts are abusive, a minority shareholder should be quite comfortable naming a higher price—even if she is eventually forced to buy at this sum. Extortionate claims, on the other hand, should be dissuaded by the possibility that the bluff will be called—requiring the claimant to *buy* shares at this inflated price. The overall framework is simply a variation on the familiar scenario where Johnny divides the cake and Janet chooses the first piece.

Specifically, these incentives can be introduced into appraisal proceedings by adding one more statutory requirement for claim perfection: every petitioner must write an embedded option allowing the controlling shareholder<sup>200</sup> to *sell* a share of stock (for each share seeking appraisal) back to the petitioner at the exact same price that the claimant demands under the appraisal request. So if I own a share of Berkshire Hathaway and Warren

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<sup>196</sup> See *supra* notes 49–51 and accompanying text.

<sup>197</sup> See *supra* Part II.C.

<sup>198</sup> It has long been understood that judges are not business experts and that much of corporate law is based on judicial restraint regarding the second-guessing of many business decisions. Judicial valuation efforts in the appraisal context are, of course, a partial exception to this philosophy. See *supra* note 74.

<sup>199</sup> See Fennell, *supra* note 31.

<sup>200</sup> There is an important design question here: whether the embedded option should be written to the controlling shareholder or to the firm itself. Consistent with my focus on freezeout transactions, I will assume in this Article that the embedded option is owned and exercisable by a controlling shareholder (though obviously this would need to be defined in statutory amendments at a threshold level, perhaps 40%). It is certainly possible, however, to require any appraisal petitioner to write the embedded option to the firm itself. This approach has the advantage of introducing the right incentives for non-freezeout appraisal claims (as was the case in *Transkaryotic*) because dissenters will not wish to assert unreasonable price demands. But giving the option to the firm may weaken incentives during a freezeout transaction (even if the controller has effective power over the management's decision whether to exercise the embedded put) because the gains from dissenter overreaching would be shared by *all* of the shareholders (not just the controller). Perhaps the ideal solution is a hybrid approach, where an option must be given to controlling shareholders if they exist; otherwise, it must be written to the firm.

Buffett announces a freezeout at \$100,000, I can perfect an appraisal demand for \$150,000 through the usual methods. But I also need to include a put option allowing Buffett to sell me an additional share at \$150,000. He is, of course, free to exercise or to ignore the option, as he wishes.

It may seem strange to force claimants to pay a fee—in the form of the embedded option grant—to obtain the legal protections offered by the appraisal remedy. But there is no reason why the law cannot parse this statutory entitlement more finely; no one is obligated to seek appraisal, and lawmakers should feel free to require this additional obligation if there is a good reason to do so. And indeed there is: it is this uncertainty about whether each claimant will be buying or selling that promotes an accurate price demand and drives down the administrative costs of appraisal proceedings (in the form of fewer contested cases).<sup>201</sup> Further, this embedded option should cost relatively little to write for bona fide claims, where the petitioner believes that the exercise price is at or out of the money.<sup>202</sup> This is not to say, of course, that an out-of-the-money option is costless to write; the duration term must be kept quite short, perhaps one or two weeks, to prevent this new requirement from becoming yet another tool for majority expropriation.<sup>203</sup>

It is worth working through an extended example to flesh out the effects (and potential failure points) of this appraisal compromise. Come back to a simplified version of *Transkaryotic*: let us assume again that a single 60% shareholder wants to conduct a statutory freezeout merger at \$37.<sup>204</sup> Twenty percent of the shares now trade frequently between small holders on the public markets. The balance of shares are owned by two other investors: Albert and Beth. Albert owns 10% of the firm; he has held these shares for the past decade and believes that the freezeout price is

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<sup>201</sup> See *supra* note 169 and accompanying text.

<sup>202</sup> If a claimant demands exactly fair value, the put would be at the money. If the claimant is willing to accept a little less, the put moves out of the money. Other variables at the time of the option grant will also contribute to the value of the option, including the volatility of the stock and the duration of the put option.

<sup>203</sup> For example, a dissenter may price the put (through her appraisal claim) at what she believes is fair value only to have subsequent adverse information drive down the fair price. An opportunistic controller may take advantage of this to exercise the put under these circumstances, though he was not previously planning to do so. It is not easy to mitigate the effects of firm volatility, but this concern can be minimized by requiring a short duration for the option. It might be sensible to couple this with a slightly shorter notification timeline under section 262(d)(1) of the DGCL. See *supra* note 67. Finally, a risk-averse dissenter may also wish to hedge this risk by purchasing put options on the stock with similar duration and strike price variables.

<sup>204</sup> I use a statutory freezeout, as opposed to a tender offer freezeout, simply to set up a scenario where appraisal rights attach with the initial transaction. The analysis would be similar if the controller pursued a tender offer freezeout followed by a short form merger, thereby triggering appraisal rights. Of course it could be difficult for the controlling shareholder to obtain the 90% ownership threshold needed to conduct a short form merger given the minority ownership blocks and viewpoints on the deal. I also ignore the effects of any takeover defenses that may be in place.

generous and fair. Beth owns the remaining 10%, a position she has also maintained for years. Unlike Albert, however, Beth feels that this price is inadequate and that the stock is really worth \$50. The final player is Carl. Carl does not yet own shares, but he hunts for situations where he can squeeze out money through a strike suit. He doubts that the shares are worth more than \$37. Carl is familiar with the amplified appraisal strategy, however, and he is considering a plan to buy some shares, bring an appraisal claim for \$80, and convince the controller to settle at \$60. Assume, finally, that all shares are deposited with Cede, and that Delaware's appraisal statute has been modified to require dissenters to write an embedded put option (as described above) in order to perfect their appraisal rights. How will each of our parties act?

Albert is easy to analyze. He is pleased with the \$37 freezeout price and will simply accept the money without considering an appraisal claim. He will probably vote for the merger, though he may decide not to bother voting if he recognizes that the controller can approve the deal with his 60% stake.<sup>205</sup> Alternatively, if the public market price for the stock rises to \$37 on the news of the deal, Albert may just sell his shares to another investor prior to the freezeout. If this happens after the vote is severed from economic ownership, Albert may be even less inclined to vote on the merger.

Beth faces a more complex decision. But if she truly believes that \$37 is a lowball offer, Beth may file an appraisal claim.<sup>206</sup> As a first step, she will instruct Cede to vote all of her shares against the merger. This cannot block the deal, of course, as the freezeout will garner a 60% or higher approval rate (depending on the actions of Albert and the small investors). Yet this will provide Beth with enough nonpositive votes to qualify for appraisal. She complies with the other requirements for appraisal, and then, as the final step in claim perfection, Beth writes an embedded option to the controller allowing him to sell her up to 10% of his stock at \$50 per share. She may be nervous about the possibility that this option will be exercised, but she should be willing to write the option if she feels that \$37 is truly inadequate.<sup>207</sup> After all, this is what she is demanding of the controller, and she is free to choose any exercise price.

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<sup>205</sup> This assumes that the controller has not engineered a majority of the minority voting condition into the approval process. See *supra* note 152 (describing this process and its effect on the legal standard of review).

<sup>206</sup> I will place her other main option—filing a fiduciary duty lawsuit to challenge the freezeout—to the side to illustrate the effects of my proposed appraisal reforms. Depending on the facts of the situation, it may indeed be possible to win a fiduciary duty case, though the controller may take measures (such as appointing a special committee of directors) to obtain an accommodating standard of review.

<sup>207</sup> Careful readers may observe that the controller has an incentive to purchase 10% of the shares on the public market at \$37 and sell them to Beth at \$50. But this assumes that Beth remains passive and that the public share price stays at \$37. Indeed, if Beth really believes that the stock is worth \$50

Given the risk of performing on the option, however, Beth may decide to lower her appraisal claim slightly in order to pocket a small (perceived) profit if the controller does exercise the option. For instance, she might request an appraisal price of \$49. If the controller accedes to this lower request, Beth will not receive the entire \$50 per share. But if the controller does exercise the embedded option, Beth will make a dollar per share (according to her valuation estimates of \$50). Regardless, Beth should not be deterred from making a claim that she views as legitimate.

How will the controller respond to Beth's appraisal demand? He has three primary options: (1) pay her the \$50 per share, (2) exercise the embedded option and sell her a 10% block at \$50, or (3) litigate the appraisal request. This decision will depend on a number of variables, including the controller's inner views about a fair price for the stock and whether he is willing to relinquish some control. If the controller is trying to expropriate value—and the fair price really is \$50 or higher—then he will not want to exercise the embedded option. Instead, the controller may just pay off Beth to get the deal through, perhaps still profiting from Albert's inability to recognize the abuse. It is also possible that the controller will litigate, hoping to convince a court that the \$37 is fair, though this strategy entails significant publicity, costs, and risks.<sup>208</sup>

On the other hand, if Beth and the controller simply have different views about the value of the stock (perhaps because one or the other is misinformed), then the controller may be happy to exercise the option. This would, of course, mean that his position drops to 50%, and that Beth's ownership rises to 20%. The majority owner needs to be willing to narrow his control position, and this could serve as a theoretical barrier to free exercise of the put option. In extreme cases, it might even require the majority holder to abandon control.<sup>209</sup> I suspect, however, that minority ownership blocks will often be less concentrated, reducing the disinclination of a majority owner to put shares to a greedy dissenter.

One other concern is worth addressing: counterparty liquidity. In order for the compromise to work as planned, Beth must be willing to challenge inadequate deals. Yet in order to do this, she must have adequate liquid resources to stand behind the embedded put if the controller elects to exercise it. If Beth has a broad liquid portfolio or access to credit markets, then this should not present a problem. But this fear of mustering resources

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(and has ample financial reserves), she should be willing to buy the loose shares herself at any price up to \$50 and claim appraisal rights for this incremental position. Even if she lacks resources, we might expect other players to step in if the fair price of the stock really is \$50. And finally, recall that Beth herself named this \$50 price. Said differently, this example does not embrace the strong form of the efficient capital markets hypothesis.

<sup>208</sup> It may also be difficult to argue that the \$37 price is fair when the controller is unwilling to sell some of his shares at the much higher price of \$50 via the embedded option.

<sup>209</sup> To illustrate, change the initial facts so that Beth holds a 20% stake and the small public owners hold just 10% of the firm.

to stand behind the embedded put may theoretically prevent some dissenters from challenging abusive freezeouts. Related to this, a controller may not believe that a financially weak dissenter's embedded put is "real" and may just litigate outrageous demands instead of attempting to collect from a counterparty who is unlikely to stand behind her position.<sup>210</sup>

Finally, does Carl qualify for appraisal rights, and, if so, how will he behave? Let us assume that he buys a 10% block at \$37 (after the record date, but before the vote) from Albert, who has sold on the news. If Albert does not bother to vote the shares, then Carl can use this unvoted pool to request appraisal—following the precedent of *Transkaryotic*. Interestingly, even if Albert votes for the merger, Carl may claim that he can use Beth's dissenting shares to pursue his claim. We do not know how a court would handle a situation where 20% of the shares vie for the 10% voted against the deal. And the answer here will also depend on the voting actions of the other small shareholders. But let us assume, *arguendo*, that Carl can qualify for appraisal. Would he mount his strike claim at \$80, seeking to settle at \$60? Probably not. Carl really believes that the stock is worth just \$37, and he will be terrified about the new requirement to couple an embedded put option with his \$80 price request. It is very likely that the controller would exercise the option, and knowing this, Carl would never initiate the claim in the first place. This is a very good outcome: we have deterred a specious claim.<sup>211</sup>

Might Carl purchase an even greater block or collude with other minority investors to reinstate an appraisal strike suit? On these facts, it is difficult to see how; even if Carl buys the entire 40% minority stake, the controller could exercise the embedded put to collect \$80 for each of these shares. Indeed, he should be happy to increase his profits by doing so. If we change the initial facts slightly, however, such that the controller starts with a 40% stake, then Carl may buy up more shares than the controller can sell under the put. Still, the controller should be happy to put the 40% of the shares back to Carl, who has effectively launched a competing buyout at \$80. Finally, the controller does not ever need to exercise the put; he can always just challenge the appraisal demand as before.

The upshot of all this, then, is a compromise framework that should provide genuine relief for oppressed shareholders and weaker incentives for plaintiffs to engage in spurious strike suits against a firm. Moreover, it might help to slash the legal costs necessary to obtain fair judgment, as there would often be less need to divine a stock's fair value through

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<sup>210</sup> Of course liquidity and creditworthiness are always concerns with asynchronous transactions. It is possible that the usual mechanisms for establishing counterparty trust, such as bonding or escrow arrangements, might also be used in this context.

<sup>211</sup> In the absence of the embedded option feature, Carl would have little reason to avoid the strike suit. *See supra* note 155 and accompanying text.

competing expert witness testimony.<sup>212</sup> This should be seen as a significant benefit; the typical appraisal case consumes copious professional and judicial resources to debate the inner details and assumptions of valuation models.<sup>213</sup>

Of course, the ultimate advantage of modifying appraisal rights in this manner is an ability to tap into the benefits of a back-end market check on freezeout pricing, while simultaneously moderating concerns about strike suits. With these reforms in place, lawmakers should be quite comfortable with the likelihood that *Transkaryotic* will result in a broader pipeline of appraisal claimants. Indeed, we should welcome the additional attention that will be placed on freezeout transactions by investors who might have previously ignored these deals. These new players will have incentives to police expropriation but little reason (or ability) to pursue strike suits. In short, come one, come all, as long as petitioners are placed in situations in which outrageous price demands may come back to haunt them.

#### CONCLUSION

Under the DGCL, minority shareholders who are disappointed with the price that they receive in a freezeout merger must bring appraisal claims through the record holder of the stock. But back-office settlement practices have evolved such that one entity, the DTC, now serves as a giant, perpetual record holder for the vast majority of shares. This means that appraisal petitioners, following recent Chancery Court precedent, can effectively sidestep a key statutory requirement to abstain or vote against the deal. This is true even when the claimants purchase shares after voting rights have been severed from economic ownership. The upshot of all this is that appraisal claims will likely multiply, taking on greater significance in the governance battles between majority and minority shareholders.

This Article has wrestled with the implications of expanded appraisal. The good news is that increased attention on freezeout transactions may serve as a back-end market check and may thereby chill majority expropriation. The bad news is that streamlining the path to appraisal may induce strike suits that block sensible transactions. My suggested compromise is to modify appraisal statutes by adopting procedural methods for eliciting and awarding the revealed subjective value of dissenting shareholders. If successful, these reconstituted appraisal rights would encourage dissenters to protest truly abusive transactions while undercutting the incentives to file illegitimate claims.

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<sup>212</sup> See *supra* note 169 and accompanying text.

<sup>213</sup> For example, a research assistant and I conducted an analysis of all Delaware appraisal cases from 1999 to 2009. The results suggest that roughly 75% of the forty-seven cases involve valuation methodology disputes. By contrast, just 17% of the cases debate whether appraisal is available for a given transaction, and 12% of the cases litigate whether some other procedural matter has been satisfied.

Along the way, the discussion has also offered a salient illustration of a much broader problem in corporate law: dysfunctional shareholder voting practices caused by complexity in the exchange infrastructure. Our mental model of corporate governance envisions a stable group of shareholders with ample time to deliberate on key balloting issues and cast meaningful votes. In actuality, the mechanisms for managing and tallying shareholder votes encompass intricate layers of intermediaries that do not inspire confidence in accurate outcomes. In this context, the appraisal puzzle is simply the latest manifestation of a much more pervasive concern.

