

INSIDE: Fair Value: A View From The Bench • How Valuation Law Evolved • Modern Economics And Appraisals

# Delaware Lawyer

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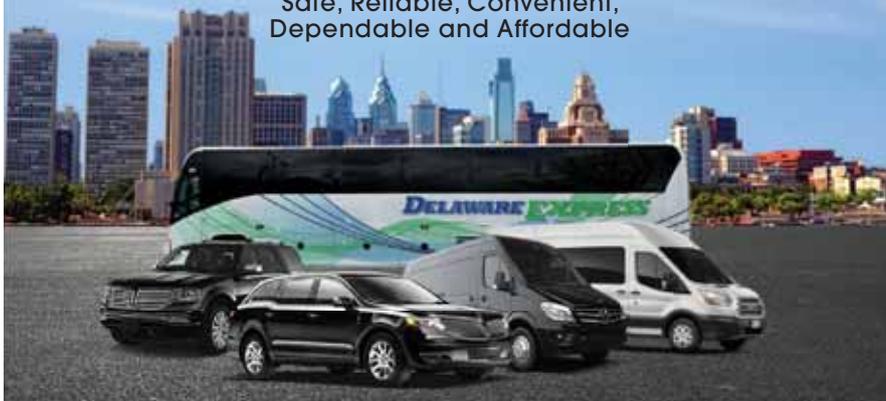
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Elena C. Norman\*

This issue focuses on deal litigation in 2017. Contributors — a judge, an academic, a general counsel and three frequent Court of Chancery litigators — were asked to write about a topic of their choosing relevant to corporate litigation. The resulting focus on appraisal litigation reflects the wide current interest in and importance of this topic. Several recent cases potentially will shape the landscape of appraisal litigation for years to come. (Note that all articles were submitted prior to the Delaware Supreme Court's recent opinion in *DFC Global Corp v. Muirfield Value Partners, L.P.*, 2017 WL 3261190 (Del. Supr. Aug. 1, 2017).)

Delaware's appraisal statute is found in Section 262 of the Delaware General Corporation Law, which provides dissenters in certain transactions with the right to the judicially determined "fair value" of their shares. Among other things, these articles reflect the questions that arise in ascertaining "fair value" and the debate as to whether the deal price or other financial methodologies are more appropriate indicators of such value. They also touch upon the question of who should have the right to pursue appraisal.

The issue begins with Vice Chancellor Glasscock's ruminations on appraisal from the perspective of a trial judge charged with applying the appraisal statute. Charlotte Newell of Sidley Austin LLP then explains the legislative origins of today's appraisal debate. Professor Eric Talley of Columbia Law School

\* I am grateful to my colleagues Daniel Kirshenbaum and Karen Pascale for their invaluable assistance preparing this issue.

explores why, despite the success of tools of modern financial economics in reshaping courtroom discourse, finance is increasingly (and unnecessarily) "greeted with a tinge of apprehension" in legal circles, including in discussions about appraisal valuations. Adam Frankel, the General Counsel of Evercore, argues that the Court of Chancery's willingness to rely on traditional financial valuation methods over the deal price creates risk for acquirers.

David McBride of Young, Conaway, Stargatt & Taylor, LLP, proposes narrowing the circumstances in which the appraisal remedy can be invoked; at the same time the article proposes liberalizing the *Corwin* doctrine, which provides the standard of review governing certain challenges to mergers approved by a fully-informed and uncoerced vote of a majority of unconflicted stockholders.

Finally, Ted Mirvis of Wachtell, Lipton, Rosen & Katz proposes that the *Unocal* doctrine be applied to the game of golf (and in so doing, comes full circle to the topic of valuation, referencing a court decision in which the court "rejected the plaintiff's invitation to apply a DCF analysis to each golfer's score to yield a result that was entirely fair.")

We hope you enjoy this issue of *Delaware Lawyer*.



Elena C. Norman

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### Adam B. Frankel



is Evercore's Senior Managing Director and General Counsel. Prior to joining Evercore in July 2006, Mr. Frankel was senior vice president and general counsel of Genesee & Wyoming Inc., a leading owner and operator of short line and regional freight railroads in North America and Australia. He also was responsible for the firm's Human Resources and Government Affairs departments. Mr. Frankel previously worked as a corporate and transactions attorney at Ford Motor Company and as an associate at Simpson Thacher & Bartlett in London and New York. He is a member of the Council on Foreign Relations and a trustee at the Sesame Workshop. Mr. Frankel has a B.A. from Brown University and a J.D. from Stanford Law School.

### The Honorable Sam Glasscock III



was appointed as Vice Chancellor in 2011 after having served as Master in Chancery from 1999 to 2011. He received a B.A. in History from the University of Delaware in 1979, a J.D. from Duke University in 1983 and a Master's Degree in Marine Policy from the University of Delaware in 1989. Before coming to the Court of Chancery, he worked as a judicial clerk, as an associate at Prickett, Jones, Elliott, Kristol & Schnee in the litigation section, as a Superior Court special discovery master and as a Deputy Attorney General in the Appeals Unit of the Department of Justice.

### Theodore N. Mirvis



is a partner in the Litigation Department at Wachtell, Lipton, Rosen & Katz. Mr. Mirvis has been with the firm for over 35 years and has litigated landmark cases regarding corporate law, corporate governance and mergers and acquisitions. A regular lecturer at the Harvard Business School and the Harvard Law School, he also teaches occasional classes at Columbia Law School, NYU Law School, the University of Pennsylvania Law School and the Law School of the Hebrew University in Jerusalem. Mr. Mirvis received a B.A., *summa cum laude*, from Yeshiva University in 1973 and a J.D., *magna cum laude*, from the Harvard Law School in 1976. At the Law School, he served as Case Officer and as a member of the *Harvard Law Review's* Editorial Board. Upon graduation, Mr. Mirvis was a law clerk to the Honorable Henry J. Friendly of the United States Court of Appeals

for the Second Circuit. He is a member of the American Law Institute and the Planning Committee of the Tulane Corporate Law Institute. He previously served as chair of the Lawyers Division of UJA-Federation of New York.

### David C. McBride



is a partner at Young Conaway Stargatt & Taylor, LLP, and concentrates his practice in the areas of corporate law and corporate and commercial litigation. He has been involved in many of Delaware's significant corporate law cases, particularly in the area of mergers and acquisitions. Mr. McBride serves as an Appointed Member of the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. He also is a Fellow of the American College of Governance Counsel and a member of the American Law Institute and the American College of Trial Lawyers.

### Charlotte K. Newell



is an associate in Sidley Austin LLP's New York office and a member of the firm's Securities and Shareholder Litigation team. Ms. Newell received her J.D. from the University of Pennsylvania Law School *magna cum laude* and thereafter served as a law clerk to the Honorable J. Travis Laster, Vice Chancellor of the Court of Chancery.

### Eric L. Talley



is the Isidor and Seville Sulzbacher Professor of Law at Columbia Law School. He is an expert in the intersection of corporate law, governance and finance, and he teaches/researches in areas that include corporate law and finance, mergers and acquisitions, quantitative methods, machine learning, contract and commercial law, game theory and economic analysis of law. He serves on the board of directors of the American Law and Economics Association (ALEA), is Chair-elect of the board of directors of the Society for Empirical Legal Studies (SELS), and was the SELS co-president in 2013–2014. Mr. Talley is a frequent commentator in the national media and speaks regularly to corporate boards and regulators on issues pertaining to fiduciary duties, governance and finance. In 2017, Mr. Talley was chosen by Columbia Law School's graduating class to receive the Willis L.M. Reese Prize for Excellence in Teaching.



# Ruminations on Appraisal\*

What are the policy implications of a dissenter's right to appraisal in a "clean" transaction?

Trial judges are bound by controlling precedent and by a healthy respect for persuasive precedent; above all, they must be faithful to the Constitution and to applicable statutes, lest they arrogate for themselves power that resides properly with the people as expressed by their elected representatives.

Appraisal actions in Delaware are statutory<sup>1</sup> and well armored by precedential case decisions. In appraisal cases, then, I am bound to apply the statute: to paraphrase the Whiffenpoofs, as a bench judge I will exercise that statute, while life and breath remain, and then pass and be forgotten with the rest.

Nonetheless, a cat, they say, may look at a king. In that vein, it is perhaps worthwhile to think about the policy implications of a dissenter's right to independent judicial appraisal in cases where stock of an entity trades freely, and where an independent and disinterested board has approved sale of the entity after exposure to the market.

Such appraisal actions are commonplace, and support an emerging boutique industry, that of so-called appraisal arbitrage. Do these actions have social utility? This brief article will consider appraisal with respect to such mergers: where the stock is readily transferable, approved by a disinterested board inde-

pendent of any controller or other conflict, and where the sale is consummated after an exposure to the market. I will refer to these mergers as "clean" mergers or transactions.<sup>2</sup>

Originally, the sale of a corporation required unanimous approval of all stockholders.<sup>3</sup> Such a rule created obvious concerns of value-reducing restraint on alienation and rent-seeking by hold-outs.<sup>4</sup> In relief of these problems, the General Assembly reformed the law so that approval by less than a unanimity — under current law, by a bare majority — was sufficient to transfer all interest in the corporation to a new owner, including that interest belonging to stockholders dissenting from the sale.<sup>5</sup>

The legislature, having terminated the traditional right for a stockholder to prevent a merger by withholding consent, gave statutory appraisal rights in compensation.<sup>6</sup> That is the traditional story of the birth of appraisal, and it may even be true.

\* This article was submitted before the release of the Delaware Supreme Court's opinion in *DFC Global Corp v. Muirfield Valve Partners, L.P.*, 2017 WL 3261190 (Del. Supr. Aug. 1, 2017).

What is not true is that problems regarding how joint property may be sold are unique to corporate stockholding. Judges and commentators have compared appraisal to eminent domain,<sup>7</sup> in which a sovereign may take property for a public purpose, but the former owner must be compensated; if she rejects the sovereign's offer, she is entitled to a judicial hearing to determine fair value for the seizure.

This is an imperfect analogy to the "clean" merger sale, to my mind; in a merger, the corporate directors have approved the sale as in the best financial interest of the stockholders, and a majority of stock is in favor. Only the minority who reject the sale are being dragged along. And, unlike with the eminent domain seizure, in a clean merger a market price has been established.

Diverse stock ownership and its implication for the sale of the company is, in my opinion, more usefully compared to cotenancy in real property and the sale of the joint estate. As with stock and corporate ownership, in cotenancy property ownership is divided among the tenants. The common law recognized that ownership in the various forms of cotenancy was problematic, with the same limitations on alienability and holdout problems applicable as with stock ownership.

Equity addressed the problem — at first with respect only to coparceners — with the remedy of partition.<sup>8</sup> Eventually partition was extended to other forms of cotenancy, as codified by statute,<sup>9</sup> the analog to appraisal here being statutory partition.

Where owners cannot agree on disposition or on other rights inherent in real property, each cotenant has a right to a statutory partition.<sup>10</sup> While large parcels may be partitioned in kind, the analog to the merger occurs where partition in kind would destroy value. In that case, the statutory remedy is a partition sale at "public vendue," that is, a statutory auction.<sup>11</sup> As a result, market price — determined via a public auction — is considered the statutory "fair" price for the property involuntarily transferred: the undivided fractional ownership interest of the respondent in the partition action.

It is quite true that a forced auction of

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**A system that allowed controllers to squeeze value from a minority could be "fair" if transparent, I suppose, but nonetheless inefficient.**

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this type may produce a lower sale price than a more traditional and lengthy exposure to the real-estate market. No unfairness is considered to result, because an involuntary partition sale is simply the flip side of the right to partition — a right attaching to jointly-held property.

Looked at another way, a potential for involuntary partition is a condition inherent in property acquired jointly; a condition known to any buyer of such property and baked into the price. Thus, there is no question of unfairness. This is the method the General Assembly has used to address the problem of alienability of jointly-held real property.

In partition, judicial action is at the front end — a dispute among co-owners over, say, sale of the property, sparks a partition action, upon which the court, pursuant to the statutory directive, compels dissenting owners to submit to a public sale. The nature of corporate mergers typically involves intense negotiations over the many considerations in valuing the company, the need for substantial diligence review and the need for confidentiality in such review and often the sale process in general.

Such considerations have led to the creation of statutory drag-along obligations on the dissenting minority and concomitant rights held by the majority once empowered by board recommendation of the merger.<sup>12</sup> Unlike with partition, these rights are not dependent on

front-end judicial intervention. Judicial relief via appraisal comes at the back end, once a sale has been consummated.

The appraisal statute mandates a judicial determination of fair value.<sup>13</sup> In what one might term "classic" appraisal, there is no reliable market to determine value; where a controller has set the price and squeezed out the minority, for instance. In such a case, the statute mandates that the court "shall take into account all relevant factors" to determine the "fair" value of the company.<sup>14</sup>

Note that this is not necessarily an issue of fairness to the stockholder — as with joint tenancy, fairness inheres in receiving what one has paid for, and a system without appraisal rights for squeeze-outs could in that sense be "fair."

The reason for appraisal must be sought, I think, in terms of efficient capital markets, not fairness. Our corporate law is designed as a menu that protects certain rights while allowing flexibility, allocated so as to enhance value and encourage investment. A system that allowed controllers to squeeze value from a minority could be "fair" if transparent, I suppose, but nonetheless inefficient: presumably, few people would invest in equity ownership subject to squeeze-out at an unfair price.

Creating conditions that encourage investment, therefore, requires a judicial appraisal, using valuation techniques, in the squeeze-out or "classic" appraisal situation.<sup>15</sup>

How should this apply in the case of what I have termed the "clean" merger, including stock that trades freely, determination by an untainted board that the merger represents greater than stand-alone value, and exposure to a market?

All stockholders, presumably, have beliefs as to the subjective value of ownership of their stock, and approval of the merger means that the merger price exceeds that subjective value for a majority of the stock. Dissenters are losers at the merger price; their subjective valuations are higher, but the statutory scheme — again, based presumably on efficiency, not equity — calls for "fair," not subjective, value. Receiving the price set by the market puts dissenters in no worse position than that available to dissenting

joint tenants in real estate.

Should dissenting stockholders in “clean” transactions receive appraisal at all? Professor Eric Talley, who has another article in this issue, and who has thought deeply and written persuasively on appraisal, has perceptively noted to this writer that appraisal is a kind of Rorschach test for views about markets. It is certainly correct, as the Court of Chancery has noted, that a public sale of a complex and expensive asset such as a corporation may attract offers at different times and under different conditions that indicate substantially differing market values for essentially the same asset.<sup>16</sup> This, of course, is — must be — of concern to a bench judge struggling to apply a statute requiring her to determine “fair value.” But what are the policy implications of this fact?

I find little to recommend extending an appraisal right to dissenters in the case of a “clean” merger. As I have expressed above, efficiency of capital markets, not

**If a stockholder’s right to appraisal upon dissent from a “clean” merger is stripped, the question is whether such a regime will limit the flow of capital to corporations.**

fairness, is the proper goal of the appraisal statute. To believe such efficiency requires appraisal with respect to a “clean” merger, one must also believe a number of subsidiary propositions.

First, that an entity has an objective, inherent value independent of market value. Second, that such inherent value is potentially higher than will be developed by a sale with market exposure. Third, that the inherent value of an acquired entity is higher than the stand-alone value of the company as determined (presumably erroneously) by its informed fiduciaries, who must approve the sale. Finally, that a bench judge, armed with self-serving expert testimony from the parties, is a more reliable diviner of inherent value than the market and the directors.

These propositions are, to my mind, more or less unlikely. Others make reasoned arguments for the unreliability of the market to set value, and champion judicial valuation.

In either case, it seems to me, efficiency is not necessarily served by judicial second-guessing of the market with respect to a “clean” merger.

If a stockholder’s right to appraisal upon dissent from a “clean” merger is

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stripped, the question is whether such a regime will limit the flow of capital to corporations. That seems unlikely to me, given the other protections inherent in the “clean” transaction — including requirements that the board determine that the merger enhances value, an informed majority vote of stockholders determining the same, and market exposure.

In such circumstances, it seems unlikely that a lack of appraisal rights would dissuade investment. To the extent it does so, that cost must be set against the costs of the availability of appraisal, which logically drives down merger price to the extent a reserve must be set aside by the buyer to account for the costs of an appraisal action plus any award.

I acknowledge that some who have examined the process argue that the potential for appraisal drives merger consideration up, to clear an effective “inherent value” price perceived as likely to result from appraisal. If true, however, that may be value-destroying as well. If such is the

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**The statute permits stockholders who have purchased stock after announcement of the merger to perfect the right to an appraisal.**

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case, and the buyer’s surplus is sufficient to accommodate the perceived appraisal premium, the deal will close, with that part of the surplus reassigned to stockholders. If the buyer’s surplus is not suffi-

cient, however, the deal will fall through; a deal that by definition the board and a majority of stockholders would have found value-enhancing.

This brings me to the strange case of appraisal arbitrage. Appraisal arbitrage is a phenomenon facilitated by our appraisal statute, as written: the statute permits stockholders who have purchased stock after announcement of the merger to perfect the right to an appraisal.<sup>17</sup> Thus, investors who believe they can achieve a surplus to the stock price (typically trading at a small discount to the merger price, representing uncertainty that the deal will close) via an appraisal action can effectively purchase a right to conduct such litigation.

If one’s view of “clean” merger appraisal is a Rorschach test, then perception of appraisal arbitrage is the whole ink-blot deck. Those who are suspicious

See **Ruminations on Appraisal** continued on page 29

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# The Legislative Origins of

# Today's Appraisal Debate

A look back at the evolution of the DGCL and the origins of the explosive rise in "appraisal arbitrage" filings.

The appraisal action has been part of the Delaware General Corporation Law ("DGCL") since the late 1800s. Until 10 years ago it enjoyed a relatively sleepy history. No more. Appraisal is now a hot topic at corporate law conferences and the subject of more than half the M&A cases Law360 has identified as the "most important to watch" in 2017.

This intensified interest is a consequence of an exponential rise in appraisal filings in the last decade. Many attribute this increased activity to "appraisal arbitrage" — the act of investing after a deal has been announced with the express intent of later pursuing an appraisal claim.

This litigation-by-acquisition model was first challenged 10 years ago and found to comply with the statute.<sup>1</sup> The subsequent rise in appraisal filings<sup>2</sup> (and the distaste some have for appraisal arbitrage) has led to debates about the scope of the appraisal statute and the Court of Chancery's role in its application.

Simplified, DGCL Section 262<sup>3</sup> requires that the Court of Chancery determine the "fair value" of a dissenting minority stockholder's holdings subject to specific procedural requirements. Generally, this right is available only to those receiving cash (read: not stock) in a transaction. This mundane-sounding

valuation standard is "liberal" and "flexible" — as the statute states, valuation is to be done by "tak[ing] into account all relevant factors."

Some of the Court of Chancery's Section 262 decisions exasperate the M&A community. Why, the reasoning goes, should the "fair value" of a public company be anything other than the price agreed to in an arm's-length process? This argument is bolstered by the near-universal acknowledgement that the "law-trained" members of the Court of Chancery are not well-situated to act as valuation experts,<sup>4</sup> and are forced to do so guided primarily by paid experts' wildly disparate opinions.<sup>5</sup>

When the Court concludes that a company is worth an amount other than the deal price, the response is often indignation; such decisions have been characterized as having "hardly been the Delaware courts' finest moments."<sup>6</sup>

Setting aside the merits of the argument: it is important to recognize that this debate could have been avoided altogether. The General Assembly and its corporate law advisers — dating back to 1899 — have made a series of decisions that ultimately (i) tasked the Court of Chancery (rather than “appraisers”) with appraisal and (ii) declined a “market”-based standard in favor of “value” (or, better yet, “fair value”).

They also have declined to directly tackle appraisal arbitrage. Consequently, those unhappy with the current state of affairs may want to refocus. After all, without these legislative determinations — perhaps, not the General Assembly’s “finest moments” — today’s debate would not exist.

#### **Avoiding the “Market” Price and Judicial Involvement in Appraisal**

At common law, appraisal was unnecessary: mergers required unanimous stockholder approval and therefore it was “within the power of a single stockholder to prevent a merger.”<sup>7</sup> By the late 1800s, this system no longer comported with economic reality. States enacted corporate law statutes eliminating the unanimous vote requirement — a substantial shift in decision-making power from the minority to the majority. In exchange, many states adopted appraisal statutes that granted dissenting minority stockholders the power to seek review of how much they were to be paid for relinquishing their investment.

The DGCL enacted in 1899<sup>8</sup> reflects this approach. Eschewing unanimity, Section 54 required a two-thirds stockholder vote for any consolidation. Section 56 granted dissenting stockholders the companion right to appraisal, albeit in a fashion we would hardly recognize today. An objecting stockholder was entitled to “the value of the stock[.]” If “value” was the source of disagreement, it was to be determined not by the Court, but instead “ascertained by three disinterested persons, one of whom shall be chosen by the stockholder, one by the directors of the consolidated corporation and the other by the two selected as aforesaid.”

In these early years, the Court of Chancery was largely a bystander to the

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**By the early 1960s: (i) the Court of Chancery was not responsible for appraisal in the first instance and (ii) case law indicated that “value” was distinct from “market value.”**

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appraisal process. A 1927 amendment rendered the appraisers’ decision “final and binding.”<sup>9</sup> A 1943 revision changed this approach and allowed a dissenting stockholder to challenge a lone appraiser’s findings by raising “exceptions” with the Court of Chancery.<sup>10</sup> The appraiser, therefore, became “akin to a Master in Chancery.”<sup>11</sup>

This increased judicial review helped to cement the (later rejected) “Delaware Block” method, which mandated that an appraiser take certain retrospective “elements of value, *i.e.*, assets, market price, earnings, etc.,” and then assign them “a particular weight” to calculate “value.”<sup>12</sup>

It appears that the 1899 General Assembly consciously determined that a dissenting stockholder was entitled to “value” — rather than, for example, “full market value.” This history and conclusion is set forth in then-Chancellor Wolcott’s 1934 decision in *Chicago Corp. v. Munds*.<sup>13</sup> As the Chancellor noted, the DGCL was modeled on New Jersey’s 1896 corporation statute which required payment of “full market value.” The Chancellor understandably concluded that Delaware’s decision to forgo New Jersey’s “full market value” test in lieu

of “value” meant that the market did not control appraisal actions in Delaware.<sup>14</sup>

In sum, by the early 1960s: (i) the Court of Chancery was not responsible for appraisal in the first instance and (ii) case law indicated that “value” was distinct from “market value.”

#### **The DGCL Revision Committee Rejects Wholesale Market Deference**

As is common knowledge for readers of this magazine, in the 1960s Delaware revised its corporation law. In 1963, a “Revision Committee” was appointed and it hired Ernest L. Folk, III to draft a report recommending revisions (the “Folk Report”). A drafting subcommittee pieced together a new statute aided by the Folk Report, “the minutes of the Revision Committee [and] other sources such as the Model Business Corporation Act[.]”<sup>15</sup>

These records — imperfect though they may be<sup>16</sup> — evidence that Professor Folk and the Revision Committee discussed whether to eliminate appraisal for stockholders in large public companies in deference to the market. They declined to do so.

Professor Folk’s Report is remarkably reflective of the modern M&A community’s appraisal critique. He “recommend[ed] that the traditional shareholder appraisal right should be substantially abolished in Delaware” and noted that “[m]uddled theory and inconsistent treatment has always been characteristic of the appraisal right in all jurisdictions.”<sup>17</sup>

Specifically, Professor Folk argued that appraisal be eliminated for all publicly traded stock in reliance on the protection the market would offer the minority: “Stated generally, this Report recommends, as a minimum, dropping cash-for-dissenters with respect to shares listed on any exchange or subject to the expanded jurisdiction of the S.E.C. under the Securities Acts Amendments of 1964. By hypothesis, there is an active market for these shares; federally required disclosure affords substantial protection; and residual equity jurisdiction to deal with ‘fraud’ remains unimpaired.”<sup>18</sup>

Appraisal would, in Folk’s view, be retained only for investments in close

corporations or “‘small’ public corporations.”<sup>19</sup>

The Revision Committee considered as much: “Prof. Folk discussed the abolishment of appraisal rights since a proxy statement would furnish stockholders with pertinent information. Mr. Arsht discussed elimination of appraisal rights where there is an established market price.”<sup>20</sup> Committee notes memorialize that, in contrast, at least one member believed “the appraisal remedy should be retained.”<sup>21</sup> In February 1966, “as a matter of policy,” the Revision Committee was prepared to eliminate appraisal for companies registered on a national exchange or boasting more than 2,000 stockholders.<sup>22</sup>

Professor Folk’s recommendation was, obviously, not wholly implemented. The 1967 DGCL excluded from appraisal stock that was “either (1) registered on a national securities exchange, or (2) held of record by not less than 2,000 stockholders” but then in its final sentence reinstated appraisal rights for stock “not converted...solely into the stock of the corporation resulting from or surviving” from the merger.<sup>23</sup>

Professor Folk was literally puzzled by the Revision Committee’s cash-versus-stock distinction. His comments on the draft statute included: “I am somewhat puzzled by the import of the final clause of 262(k)... I take it to mean that if stockholders do not receive shares (or securities) of the surviving or new corporation, then ‘this subsection,’ which denies the appraisal remedy in certain circumstances, ‘shall not be applicable’; and therefore that such shareholders are entitled to the appraisal remedy. I must be missing something, but I wonder if this is the intent of the provision?”<sup>24</sup>

It was. The Revision Committee and the General Assembly eliminated appraisal in stock-for-stock public company deals in the name of market deference, but retained it when stockholders received another form of compensation.

The specifics of the Revision Committee’s deliberations on this point are largely lost to time. Mr. Arsht stated in a 1967 article that “[t]he principal rationale behind [§262(k)] is that in the circumstances in which it applies a pub-

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## The Revision Committee and the General Assembly eliminated appraisal in stock-for-stock public company deals in the name of market deference.

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lic and presumably active market for the stock will exist and a dissenting stockholder will not be locked into a situation if he prefers to get out.”<sup>25</sup> He elsewhere noted, however, the potential imperfection of the market — perhaps explaining the decision to further protect a stockholder receiving cash.<sup>26</sup>

Another committee member explained that eliminating appraisal altogether raised a “fear that courts might more easily disapprove ‘unfair’ mergers if the shareholders had no alternative remedy.”<sup>27</sup>

The Revision Committee may not have anticipated the continued impact of its cash-versus-stock distinction. Mr. Arsht’s *Substantive Changes* touts the revision as having “abolished” appraisal where there is “reasonable assurance of a public market” with an almost after-the-fact reference that this was “qualified” based on the form of consideration.<sup>28</sup> Needless to say, cash financing of large public company transactions is quite different today. It seems reasonable to presume that the Revision Committee was not contemplating, for example, the possibility of a \$100-billion cash deal.<sup>29</sup>

Corollary to the retention of appraisal for cash deals, Section 262 retained the mandate to determine “value.” Other formulations were presumably discussed. The Revision Committee drew from the

1960 Model Business Corporation Act (“MBCA”),<sup>30</sup> which referred to “fair value.”<sup>31</sup> MCBA comments recited the “variety of terms employed to express the basis of valuation of shares” and noted Delaware’s status as one of 17 states using “value,” while 19 others used “fair value,” and eight others used some “market”-based formulation.

Finally, also retained was the use of an “appraiser,” empowered to determine “the value of the shares upon such investigation as to him seems proper,” subject to the hearing of exceptions by the Court of Chancery.<sup>32</sup>

### The Court of Chancery as Valuation Expert and the “Fair Value” Inquiry

While the General Assembly and its advisers had previously rejected a market-based test and required the Court of Chancery to oversee an appraiser’s decisions, it was in the 1970s and 1980s that the Court of Chancery was definitively tasked with a sweeping valuation inquiry.

In 1976, Section 262 was amended to require the Court of Chancery to “appraise the shares.” Eliminating use of an appraiser was touted as “streamlining... a time-consuming and wasteful process.”<sup>33</sup> The 1976 revision also first incorporated “fair value.” Remarkably, this appears to have been unintentional. The accompanying bill synopsis states: “[t]here is no intent to modify or affect... the substantive law used to value shares of stock[.]”<sup>34</sup>

In 1981 a further amendment added four additional references to “fair value” and the “all relevant factors” mandate, but the accompanying synopsis provides no material guidance on this point.<sup>35</sup> Regardless, these changes quickly had an impact. In 1983, the rigid, retrospective “Delaware Block” method was rejected in favor of today’s “liberal approach” to valuation permitting “proof of value by any techniques or methods which are generally considered acceptable in the financial community[.]”<sup>36</sup>

The 1976 and 1981 amendments to incorporate “fair value” and “all relevant factors” were deemed “significant” to this finding, and illustrating “a legislative intent to fully compensate shareholders for whatever their loss may be[.]”<sup>37</sup>

## The Current Debate

By 1983, the Court of Chancery was affirmatively tasked with applying a broad, flexible valuation methodology. For nearly 25 years, however, this system generated the occasional groan rather than uproar. In 2007, things shifted with the Court of Chancery's *Transkaryotic* decision, holding that appraisal arbitrage comported with Section 262. At the fore was the "policy concern" that it would "pervert the goals of the appraisal statute by allowing it to be used as an investment tool."<sup>38</sup> As the Court of Chancery noted then, "[t]o the extent that this concern has validity, relief more properly lies with the Legislature.... The Legislature, not this Court, possesses the power to modify § 262 to avoid the evil, if it is an evil, that purportedly concerns respondents."

This call has been repeated. In April 2015, for example, seven law firms banded together and urged legislative action to eliminate appraisal arbitrage to "reduce the unseemly claims-buying that is rampant and serves no legitimate purpose."<sup>39</sup>

To date, the General Assembly has only indirectly addressed the issue of appraisal arbitrage and otherwise left untouched the Court of Chancery's responsibility for a flexible valuation standard. In 2016, Section 262 was amended to (i) require petitioning stockholders to represent over 1% of outstanding shares (or, over \$1 million) and (ii) permit prepayment to an appraisal petitioner to reduce interest accrual. It is not yet clear what impact these amendments will have.

As of this writing, in 2017, 14 deals have been challenged.<sup>40</sup> A majority are easily tied to arbitrageurs via a Google search.

Section 262's evolution highlights a number of opportunities to have chosen a different path for the appraisal claim. Corporate valuation is a complex mathematical exercise far from the wheelhouse of law-trained lawyers and judges. The General Assembly and its advisers, however, have deliberately tasked the Court of Chancery with a sweeping, liberal review of valuation activities conducted in the first instance by those immersed in the world of finance.

To the extent this system is imperfect, it is a result of legislative determinations dating back well over a hundred years. Those unhappy with the current state of the appraisal claim should be mindful of this reality and advocate for change with those in a position to create it: the General Assembly and its corporate law advisers. ♦

## NOTES

1. *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007).
2. "Sixty-two appraisal actions were filed in 2016, representing \$1.9 billion in face-value claims, compared to sixteen actions, representing \$129 million in face value, in 2012." Guhan Subramanian, *Using the Deal Price for Determining 'Fair Value' in Appraisal Proceedings* (SSRN Draft Feb. 6, 2017).
3. 8 Del. C. § 262.
4. *See, e.g., In re Appraisal of Ancestry.com, Inc.*, 2015 WL 399726, at \*1 (Del. Ch. Jan. 30, 2015) ("I have commented elsewhere on the difficulties, if not outright incongruities, of a law-trained judge determining fair value of a company in light of an auction sale....").
5. *See, e.g., In re Appraisal of Dell*, 2016 WL 3186538, at \*45 (Del. Ch. May 31, 2016) ("Two highly distinguished scholars of valuation science, applying similar valuation principles, thus generated opinions that differed by 126%, or approximately \$28 billion. This is a recurring problem.").
6. W. Carney & M. Heimendinger, *Appraising the Nonexistent*, 152 U. PA. L. REV. 845, 845 (2003).
7. *Salt Dome Oil Corp. v. Schenck*, 28 Del. Ch. 433, 442 (Del. Feb. 5, 1945); *see also Voeller v. Neilston Warehouse Co.*, 311 U.S. 531, 535 n.6 (1941).
8. A copy is available at <http://delawarelaw.widener.edu/files/resources/dgcl1899.pdf>.
9. 35 Del. Laws c. 85 § 20 (1927).
10. 44 Del. Laws c. 125 § 7 (1943).
11. *In re Gen. Realty & Utilities Corp.*, 29 Del. Ch. 480, 490 (1947).
12. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712 (Del. 1983).
13. 20 Del. Ch. 142 (1934). This was not a traditional appraisal opinion. Rather, the resulting corporation was seeking to compel transfer of already-appraised stock.
14. *Id.*; *see also Tri-Continental Corp. v. Battye*, 74 A.2d 71, 72 (Del. 1950) ("market value, asset value, dividends, earning prospects, the nature of the enterprise and any other facts... are not only pertinent... but must be considered").
15. S. Samuel Arshat, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 16 (1976) [hereinafter *A History*].
16. "[N]o single record can be looked to reconstruct the deliberations of the Revision Committee" and "[t]here is a major gap in the records...where changes depart from both the Folk Report and the Revision Committee's conclusion." *Id.* at 16-17.
17. Ernest L. Folk, III, *Review of The Delaware General Corporation Law for the Delaware Corporation Law Revision Committee 1965-1967* at 196 available at <http://delawarelaw.widener.edu/files/resources/folkreport.pdf> [hereinafter *Folk Report*]. *See also* Arshat & Stapleton, *Analysis of the New Delaware Corporation Law* at 341 (Prentice Hall 1967) [hereinafter *Analysis*] (describing appraisal as a "mixed blessing" that "should be preserved only for those cases in which there is no public or active market for the shares").
18. *Folk Report* at 198.
19. *Folk Report* at 199.
20. September 3, 1964 Minutes, available at <http://delawarelaw.widener.edu/files/resources/committeeminutes.pdf>.
21. Comments on *Folk Report*, July 8, 1966, available at <http://delawarelaw.widener.edu/files/resources/committeedocuments.pdf>.
22. *Supra* note 22 (Feb. 15, 1966 Minutes).
23. 56 Del. Laws c. 50 § 1 (1967).
24. Letter from E. Folk to R. Corroon, Dec. 20, 1966, available at <http://delawarelaw.widener.edu/files/resources/committeedocuments.pdf>.
25. *Analysis* at 341.
26. "It can be argued that there is no necessary connection between the existence of a public market and the need for an appraisal right and this is, of course, true. The management of a corporation whose stock is traded on an exchange may agree to a merger so improvident that it drives the market down before all objecting stockholders can escape at a price which fairly reflects the value of the enterprise...." Arshat & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 89 (Nov. 1967) [hereinafter *Substantive Changes*].
27. *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 873 n.93 (1969).
28. *Substantive Changes* at 89. *See also* Folk, *The Delaware General Corporation Law* at 373 (Little, Brown 1972) ("the right is of decreasing importance...").
29. Law360, *4 Takeaways from the 2017 Tulane Corporate Law Institute* (Apr. 3, 2017).
30. *A History* at 16.
31. MBCA § 74 (1960).
32. 56 Del. Laws c. 50 § 1 (1967).
33. 60 Del. Laws c. 371 §§ 3-12 (1976).
34. *Id.* (commentary).
35. 63 Del. Laws c. 25 § 14 (1981).
36. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713-14 (Del. 1983).
37. *Id.*
38. 2007 WL 1378345, at \*5.
39. Law360, *Corporate Firms Take Aim at Delaware's Appraisal Laws* (Apr. 7, 2015).
40. This is the result of a Bloomberg Law search (as of May 16, 2017).

## FEATURE

Eric L. Talley

Isidor & Seville Sulzbacher Professor  
of Law, Columbia Law School.

# Finance in the Courtroom:

# Appraising Its Growing Pains



Increasingly complex  
and technical M&A  
economic tools have  
become essential in  
the modern courtroom.

The command *Eat your broccoli*, long a linchpin of the prudential parenting handbook,<sup>1</sup> carries added symbolic weight among mergers and acquisitions (M&A) lawyers. For them, a metaphorical species of broccoli has been dominating the menu of late — one whose intellectual consumption is no less compulsory: the tools of modern financial economics.

Signs are easy to spot. Rapidly proliferating continuing legal education panels and executive education programs, first-year associate “boot camps,” and targeted professional journals are all increasingly geared towards fomenting greater literacy in modern finance among the practicing bar.

Law students, too, have taken note: over 90 percent of my students who plan seriously to practice in the M&A field, for example, will take at least one class in corporate finance before graduation.

The influence finance enjoys in the courtroom is hardly news anymore. In fact, the field’s enduring bear hug of M&A practice was all but *solicited* more than three decades ago with a cluster of watershed cases that would collectively usher it in — opening a door that has yet to be shut. Many of these opinions — such as *Weinberger v. UOP*,<sup>2</sup> *Smith v. Van Gorkom*<sup>3</sup> and *Revlon v. MacAndrews &*

*Forbes*<sup>4</sup> — remain to this day as beacons on the M&A landscape.<sup>5</sup>

And yet, notwithstanding its considerable success in reshaping courtroom discourse, finance is increasingly greeted with a tinge of apprehension, even among its ardent supporters. While this reception no doubt has many drivers, key among them are:

- 1) The necessarily generalist backgrounds of most legal practitioners and judges;
- 2) The progressively specialized nature of finance, often manifest in highly technical (and seemingly impenetrable) debates about assumptions, methodologies and techniques; and
- 3) The ever-widening gulf between (1) and (2).

Perhaps no topic better embodies the mid-life crisis facing courtroom finance than the post-merger appraisal proceed-

ing, long a sleepy practice area that has come recently to command center stage in Delaware corporate litigation.<sup>6</sup> In many ways, appraisal constitutes a perfect storm for jurisprudential *ennui*: its authority emanates from statute rather than common law<sup>7</sup>; the text of the statute is (at best) syntactically tormented<sup>8</sup>; there is not a clear allocation of burdens<sup>9</sup>; claims trading is widespread, even after the record date for the merger<sup>10</sup>; buyer-specific deal “synergies” are excluded, though often difficult to isolate<sup>11</sup>; experts on both sides invariably stake out extreme ends of the valuation spectrum<sup>12</sup>; and courts are prohibited from implementing incentive mechanisms designed to elicit greater moderation.<sup>13</sup>

And, unlike highly trained (and highly remunerated) investment bankers — whose job requires generating a “football field” *range* of discounted cash flow (DCF) valuations — a judge presiding over an appraisal proceeding must conjure up a *single number* at the end of the process.<sup>14</sup>

The confluence of these factors can leave a presiding factfinder at sea, with little guidance, sketchy support, and no assurance that later cases are destined to get any easier.<sup>15</sup>

Viewed against this backdrop, it is hardly surprising that Delaware courts and practitioners have long foraged for a “broccoli substitute” of sorts — something that channels fair value while sidestepping the need to interrogate, decipher and ultimately reconstitute the messy layers of experts’ DCF opinions.

And as it happens, a seemingly alluring candidate has persistently stepped forward of late: the merger price itself. As the product of arm’s-length bargaining, forged in the “crucible of objective market reality”<sup>16</sup> (the argument goes), the negotiated deal price delivers a ready (and convenient) reference point — one that ostensibly obviates the need to grapple with tedious financial valuation metrics.

But as the great American playwright Arthur Miller demonstrated over a half century ago, for those who seek a reckoning with objective truth, there are crucibles ... and then there are *Crucibles*.<sup>17</sup>

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In game-theory terms, the merger price is best able to deliver a reliable reflection of fair value when — somewhat ironically — courts can *credibly threaten to eschew it*.

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From which does the merger price emanate? As of this writing, the Delaware Supreme Court is considering two significant appeals<sup>18</sup> that take on this question in two stages: First, in the context of a qualifying arm’s-length sale process, should the Court of Chancery be *required* to defer to the deal price? And if so, how does one determine whether the sale process in any given case qualifies it for such deference?

In the interests of full disclosure, I helped author an *amicus* brief in one of these matters on behalf of myself and 20 other professors of law, economics and finance (including a Nobel laureate).<sup>19</sup>

On the one hand, our brief specifically endorses the idea that deal price may well reflect fair value, at least in appropriate circumstances.<sup>20</sup> Nevertheless, it also argues that: (a) current doctrine already gives the Chancery Court adequate discretion to embrace the merger price when such circumstances are present; (b) a strong deal price deference requirement is functionally equivalent to a judicial repeal of the appraisal statute, improperly bypassing the Delaware General Assembly; and (c) merger price deference, if anticipated in advance by buyers, can cause them to soften their bidding strategies, undercutting the probative value of deal

price as a reflection of fair value.

In game-theory terms, the merger price is best able to deliver a reliable reflection of fair value when — somewhat ironically — courts can *credibly threaten to eschew it* in an ensuing appraisal proceeding (even if they don’t ultimately follow through).

But regardless of what happens in the cases on appeal, the ongoing kerfuffle over appraisal has important implications that deserve our reflection — implications about both the proper scope of finance and its relationship to law.

Among most M&A practitioners, modern finance likely conjures up the concept of *valuation*, and specifically DCF analysis: the process by which an expert (or a reluctant judge) cobbles together a present discounted valuation of a business entity combining forward looking cash flow projections, risk/tax/capital-structure adjusted discount rates, and terminal value projections. (Diving into the details of this process occupies a large fraction of my own corporate finance course at Columbia.) The pivotal role of valuation theory is self-evident in the M&A litigation context — both inside and outside of appraisal.

But valuation is only half the story. Another major area of financial economics — and one that has received relatively less judicial focus by comparison — concerns *auction design*. Auction theory has been one of the most fertile and interesting areas in economics for decades, with significant advances made in the last quarter century. It holds obvious relevance in the M&A context too, delivering important insights into (*inter alia*): how to design bidding protocols that maximize revenue and/or efficiency; how to adapt such protocols for different sorts of bidder configurations (*e.g.*, private versus common valuations); how best to share information among prospective bidders; how to set an optimal reservation price; the effects of ownership toeholds; and the extent to which market tests and deal protections can encourage bidder competition.

At the same time, an acknowledged downside of auction theory is that it, too, has evolved into a technical and complicated field — one that can seem

inaccessible even to sophisticated generalists. That complexity may well have induced Delaware courts to resist engraving auction design desiderata into legal doctrine. In *Paramount v. QVC*, for example, the Delaware Supreme Court specifically recognized the complexity of designing sales processes, noting that even under *Revlon*, courts will not scrutinize directors' business judgment if the process was, on balance, within a range of reasonableness.<sup>21</sup>

This approach has been reaffirmed many times over, most recently in *C&J Energy Services*,<sup>22</sup> which similarly held that "Revlon and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks."<sup>23</sup>

Delaware courts have likewise rebuffed auction theory when invoked by defendants. In *Omnicare v. NCS Healthcare*,<sup>24</sup> the Delaware Supreme Court (in) famously rejected a competitive sales process that appeared — by nearly all objective measures — to be strongly consistent with textbook tenets of optimal auction design.

The jurisprudential stiff-arming of auction theory is perhaps understandable from a broader perspective. In many real-world disputes, optimal auction design may simply be a heavier lift than DCF analysis. And thus, a finance-wary court could easily prefer — if confronted with the choice — to adjudicate valuation over auction design. Such a preference might also shed light on why the Chancery Court has frequently resisted enjoining a deal on *Revlon* grounds (thereby sidestepping auction theory) if the transaction is also eligible for appraisal or quasi-appraisal later on (where valuation takes center stage).<sup>25</sup>

But that's just the point. Suppose (for argument's sake) that the cases now pending before the Delaware Supreme Court culminated in an interpretation of the appraisal statute *mandating* merger price deference — at least for qualifying arm's length transactions. While such an outcome might no doubt deliver a

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reprieve to the judiciary as to valuation matters, fact-finders would hardly be out of the woods. Rather, they would now have to navigate a less familiar grove in the metaphorical broccoli forest: auction theory.

Indeed, a merger-price deference rule of the sort posited above would almost necessarily train judicial attention on assessing whether the predicate conditions for a "qualifying" transaction are present in each case. And that determination, in turn, would seemingly require courts to deploy the lens of auction design to scrutinize (with possibly unaccustomed vigor) the sales process itself, its timing, bidding rules, bidder recruitment protocols, the permissibility of alternative deal/financing structures, information disclosure protocols, reserve pricing, post-bidding market checks, deal protection, the incentives of target directors and financial advisers, and so forth.

At a higher level, the merits of embracing the merger price may ultimately boil down to singling out one's judicial weapon of choice from corporate finance's cruciferous arsenal: valuation versus auction design. Delaware law currently vests substantial discretion over this choice with the Chancery Court —

discretion that makes considerable sense in the fact-intensive milieu of appraisal proceedings. And it bears noting that the Chancery Court has been anything but bashful about utilizing its discretion to embrace the deal price (or even less) when facts support doing so.

Indeed, a sizable majority of appraisal valuations issued by the Chancery Court the last four years have produced valuations either at or a *little below* the deal price.<sup>26</sup> A timely example can be found in Vice Chancellor Slight's well-reasoned opinion in *PetSmart*,<sup>27</sup> where the record reflected a robust and well-organized pre-signing auction process, motivated competition, numerous bidders of all flavors and little evidence of market failure<sup>28</sup> — all factors that should weigh heavily in favor of the deal price.<sup>29</sup>

The petitioner expert's DCF valuation, in contrast, utilized cash flow projections that either (i) reflected impermissible buyer-side synergies, or (ii) embodied hockey-stick-shaped cash-flow chimeras designed more to bolster negotiation leverage than to divine value.

On the basis of the factual record as he determined it, the Vice Chancellor's embrace of the merger price seems both theoretically defensible and empirically sound — and, it is an outcome he reached easily under existing doctrine.

While I remain skeptical of the merits of a merger price deference "rule" for appraisal cases, there is still significant room to improve how such cases are tried and adjudicated. For example, the now two-decade-old prohibition on the judicial use of incentive devices such as "baseball" arbitration to moderate extreme expert opinions perhaps deserves to be reconsidered.<sup>30</sup> (Here it merits observing that a variation of baseball arbitration still often occurs, whereby the judge sequentially selects between the experts' competing opinions on an *item-by-item* basis (as to the equity risk premium, estimated beta, de-leveraging techniques, discounting stages, perpetuity growth rates, applicable tax rates, and so forth.))

In addition, the Chancery Court may choose to experiment once again with retaining an independent expert to advise and consult in such matters, both as to

valuation and auction design. Though reputed to be an unsatisfying experiment when previously attempted, the nature of the disputes has changed too.<sup>31</sup>

Finally, judges should be mindful of their own staffing decisions: as noted above, an increasing number of law graduates (and prospective clerks) now receive serious training in financial economics — skills that can be helpful in navigating future appraisal cases. Each of these measures (and perhaps others) is consistent with the common-sense goal of affording Chancery Court judges the flexibility to ascertain fair value in a manner consistent with the facts and circumstances of each case.

After all, if you *have* to eat broccoli, you best be the one who chooses the recipe. ♦

## NOTES

1. Some, of course, have notoriously dissented from this edict. See Daniela Diaz, *George H.W. Bush still hates broccoli*, CNN Online (6/25/2016) (<http://www.cnn.com/2016/06/25/politics/george-h-w-bush-broccoli-twitter/>).
2. 457 A.2d 701 (Del. 1983).
3. 488 A.2d 858 (Del. 1985).
4. 506 A.2d 173 (Del. 1986).
5. See generally Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL ED. 342 (2005).
6. See Albert Choi & Eric Talley, *Appraising the 'Merger Price' Appraisal Rule*, U. Va. Law & Econ. Research Paper No. 2017-01 (2017) (<https://ssrn.com/abstract=2888420>); Guhan Subramanian, *Using the Deal Price for Determining 'Fair Value' in Appraisal*

*Proceedings* (2017) (<https://ssrn.com/abstract=2911880>).

7. DGCL § 262.

8. See, e.g., Robert Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 30 (1995).

9. *In re Appraisal of Ancestry.com*, C.A. No. 8173-VCG (Del. Ch. 2015).

10. *In re Appraisal of Transkaryotic Therapies, Inc.*, C.A. No. 1554-CC (Del. Ch. 2007).

11. *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182, 1187 n.8. (Del. 1988).

12. *In re Appraisal of SWS Group, Inc.*, C.A. No. 10554-VCG, at 2 (Del. Ch. May 30, 2017).

13. *Gonsalves v. Straight Arrow Publishers, Inc.*, 701 A.2d 357 (Del. 1997).

14. Choi & Talley, *supra* note 7, at 2.

15. See, e.g., *In re Ancestry.com*, *supra* note 10, at 1 (“this task is made particularly difficult for the bench judge, not simply because his training may not provide a background well-suited to the process, but also because of the way the statute is constructed”).

16. *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 42 (Del. Ch. 2007).

17. Arthur Miller, *The Crucible* (1953) (dramatizing the 17th-century Salem witch trials).

18. *Dell Inc. v. Magnetar Global Event Driven Master Fund Ltd. et al.*, Supreme Court of Delaware (Case No. 565, 2016); *DFC Global v. Muirfield Value Partners et al.*, Supreme Court of Delaware (Case No. 518, 2016).

19. See Brief of Law, Economics and Corporate Finance Professors as Amici Curiae in Support of Petitioners-appellees and Affirmance, *DFC Global v. Muirfield Value Partners et al.*, Supreme Court of Delaware (No. 518, 2016) (Feb. 3, 2017) (<http://lawprofessors.typepad.com/files/dfc-holdings---appraisal.pdf>).

20. *Id.* at 5, 15-16. These circumstances include robust bidding among multiple buyers, supermajority conditions, and easily comparable bids. For a formal theoretical development of

this idea, see Choi & Talley, *supra* note 7.

21. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 46 (Del. 1994).

22. *C&J Energy Services v. City of Miami Gen. Employees' & Sanitation Employees' Ret. Trust*, 107 A.3d 1049 (Del. 2014).

23. *Id.* at 1053.

24. *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

25. See, e.g., *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1023 (Del. Ch. 2005) (denying an injunction and noting that stockholders' alleged harm “can be rectified adequately in a later appraisal proceeding”).

26. These include *Huff v. CKx* (2013), *In re Ancestry.com Inc.* (2015), *Merlin Partners v. AutoInfo, Inc.* (2015), *LongPath v. Ramtron* (2015) (very slightly below deal price), *Merion Capital v. BMC Software* (2015); *In re Lender Processing Servs., Inc.* (2016); *In re PetSmart, Inc.* (2017); and *In re SWS Group, Inc.* (2017) (10 percent below deal price).

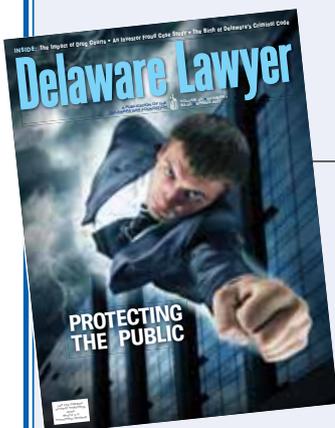
27. *In re Appraisal of PetSmart, Inc.*, C.A. No. 10782-VCS (Del. Ch., May 26, 2017).

28. See *Id.* at 4, 108.

29. See Choi & Talley, *supra* note 7, at 24-25.

30. In baseball arbitration, the judge pre-commits to selecting the most reasonable side's account hook-line-and-sinker, with the intended effect that the parties will moderate their arguments to increase the chance of their side being ultimately adopted by the adjudicator. Such processes were invalidated as inconsistent with the court's duty under DGCL § 262 to produce an independent valuation. See *Gonsalves*, *supra* note 13.

31. The changes are many, and include the frequency of litigation, the stakes involved, the sophistication of petitioners, the role of appraisal arbitrage, and the prevalence of claims trading. See Michael Greene, *M&A Deal Price Challenges Spiking in Delaware*, Bloomberg News (1/17/2017) (<https://www.bna.com/ma-deal-price-n73014449766/>).



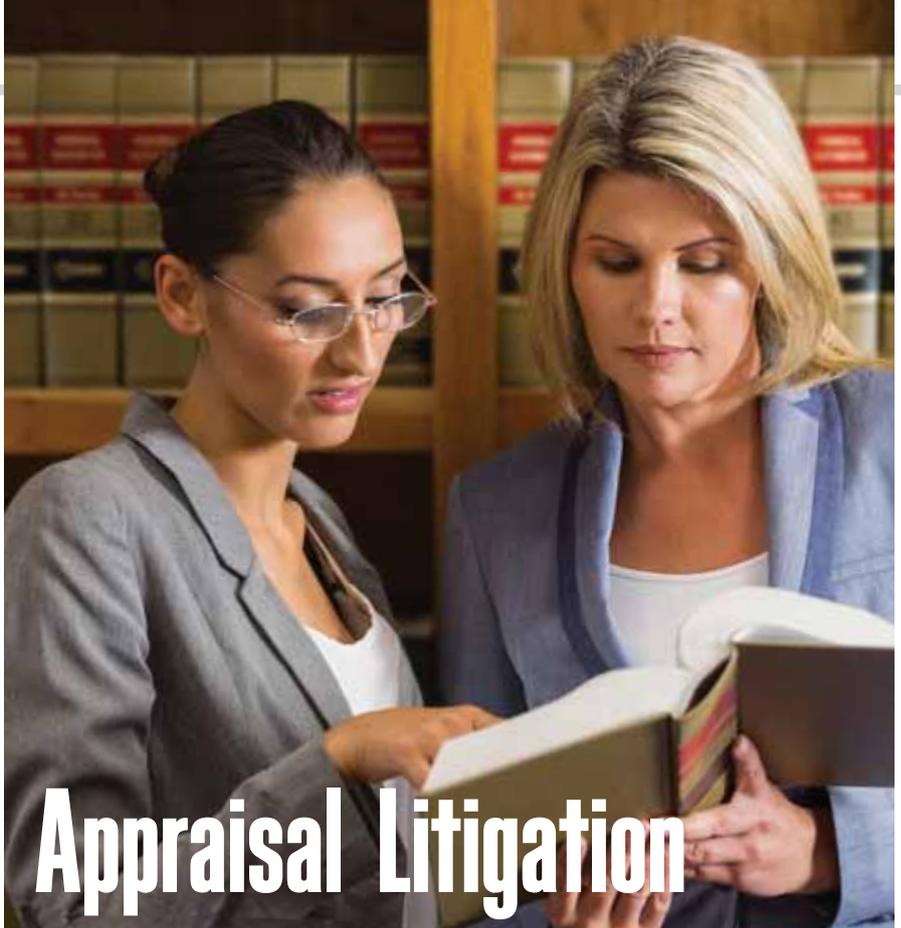
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# Reflections on

# Appraisal Litigation



As new technologies disrupt traditional markets, discounted cash flow valuations may be inadequate in determining fair deal values.

The Court of Chancery has often stated that the appraisal statute is a legislative remedy to provide dissenting shareholders a judicial determination of the intrinsic worth (fair value) of their shareholdings.<sup>1</sup> In applying this legislative remedy, the Court has relied heavily on academic valuation methodologies, primarily the discounted cash flow (“DCF”), to determine fair value.<sup>2</sup>

**T**he Delaware Supreme Court has made clear that even in a full auction without conflicts, the Court of Chancery will not be bound by the deal price as the sole determinant of fair value in an appraisal action.<sup>3</sup> As a result, the potential for significant cost uncertainty looms on the Delaware transaction landscape, regardless of how hard seasoned M&A advisors and corporate fiduciaries work to ensure a process that is robust and pristine.

In several opinions, the Court of Chancery has highlighted the difference between fair value and fair market value as the reason for not exclusively relying on the deal price in an appraisal action.<sup>4</sup> The Court has also pointed to the statute’s different temporal focus, requiring the Court to determine the value of the target at the moment just before the consummation of the merger rather than the date of signing, taking into account shifts

in applicable markets and opportunities between signing and closing.<sup>5</sup> Finally, the Court has highlighted how the appraisal process requires the Court to look beyond short-term distortions in value (“anti-bubbles”) in determining fair value.<sup>6</sup>

In attempting to remedy the perceived distortions between the fair market value and the judicially determined fair value, the Court often applied valuation methods that frequently create their own distortions. In particular, when eschewing the deal price, the Court tends to focus on the DCF valuation model to calculate fair value. The DCF relies on current projections and estimates for the next few years (sometimes up to five years) and then uses, absent an identifiable risk of insolvency, a generalized and theoretical perpetual growth rate tied to inflation, referred to as the terminal growth rate.

One may question the wisdom of re-

lying on management projections for a variety of reasons. However, a potentially greater shortcoming of the DCF methodology relates to the determination of fair value for the period beyond projections, because often the DCF employs a terminal growth rate. Estimating a terminal growth rate in this manner prevents the fact finder from taking into account new disruptive technologies that are constantly (and in many ways insidiously) impacting the marketplace. These disruptions often seem to appear out of nowhere to company management, like a black swan.

The issue is most pronounced for companies where DCF-based valuations are predominantly derived from the value associated with the period beyond management's projections, and often the implied price-to-earnings multiples associated with such DCF valuations are vastly different from market-based valuations. This is not to say that the DCF is fundamentally flawed, just that it has its limitations, as does any theoretical methodology.

Recent secular shifts in the retail industry provide a good illustration of the shortcomings of the DCF in isolation. It would have seemed logical only a few years ago to determine fair value of mall-based brick-and-mortar retailers by applying a terminal growth rate that was equal to or exceeded inflation or these retailers' growth rate over the then-previous years. The decline in mall traffic and the rise of e-retailers such as Amazon.com may be ubiquitous now, but would have been hard to predict — much less financially model — at that time.

Another recent example is the 2012 bankruptcy of the Eastman Kodak Company, which resulted, at least in major part, from the industry's secular shift from film-based photography to digital photography. These types of secular trends that occur over many years are different from short-term market disruptions that the appraisal statute and related cases instruct us to ignore.

As the Delaware courts have acknowledged, valuation, as well as the determination of a company's fair value in an appraisal proceeding, is an art, not a science.<sup>7</sup> While there is no foolproof valuation method, relying on the deal price as an indicator of fair value in cases where

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## Appraisal arbitrageurs still have plenty of incentives to pursue appraisal litigation, thereby increasing the risk for acquirers.

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there was a robust and clean process might be the best way to account for the aforementioned industry uncertainties. This is because it is the company, along with the strategic and financial bidders engaged in the auction process, that are most familiar with industry trends and are best able to identify future secular shifts and potential disruptors.

Additionally, a robust fairness opinion process where bankers analyze multiple valuation methodologies can provide further assurance that the deal price is an accurate indicator of a company's fair value, taking into account idiosyncratic valuation inputs. Bankers will generally include a DCF valuation in their analysis, and it will remain a critical tool in determining fairness — just not the only tool.

This is not to suggest that the Court of Chancery should always rely on the deal price as an indicator of fair value. Certainly, it may be reasonable for the Court to be skeptical of the deal price when a transaction is not the result of an arm's-length process, advisers and fiduciaries are conflicted, and there was no market check. In such a situation, the Court should also utilize traditional valuation methods to help determine fair value, while simultaneously acknowledging the limitations of those methods.

But when a transaction is a result of a robust and un-conflicted auction process, the Court should favor the deal price over other traditional valuation methods in de-

termining fair value. Otherwise, to treat all appraisal claims with the same degree of rigor would undercut incentives for fiduciaries and advisers to run a robust and clean process.

The Court of Chancery's willingness to rely on traditional valuation methods over the deal price in determining fair value creates risk for acquirers. Although in one recent case, the Court found fair value to be less than the deal price by averaging a number of values derived from multiple academic valuation techniques, the Court has generally determined a company's fair value to be substantially higher than the deal price.<sup>8</sup> With appraisal litigation becoming more prevalent,<sup>9</sup> acquirers face a significant risk that the cost of their acquisition will materially increase as a result of the Court's fair value determination.

The Delaware Supreme Court has noted the high costs of appraisal actions on the parties in explaining why the Court of Chancery should not be required to conclusively or presumptively defer to the deal price.<sup>10</sup> But given the relatively high statutory prejudgment interest rate and the growing prevalence of appraisal arbitrage-focused funds, the costs are becoming one-sided, with acquirers shouldering a greater burden.

The 2016 amendment to Section 262 of the Delaware General Corporation Law that allows for pre-payment of interest to stockholders seeking appraisal before the entry of judgment provides some relief to acquirers and helps to discourage statutory interest rate arbitrage, but problems remain. Appraisal arbitrageurs still have plenty of incentives to pursue appraisal litigation, thereby increasing the risk for acquirers.<sup>11</sup>

To protect against this risk, acquirers have increasingly attempted to negotiate closing conditions that allow them to terminate the transaction if a certain percentage of stockholders demand appraisal. The inclusion of "appraisal outs" — as these closing conditions are commonly referred to — in merger agreements has steadily risen since 2014.<sup>12</sup>

The threshold amount at which an acquirer can terminate the transaction is often heavily negotiated, with the acquirer favoring a lower threshold and the target company favoring a higher threshold. Un-

surprisingly, the range of “appraisal out” thresholds in merger agreements since 2014 has been very broad, ranging from 1% to 28.4%.<sup>13</sup>

However, “appraisal out” conditions are imperfect solutions to protect against this risk. Recent data suggests that the percentage of stockholders seeking appraisal most likely will not meet the necessary threshold that would allow an acquirer to terminate the transaction.<sup>14</sup>

Yet, even if an acquirer is able to negotiate a low threshold and only a small percentage of stockholders seek appraisal, the risk that the Court will determine a company’s fair value to be substantially higher than the deal price, combined with the expense of litigating the appraisal proceeding, leaves an acquirer susceptible to significant costs.<sup>15</sup> ♦

256 (Del. 1991).

2. *See, e.g., In re Orchard Enterprises, Inc.*, 2012 WL 2923305 (Del. Ch. July 18, 2012); *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218 (Del. Ch. Dec. 31, 2003).

3. *Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 218 (Del. 2010).

4. *See, e.g., In re Appraisal of Dell Inc.*, 2016 WL 3186538, at \*21 (Del. Ch. May 31, 2016).

5. *See, e.g., Merion Capital L.P. v. Lender Processing Servs., Inc.*, 2016 WL 7324170, at \*23 (Del. Ch. Dec. 16, 2016) (citing *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 298 (Del. 1996)).

6. *See, e.g., Dell*, 2016 WL 3186538, at \*23 (quoting *Golden Telecom*, 11 A.3d at 217).

7. *See Matter of Shell Oil Co.*, 607 A.2d 1213, 1221 (Del. 1992); *In re Smurfit-Stone Container Corp. S’holder Litig.*, 2011 WL 2028076, at \*24 (Del. Ch. May 20, 2011).

8. From 2010 through September 2016, the average premium to the deal price awarded by the Court in an appraisal proceeding was 45%. Gail Weinstein, Christopher Ewan and Steven J. Steinman, *Delaware Appraisal Results are More Predictable than They Seem*, N.Y. L.J. (Oct. 31, 2016). The amounts ranged from 14.5% below the merger price to 258% above the merger price. *Id.*

9. Since 2012, there has been a 267% increase in appraisal petitions compared with only a 140% increase in deals subject to appraisal petitions. Michael Greene, *Dealmakers Eye Safeguards Amid Rising Valuation Challenges*, BLOOMBERG BNA (Apr. 18, 2017) <https://www.bna.com/dealmakers-eye-safeguards-n57982086799/>.

10. *See Golden Telecom*, 11 A.3d at 218.

11. *See, e.g., Gaurav Jetley & Xinyu Ji, Appraisal Arbitrage — Is There a Delaware Advantage?*, 428 Bus. Law. 71 (2016).

12. Wachtell, Lipton, Rosen & Katz, *Appraisal Rights and Other Private Equity Developments* 9 (2017).

13. *Id.*

14. For example, out of the 1,168 appraisal-eligible transactions from 2004-2013, only 48 had 1% or more of stockholders seek appraisal. Charles R. Kosmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551 (2015). By contrast, the lowest threshold for an “appraisal out” condition in both 2015 and 2016 was 5%.

15. An acquirer can attempt to condition the closing of the transaction upon the Court’s final determination of fair value. However, the target company most likely would not agree to such a condition due to the enormous amount of deal uncertainty it would create.

NOTES

1. *See, e.g., In re Appraisal of Dole Food Co., Inc.*, 114 A.3d 541, 548 (Del. Ch. 2014) (quoting *Ala. By-Products Corp. v. Neal*, 588 A.2d 255,

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# Rebalancing The Merger Litigation Landscape

The arguments for narrowing the appraisal remedy and liberalizing *Corwin*.

Merger litigation in the Delaware Court of Chancery has been a hotly-debated topic over the past decade. Class-action merger litigation is critically important to maintain the accountability of boards of directors in approving or rejecting merger proposals. It also has been the source of abusive litigation fostered by a regime of disclosure-only settlements that incentivized class counsel to challenge nearly every merger.<sup>1</sup>

**A**ppraisal — once a seldom used remedy — now is an emerging area of financial arbitrage. These issues have fostered a considerable volume of judicial, legislative and academic output. This necessarily short — and not so scholarly — article adds to that volume.

This article proposes to rebalance the merger litigation landscape by making two changes in the currently prevailing (but not entirely settled) law.

First, the appraisal remedy should be narrowed. It is a remedy that was born with one purpose — providing an “exit” for stockholders who dissented from a merger approved by a majority of stockholders. Now, however, it serves an entirely different purpose — providing a judicial valuation for stockholders who are dissatisfied with the merger consideration.

The statute was created in large part to serve one purpose, which is now outdated,

and has never been restructured to serve its current purpose. The appraisal remedy ought to be limited to those mergers (and perhaps other transactions) where there is a reason to suspect the merger valuation may not be “fair.”

Second, the doctrine articulated in *Corwin v. KKR Financial Holding LLC*<sup>2</sup> is being used to preclude otherwise viable breach of loyalty claims concerning a merger when the merger is approved by a fully-informed and uncoerced vote of a majority of the unconflicted stockholders.

This article advocates that the claim preclusion effect of a stockholder vote (as distinct from the shift in the standard of judicial scrutiny) not be applied to three types of claims:

- (a) claims arising from “deal protection” provisions included in a merger agreement;

(b) claims of entire fairness where a majority of the board is interested in the merger (but not claims where a majority of the board merely lacks independence); and (c) claims where the allegations establish that it is reasonably conceivable that some directors who approved the merger were acting for a purpose other than the best interests of the corporation and stockholders and that such motivation had a material effect on the merger's terms.

Like any effort at compromise, this proposal aspires to acceptance — perhaps not enthusiastically — by both stockholder advocates and corporate directors and their defenders. However, like all compromises, it risks being hated by everyone. But it is offered to promote a debate and dialogue that could alter this author's opinion on these very issues.

### Appraisal

The traditional explanation for the existence of appraisal rights is that appraisal was given to dissenting stockholders when mergers were permitted without unanimous consent. The underlying premise for the grant of such rights was that a dissenting stockholder should not be forced to undergo the fundamental change in their investment resulting from a merger. The dissenting stockholders were given the ability to “exit” the investment by requiring the corporation to repurchase their shares for “fair value.”<sup>3</sup>

Given this purpose, it was understandable that appraisal was not needed and not provided when the dissenting stockholder could exit the investment by selling shares on the public market.<sup>4</sup> It also was understandable that the “fair value” for the shares would not include any value attributable to the merger in which the stockholder did not wish to participate.<sup>5</sup>

However, this purpose for the appraisal remedy no longer is sensible in most mergers. A merger is no longer considered to be such a fundamental change in the stockholder's investment that a non-consenting stockholder should be provided an “exit” from the investment.<sup>6</sup> But while the purpose for providing appraisal for all mergers without a “market out” has evaporated, the appraisal remedy has not been correspondingly narrowed.

Over the history of the appraisal stat-

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## Appraisal was not needed and not provided when the dissenting stockholder could exit the investment by selling shares on the public market.

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ute, a second purpose has evolved, and that is to provide a judicial determination of fair value for a stockholder who dissents from the merger consideration the majority has approved. However, the appraisal remedy for this purpose ought to be limited to where it is needed.

It is needed when there is a reason to believe that the process by which a board and stockholders approved a merger involved either fiduciaries who were conflicted or stockholders who received different consideration. The obvious example is a “going private” merger where a controlling stockholder forces the public or minority shareholders to sell their shares to the controller, regardless of whether they are willing to do so or not.

There are other situations in which the officers, directors or a majority of stockholders may have interests that potentially conflict with those of the dissenting stockholders. In these circumstances, it makes sense to provide a valuation remedy independent of claims for breach of fiduciary duty. However, defining those situations by statute is a daunting task, although the Model Business Corporation Act attempts to do so by defining “interested transactions.”<sup>7</sup>

There are essentially two methods by which appraisal could be limited to “interested transactions.” One method is to create a judicial or statutory presumption that the merger consideration approved by the board and a majority of stockholders

is “fair value” unless the circumstances of the merger suggest that the deal price is not “fair” and other valuation metrics need to be used to arrive at a fair price. The circumstances in which the merger consideration may not represent a fair market value typically are “interested” mergers.

The theory of this proposed change is that dissenting stockholders will be motivated to limit their petitions for appraisal to those situations in which they believe they can prove a divergence between the deal price and “fair value.” Presumably, a well-shopped transaction approved by disinterested and independent directors and by a majority of unconflicted stockholders will not be an attractive candidate for appraisal.

The biggest advantage of this solution is that it is flexible and can provide a remedy whenever needed. However, there are two disadvantages to this solution.

One problem is that it does not provide any deal certainty to parties entering into a merger because the merger is still legally subject to appraisal demands. A stockholder may perceive a valuation issue where the parties to the merger see none (not uncommon) or a dissenting stockholder may be either irrational or manipulative, using the appraisal process as leverage for a special price for the dissenter.

Another problem is that valuation analysis is a difficult concept to mold into a tool for predictably and consistently separating interested or conflicted transactions from arm's-length deals. The more complex and fact-intensive the inquiry, the less likely it is that the doctrine will have the effect of limiting appraisal demands to “interested” mergers.

In addition, the financial analysis of “fair value” is a minefield of disputed financial premises and the nature of the analysis may change with the objective of the fair value determination. Indeed, the concept that the deal price — which essentially means the “market value” of the stock in the market for corporate control — equates with “fair value” is contrary to the “intrinsic value” doctrine the Delaware courts have embraced to justify takeover defenses that a board may employ to defeat a tender offer at a premium to the market.

An alternative method is to amend the appraisal statute to limit the appraisal remedy to two situations:

- (a) where the merger works such a substantial change in the nature of the investment that a dissenting stockholder should not be forced to accept it; and  
 (b) where the transaction is an “interested transaction.”

An interested transaction would be defined to capture those situations in which the officers, directors or a majority of the stockholders have an interest that conflicts with that of the dissenting stockholders.

This solution has several advantages and disadvantages. One advantage is that it will provide greater, though not perfect clarity as to when appraisal applies, so that parties may plan transactions and set merger terms confident that additional payments will not be due to dissenting stockholders.

Another advantage is that it does not require the valuation analysis to be restructured into a tool to limit the scope of the appraisal remedy. For example, market value may not equal fair value when the purpose of an appraisal is to provide a remedy for stockholders being eliminated in a “going private” transaction, if the transaction occurs when the market is depressed.

The major disadvantage of this approach is the difficulty of statutorily defining “interested transactions.” What conflicts and whose conflicts justify providing a valuation remedy?

This statutory solution may also resolve or limit the controversy over the appropriateness of appraisal arbitrage, where stock is purchased after the transaction is announced for the purpose of making an appraisal demand. If the purpose of appraisal is to provide an “exit” for investors undergoing fundamental change, it makes no sense to allow an investor to purchase stock after the merger is announced and then contend that they should not be forced to go along with the merger because it works a fundamental change. Those investors bought with knowledge and implicit acceptance of that change.

Yet, the breadth of the appraisal statute — and the opportunities for arbitrage — are based upon this largely outdated purpose. Thus, appraisal arbitrage is inconsistent with the purpose for which appraisal is provided in most mergers. However, where the merger is an interested transaction, appraisal arbitrage may provide an

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## Cases actually decided by the Supreme Court have only precluded claims based upon a lack of independence and gross negligence.

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imperfect market check on the fairness of the merger price.

At a minimum, when a stockholder is being compelled to sell to a controller at a price set by the controller, it seems fair not to further disadvantage that stockholder by precluding a sale to a purchaser who will seek appraisal for the shares. By limiting appraisal mostly to “interested” transactions, appraisal arbitrage is eliminated in the situations where it is most egregious and only allowed where there is some policy justification for it.

### Stockholder Votes and Claim Preclusion

In *Corwin v. KKR Financial Holdings LLC*<sup>8</sup> the Delaware Supreme Court revisited a topic that has bedeviled the courts for decades: what effect does a fully-informed, unconflicted and uncoerced stockholder vote approving a transaction have on stockholder claims arising from that transaction?

Such approval gives rise to two questions: Does the stockholder approval affect the standard of judicial scrutiny that applies to the claims asserted? And does the stockholder approval actually preclude claims that would otherwise survive a motion to dismiss and could ultimately be proven at trial?

On the standard of judicial scrutiny, it seems clear that the business judgment rule should apply to any claim against directors based upon a transaction conditioned on such a stockholder vote and to

which the entire fairness standard does not apply at the threshold. It does not seem appropriate to subject director approval of such a transaction to heightened scrutiny, such as under *Reylon*.<sup>9</sup> However, assuming the business judgment standard of review applies, what claim preclusion effect does a stockholder vote have?

The Delaware Supreme Court and the Court of Chancery have stated the general rule that where the transaction does not give rise to entire fairness scrutiny at the threshold, the requisite stockholder vote will preclude all claims except for a claim of waste.<sup>10</sup> Under this standard, all other claims for breaches of the duty of care or the duty of loyalty are precluded by the stockholder vote.

However, while the courts have articulated a broad general rule, the cases actually decided by the Supreme Court (at the time this article was written) have only precluded claims based upon a lack of independence<sup>11</sup> and gross negligence.<sup>12</sup> The Court of Chancery has gone further and precluded claims for breach of loyalty where a majority of the board is alleged to be interested, although the allegations of interest in each case appeared very weak.<sup>13</sup>

In only one case — by order, not opinion — has the Court of Chancery precluded a loyalty claim where the Court expressly held that the loyalty claim would have survived a motion to dismiss in the absence of a stockholder vote.<sup>14</sup>

With respect to a claim for breach of the duty of care, the claim preclusion issue is almost hypothetical given the prevalence of exculpatory charter provisions. However, if the material facts giving rise to the alleged lack of care are disclosed, there seems little policy reason to allow the shareholders to accept the benefit of the merger and then sue the directors for having provided the opportunity to them. A claim for violation of the duty of care ought to be extinguished or precluded by the requisite stockholder vote.

Claims respecting violations of the duty of loyalty come in a variety of forms and the policy considerations with respect to them differ. Where the claim is that a majority of the board is not independent of a person with a conflicting interest in the merger, the business judgment rule ought to apply to such a claim — as the

Court of Chancery held in *Corwin* — and a claim that the transaction was not entirely fair ought to be extinguished. The reason is that the requisite stockholder vote has provided an independent check on the transaction.

In this situation, the independent directors would only be liable because of their lack of independence, not because of any interest in the transaction. The independent stockholder vote ought to relieve the directors of that potential liability.

By contrast, where the claim is based on the allegation that a majority of the board is interested in the transaction, several differentiating factors arise. Most fundamentally, self-dealing fiduciaries have a substantive obligation to deal with their beneficiaries only on terms that are fair. In this context, entire fairness is not only a standard of judicial scrutiny, it is a substantive rule.<sup>15</sup> The substantive obligation of a controlling stockholder to pay a fair price is not extinguished by a stockholder vote.<sup>16</sup>

The same rule would seem appropri-

ate in the case of a merger involving an interested board, which has a similar substantive obligation. In both situations, the fiduciaries do not have the voting power to cause the transaction to occur, but both have a substantive obligation to consummate the transaction only on fair terms.

Also, the fiduciary duty claim in both situations can be largely extinguished by the institution of a properly functioning special committee in addition to the stockholder vote.<sup>17</sup> Where an interested board is not willing to put such a committee in place, the stockholder vote should not preclude the obligation to be fair or preclude a claim for unfairness, even if the burden of proving unfairness is shifted by the stockholder vote to the plaintiff.

What about a claim for bad faith conduct? If a plaintiff is able to allege facts substantiating that it is reasonably conceivable that some of the directors acted for a purpose other than the best interests of the corporation or shareholders and it is reasonably conceivable that this impro-

per motivation affected the terms of the merger, that claim ought not be precluded by the stockholder vote, and the plaintiff ought to be given the opportunity to prove that claim, as difficult as such proof will be.

The claim preclusion effect of the *Corwin* doctrine is built on the premise that there is a fundamental inconsistency between the stockholders accepting the terms of the merger after being fully informed of the circumstances of the merger and suing directors with respect to defects known to them. However, there is one defect that is never disclosed to stockholders — that directors are acting for some reason other than the best interest of stockholders or the corporation.

Disclosure of facts giving rise to a suspicion is not sufficient to alter the stockholder's reasonable expectation that the directors were doing their best to achieve the best outcome for the stockholders and the corporation, despite their conflicts and flaws in their conduct. If, in fact, a plain-



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tiff were able to prove at trial that was not the case, the vote of the stockholders does not suggest that the stockholders knowingly accepted such improper motivations. The Plaintiff may be able to adequately allege and ultimately prove bad faith based upon a combination of facts pertaining to the process, the result or values achieved, board conflicts or lack of independence.

A stockholder vote should not preclude that claim even if all of the facts alleged in the complaint were disclosed and the vote was uncoerced. The stockholders are entitled to expect that their directors — however conflicted and however imperfectly — are trying to do the right thing. The stockholders' vote for the transaction is not inconsistent with that expectation.

Finally, the courts have not resolved the effect of the requisite stockholder vote on a claim based upon the “deal protection” provisions of a merger agreement.<sup>18</sup> In this case, the *Corwin* doctrine seems inapplicable for at least two reasons.

First, the stockholder vote occurs after those provisions have become operative and take effect, unlike the merger that is not consummated unless and until the vote is achieved. These provisions are effective and have their operative effect regardless of the vote. When the stockholders vote on the merger, they are deciding whether to accept or reject the transaction. They are not voting on whether the deal protection terms will or will not become effective.

Second, to the extent the vote on the merger could be interpreted as a vote on the deal protection provisions, it is not an uncoerced or voluntary vote. The stockholder is faced with the choice of accepting the transaction or rejecting it because of the deal protection terms. At best, it is expression of the view that the stockholder is not inclined to risk losing the deal to find out if there is a better offer. If the deal protection provisions were not reasonable in the first instance, that choice is not a choice the stockholder should have been forced to make.

However, to say that the stockholder vote does not preclude such a claim or override the *Unocal* doctrine is not to say that directors on a claim for money damages have the burden to prove the deal protection provisions were reasonable or that

proof of unreasonableness by a plaintiff establishes a personal liability, especially if there is an exculpatory charter provision.

### Conclusion

The suggestions made here for the development of the *Corwin* doctrine, if accepted, will not open the floodgates to abusive or excessive litigation. There are few cases where a majority of the board is interested in the merger, and there are few cases where a plaintiff could even allege, much less prove a case of bad faith.

The proposal made with respect to the appraisal statute similarly will not close the courthouse door where the stockholder deserves the appraisal remedy. There will be few cases where “fair value” is substantially different from the merger consideration in an arm’s-length deal, particularly if deal synergies are not included in the computation of fair value.

And the amendment of the merger statute to narrow the circumstances in which appraisal applies might be accompanied by meaningful modification of the appraisal procedure or definition of fair value to make it more practical to use.

In any event, these proposals are offered for your consideration. Is everyone unhappy? ♦

### NOTES

1. *In re Trulia Inc. Shareholder Litigation*, 129 A.3d 884 (Del. Ch. 2016).
2. 125 A.3d 304 (Del. 2015).
3. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal’s Role in Corporate Law*, 84 Geo. L. J. 1 (1995).
4. 8 Del. C. §262(b)(1). However, there is an exception to this “market out” exception where the stockholders receive any cash consideration in the merger, other than for fractional shares. *Id.* at §262(b)(2). This exception for mergers involving cash consideration serves the purpose of providing a judicial valuation, particularly, albeit not exclusively in the case of “cash out” mergers.
5. 8 Del. C. §262(h).
6. There are certain mergers that cause a change so fundamental that dissenters should be permitted to exit if they wish. These would include, for example, a merger in which a for-profit corporation is converted into a benefit corporation. 8 Del. C. §363(b). But there are few of these types of mergers.
7. MBCA §13.01.
8. 125 A.3d 304 (Del. 2015).
9. *Revlon Inc. v. MacAndrews & Forbes*, 506 A.2d 173 (1986).
10. See *e.g.*, *In re Paramount Gold & Silver Corp. Stockholders Litig.*, No. CV 10499-CB, 2017 WL

1372659, at \*1 (Del. Ch. Apr. 13, 2017).

11. *Corwin*, *supra*, affirming *In re KKR Financial Holdings LLC Shareholder Litig.*, 101 A.3d 980 (2014) (dismissing claim based on allegation that a majority of the directors were not independent of an interested party); *City of Miami Gen. Employees’ & Sanitation Employees’ Ret. Trust v. Comstock*, No. 482, 2016, 2017 WL 1093185, at \*1 (Del. Mar. 23, 2017) (affirming dismissal under *Corwin* but Court of Chancery found a majority of the board neither interested nor lacking independence) and *In re Volcano Corporation Stockholder Litig.*, 2017 WL 563187 (Del. 2017) affirming *In re Volcano Corp. Stockholder Litig.*, 143 A.3d 737 (Del. Ch. 2016) (dismissing action alleging that directors were interested in merger, but the Court did not find that such allegations were sufficient to establish such an interest).

12. *Singh v. Attenborough*, 137 A. 3d 151 (Del. 2016) (claim for gross negligence).

13. See *In re Volcano Corp. Stockholder Litig.*, 143 A.3d 737 (Del. Ch. 2016), *aff’d*, 2017 WL 563187 (Del. 2017) (dismissing action alleging directors were interested in merger but no finding that actionable interests had been alleged); *Larkin v. Shah*, 2016 WL 4485447 (Del. Ch. 2016) (same); and *In re Merge Healthcare Inc.*, 2017 WL 395981, at \*5 (Del. Ch. 2017) (same). *But see City of Miami Gen. Employees v. Comstock*, No. CV 9980-CB, 2016 WL 4464156, at \*19 (Del. Ch. Aug. 24, 2016), *aff’d on other grounds sub nom. City of Miami Gen. Employees’ & Sanitation Employees’ Ret. Trust v. Comstock*, 2017 WL 1093185 (Del. Mar. 23, 2017) (despite a stockholder vote, the Court examined whether a majority of the directors were interested in the transaction and found they were not).

14. *In re Columbia Pipeline Group, Inc.*, 2017 WL 898382 (Del.Ch. 2017) (concluding that Plaintiff alleged a claim of bad faith and breach of the duty of loyalty that would survive a motion to dismiss, but nonetheless dismissing the claim based upon a stockholder vote).

15. See, *e.g.*, Welch, Saunders and Voss, *Folk on the Delaware General Corporation Law*, §141.02[A][2] (“...[T]he duty of loyalty... requires a fiduciary to refrain from self-interested transactions with the corporation unless the terms are fair.”) Where the directors are “interested” in the merger by virtue of an interest derived from a third party, not as a result of an interest obtained from the corporation, a better argument might be made that the claim is precluded, at least where the benefit from the third party did not come at the expense of the corporation or its stockholders. In this circumstance, the fiduciary may not have the substantive obligation of fairness.

16. *Larkin v. Shah*, 2016 WL 4485447 (Del. Ch. 2016).

17. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

18. *In re Paramount Gold & Silver Corp. Stockholders Litig.*, 2017 WL 1372659, at \*6 (Del. Ch. 2017).

of market fundamentalism in appraisal often nonetheless see arbitrage as a market-based public good. In this view, the chose-in-action of a potential appraisal suit is an asset like any other and alienability allows that asset to go to its best use, in the hands of an owner with the understanding and resources to exploit it.

Conversely, others who rely on the salutary effects of market exposure to argue that appraisal is unnecessary disregard the beneficial effect of the market when it comes to arbitrage of the appraisal cause of action; they tend to sputter about champerty.

In my view, appraisal arbitrage is no better or worse than the underlying appraisal cause of action: whether that action promotes efficiency or not, the effect — good or ill — is simply magnified by the availability of arbitrage.

Appraisal arbitrage is symptomatic, however, of how appraisal in practice has deviated from the traditional view of compensation for dissenters, whose stock is taken against their will. The arbitrageurs are hardly dissenters. They face three outcomes. In the first, the merger is consummated, and they receive an appraised value higher than their cost of the stock together with the cost of litigation, a win. Second, the merger is consummated, but the appraised value is at (or even below) the merger price, in which case the cost of litigation represents a modest loss. Third, the real risk: that the merger from which they are statutory “dissenters” will be voted down or otherwise fail.

This last is the outcome arbitrageurs most fear; that the majority of stockholders will themselves “dissent from” — vote against — the deal. In such a case, the arbitrageur becomes a stockholder in a going concern, with a stock price likely reverting to the pre-announcement price, typically representing a substantial discount to the merger-inflated price paid by the arbitrageur.

In other words, the great risk to the arbitrage model is that a majority of stockholders will agree with the arbitrageur’s position that the merger price is not fair value. It is worth noting that the stockholder who has sold to the arbitrageur is herself not a dissenter; to

the contrary, she has decided to lock in the benefits of the merger, typically at a modest discount to the merger price. The dissenting stockholder in solicitude for whom the statute was ostensibly designed is absent in this scenario.

In such a universe, it is perhaps not unreasonable to examine first principles, and whether it is value enhancing to direct a trial court to apply valuation methodologies to determine fair value apart from that approved by an impartial, disinterested board, a majority of stock, and the market itself. ♦

*I acknowledge with gratitude the assistance of Jason Hilborn and Chad Davis in writing this article.*

**NOTES**

1. 8 Del. C. § 262.
2. There is a devil, of course, in the details: how to demonstrate that a particular transaction is “clean” as I have defined it. This devil I have cleverly avoided in this brief rumination.
3. See, e.g., *Voeller v. Neilston Warehouse Co.*,

- 311 U.S. 531, 535 n.6 (1941); *Matter of Enstar Corp.*, 1986 WL 8062, at \*5 (Del. Ch. July 17, 1986).
4. See *Salomon Bros. Inc. v. Interstate Bakeries Corp.*, 576 A.2d 650, 651–52 (Del. Ch.1989).
5. See 8 Del. C. § 251.
6. See *Alabama By-Prod. Corp. v. Cede & Co.*, 657 A.2d 254, 258 (Del. 1995).
7. See *Francis I. duPont & Co. v. Universal City Studios, Inc.*, 343 A.2d 629, 634 (Del. Ch.1975) (quoting Ernest Folk, *The Delaware General Corporation Law*, A Commentary and Analysis (1972)).
8. See *Peters v. Robinson*, 636 A.2d 926, 928–29 (Del. 1994). See generally Coparcenary, BLACK’S LAW DICTIONARY (10th ed. 2014) (Westlaw).
9. See 25 Del. C. § 721.
10. See *id.*
11. See 25 Del. C. § 729.
12. See generally 8 Del. C. § 251.
13. 8 Del. C. § 262 (h).
14. *Id.*
15. I note the overlap between common-law fiduciary duty and statutory appraisal relief here.
16. See generally *In re Appraisal of Dell Inc.*, 2016 WL 3186538 (Del. Ch. May 31, 2016).
17. See *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at \*3–5 (Del. Ch. May 2, 2007).

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posture of the case, to credit the allegations of the complaint unless they were “really really really inconceivable. Plaintiff-Appellant Wolfie missing a short putt is entirely conceivable.”

Moving to the merits, the Court noted that its review was *de novo, de facto, de minimus* and *de Niro*. The Court carefully traced the origins of the rules of golf, ascribing them to an old notebook discovered behind a pile of “books and records” when the Court of Chancery decamped from its previous quarters to its current location. The opinion contains a lengthy section headed “Frolic and Detour” in which the author (anonymous, as the opinion was *per curiam*) compares golf to seven other sports that also involve clubs and mental anguish (a group in which, perhaps surprisingly, the Court included e-discovery).

Having decided that *Unocal* applied, the Court readily disposed of its application. The Court wrote that the central purpose of *Unocal* review is to prevent Draconian results, regardless of the doctrinal twists and turns involved. The Court concluded: “Say what you will about Draco, even Draco would not count a one-foot putt the same as a shot of every other distance and difficulty. Reasonableness has to mean something.”

The Court’s discussion revealed an astute knowledge of the intricacies of high-level golf play. The Court referenced the differences between various side-hill lies, three forms of rough, raked and unraked bunkers, right- and left-breaking putts, blind hazards, pot bunkers, changing wind conditions, embedded balls (both in bunkers and through the green), stimp meter readings, and — of course — the undisputed facts that some shots must cover distances of hundreds of yards whilst others (like that one at issue) need travel only inches or a mere one revolution of the golf ball.

The Court observed: “How in the world is it reasonable to treat each and every shot equally? Reasonableness must be contextual and applied situationally. Treating the obviously unequal as equal is the essence of disproportionality, which cannot stand under *Unocal*.”

There was a stinging dissent from the newest member of

the Court, Justice Francis L.B.<sup>2</sup> du Pont. The dissent was, unusually, in the form of a poem. That format appears to have resulted from the oral argument of one New York lawyer who asked in open court: “Shall I sing?” The chorus of the poem, repeated every four lines, read as follows:

Is there nothing sacred anymore,  
Even the right to yell “fore”?  
What’s next I have to say,  
Can’t we just let ’em play?

The majority opinion also addressed a number of related issues, several raised *sua sponte*:

1. The Court noted that the member-guest is billed as an “annual tournament,” which had prompted the plaintiff to raise as a back-up argument that the immediately preceding tournament was 13 months and one day previous. Rejecting this absurd claim, the Court wrote: “This argument is ridiculous. Annual does not mean once a year. Annual does not mean annually. Annual means yearly. Annual does not imply anything about calendar years. Annual has nothing to do with the ‘ball drop’ in Times Square; the only ball drop in this case relates to the drop zone next to the water hazard on the par 3 twelfth hole. Annual means approximately 12 months (known, even to hackers, as a year, more or less) apart.”
2. The plaintiff also complained that the opposing team had driven its golf cart off the paved path and onto the fairway, alleging that the intent had been to block the plaintiff’s path to the green. The Court rejected that claim, reasoning that while “courts must stay in their lanes, there is no such doctrine applicable to golf carts.” The Court added that if club members wanted to prevent golf carts from veering off the path, they could have adopted an “Exclusive Path Bylaw.”
3. The Court also rejected the plaintiff’s invitation to apply a DCF analysis to each golfer’s score in order to yield



a result that was entirely fair. The Court noted the facial appeal of such a scientifically precise methodology, but determined as a matter of its discretion to leave the actual scoring to the Court of Chancery on remand. In that regard, the Court mentioned the amicus brief filed under seal by 112 of the 113 members of the faculty of the Harvard Law School, advocating that *Unocal* be held to require that a regression analysis be applied on a hole-by-hole basis utilizing Tobin's Q and the investment model with a deleveraged Berra beta calculated on a smoothing basis, weighted one-third forward-looking and two-thirds backwards as seen in the mirror in the twelfth floor restroom of the courthouse. The Court profusely thanked these academics for what it called their "typically helpful if un-welcome and un-invited contribution," but dismissed their position as "unduly WACCy even for folks who have never been outdoors in their lives."

A lengthy addendum to the opinion addressed itself to the reported conduct of the gallery at the tournament. The addendum noted that it was not appropriate for any member of the gallery to say anything while a swing or a question was pending and warned that anyone caught yelling "In the hole!," "You're the man!," or the like would be denied *pro hac vice* status in the Delaware courts for a minimum of three years.

The Court stated: "We no longer require patrons of golf events to wear white shirts but we do insist on a modicum of professionalism, especially for foreigners admitted to the First State as a matter of privilege, not right." The Court concluded that it had not been so "revulsed" since Texas lawyers has last appeared in Delaware and noted that, in the event of any future misconduct by golfers or the gallery, the Delaware courts were "but a phone call or a solid 8-iron away."

Reaction to the Supreme Court's opinion within the legal community has been swift and harsh. The Gang of Seven of the New York law firms put out a client alert the next day



that roared: "OK, Now They Have Really Gone Too Far." The thrust of the memo seemed to be that Delaware ought not be rewriting the rules of golf when there are so many other rules that need rewriting, especially when the USGA, R&A, and several other of golf's governing bodies are already engaging in a lengthy public process to revise the rules of golf from a lengthy set of incomprehensible, arbitrary and capricious rules to a much shorter set of incomprehensible, arbitrary and capricious rules designed to speed up the pace of golf and thus increase the consumption of post-golf alcohol.

The memo even suggested that golfers might consider picking up their clubs and moving to another state, although there was no clear consensus as to which, or even noted golfing meccas Ireland and Bermuda. Notably, one unnamed firm was listed as abstaining to the client memo. Rumor has it that that firm was unaware that there was a game called "golf," and had, at last word, assigned two associates (and three partners) to pull an all-nighter to research what "golf" is.

Memoranda issued by the leading Wilmington law offices were more muted. One example praised the Court's "characteristic thoughtfulness" and sternly admonished that anyone who did not take the Court's message to heart was risking severe sanctions. Another wrote: "Our courts have long and admirably developed the common law and there is perhaps nothing more common than a missed short putt." One memo went so far as to welcome the ruling as "certain to create a flood of litigation in our courts to replace disclosure-only settlement cases."

As expected, the decision has prompted calls to federalize the rules of golf. One member of Congress, just back from a golf junket with "constituents," was quoted as saying: "If it takes the Emperor on the Potomac to right this wrong, then let's do it. After all, look how well Dodd-Frank and Sarbanes-Oxley have worked out!"

As of this writing, there has been no tweet from the Oval Office or Mar-a-Lago on the subject. ♦

NOTES

1. Mr. Mirvis is an alleged hacker. The views expressed are his alone and should not be ascribed to any golf institution or club of which he is, or was, a member, or that has allowed him to enter its hallowed grounds. Apologies to Michael Murphy.
2. "Long Ball."



# Golf in the Kingdom of the First State: *USGA v. Unocal*

Controversy is par for the course when considering whether all golf shots are created equal.

In its April 1, 2017 decision, the Delaware Supreme Court — for the first time — ventured into the arena of golf. In *Wolfie v. USGA*, the Court found that the United States Golf Association’s Rules of Golf are subject to enhanced scrutiny and that, applying such scrutiny, it was not (in the Court’s view) “reasonable in relation to the threat posed” for the USGA to count a one-foot putt (actually, three inches, according to the record) the same as a 253-yard drive (according to the plaintiff).

The Court thus remanded for further proceedings by the Court of Chancery, albeit with an unusual addendum specifying that no hearings were to be held on the first tee if a faster group was waiting to tee-off, and also castigating the members of the gallery at the subject tournament for unruly behavior (more on that below).

The action arose inauspiciously. According to the complaint, one anonymous member of the Delaware bar identified only as “Wolfie” was duly enrolled in a member-guest tournament at the Rodney Square Golf Club, to be held, as is traditional, in Bear, Delaware. The tournament is also known as the “Small Wonder” for reasons that the record did not reveal beyond the comment by one witness that the Club was “A Place to be Somebody.”

The complaint alleged that this “golfer” had claimed a handicap of 36, which is the highest available under the USGA rules. Allegedly, on the 18th hole, the plaintiff missed a one-foot putt that would have — had he made it, rather than violently topping it all the way off the green — entitled his team to avoid the ignominy of a “###@###\* Dead Last” place finish in the tournament. When the plaintiff’s protestations to the bar cart



attendant went unanswered, he filed suit in the Court of Chancery.

The complaint alleged that the USGA rule treating all golf shots equally for scoring purposes violated *Unocal*’s “reasonableness” test that was applicable because the circumstances “touched” upon issues of “control,” *viz.*, the plaintiff’s inability to control his putts.

Argument in Chancery consumed three days, including breaks for hot dogs and soda, but the Court announced its decision immediately in a transcript ruling that was duly disseminated by the well-known journal, *Chancery Yesterday Tonight*. The decision was brief. It stated in full: “Really? This is the most ridiculous case I’ve ever seen — and, given the plethora of appraisal cases, I’ve seen some doozies. If I ruled for the plaintiff, my ruling would have the half-life of a fruit fly.”

The “settle order” process nonetheless took seven months and 67,591 billable hours. An appeal was taken promptly and heard *en banc* by the Delaware Supreme Court.

The Supreme Court’s opinion cut to the heart of the matter. Citing the “omnipresent spectre,” the Court held that enhanced scrutiny is “unremitting.” As such, the opinion reasoned, it was required to use the “tools at hand” to leave no grievance behind. The decision’s money quote: “The doors of our courts are always open, and we see no reason to deny justice to hackers who may be unfairly victimized by arbitrary rules of the game of golf.”

The Court emphasized that it was obliged, in the procedural

See **Golf in the First State** continued on page 30



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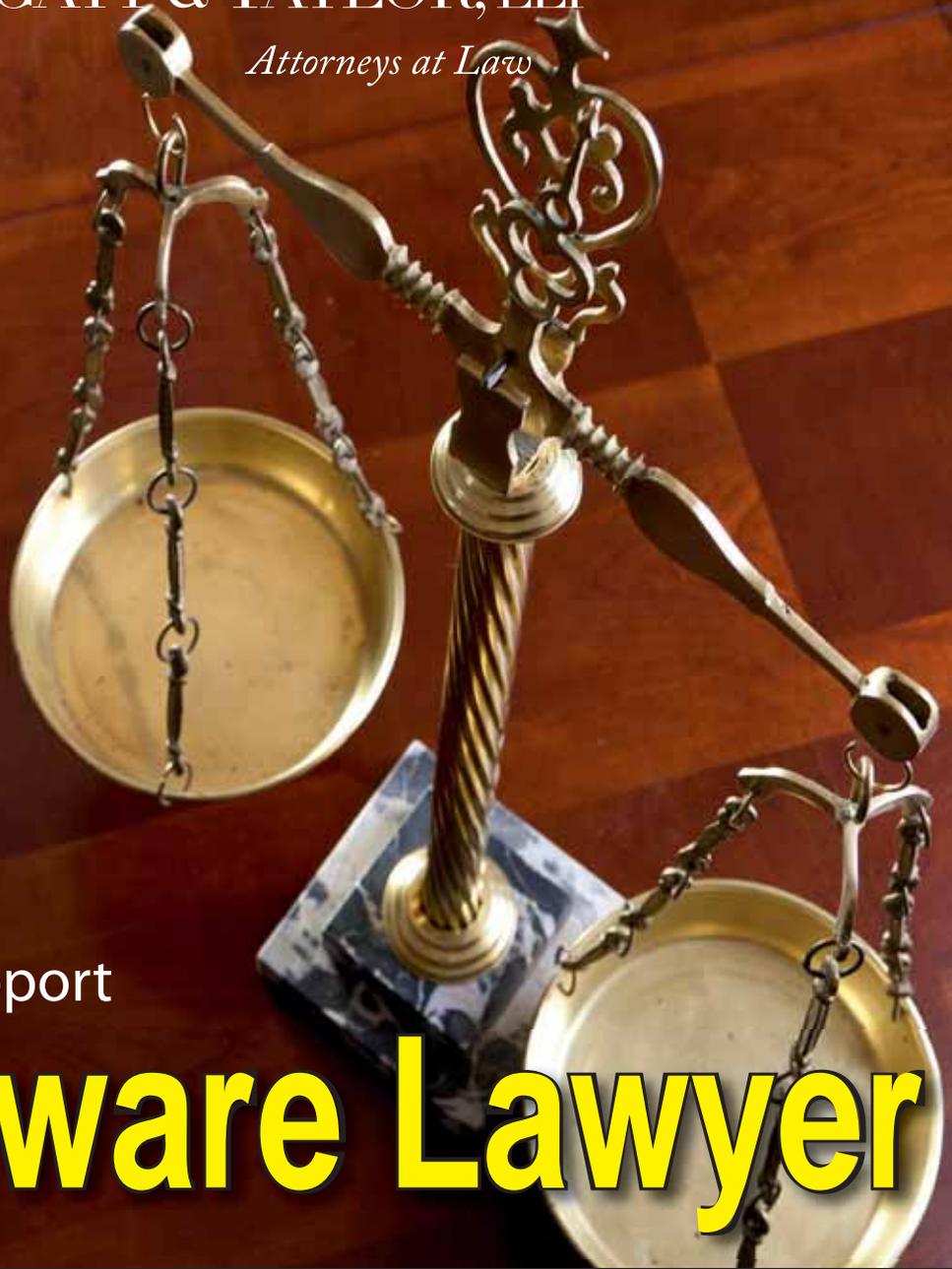
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