

THE ROLE OF APPRAISAL IN CORPORATE LAW

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Appraisal statutes give objecting shareholders the option to sell their shares back to the corporation for "fair value" following certain fundamental corporate changes. Although the specifics of appraisal differ from jurisdiction to jurisdiction, most state appraisal statutes share several basic features: they confer appraisal rights upon shareholders who object to transactions such as mergers and consolidations, sales of all, or substantially all, the corporation's assets (other than in connection with dissolutions) and "serious" charter amendments, such as those altering the purposes for which the corporation is organized;¹ they define "fair value" as the value of the shares prior to giving effect to the transaction from which the shareholders dissent;² and they include a "market out" that withdraws appraisal rights when the objectors' shares are publicly traded.³

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¹ See, e.g., DEL. CODE ANN. tit. 8, § 262(b) (1997); REVISED MODEL BUS. CORP. ACT § 13.02 (1985); 2 PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.21, at 299 (American Law Inst. 1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE]. The comments to section 7.21 of the PRINCIPLES OF CORPORATE GOVERNANCE report that statutes in all American jurisdictions authorize a right of appraisal for dissenters to certain mergers and consolidations; statutes in at least 46 jurisdictions provide for appraisal on a sale of substantially all corporate assets; and at least 25 jurisdictions grant appraisal in the event of specified amendments to the corporate charter. 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra*, § 7.21, comment a, at 301.

² See, e.g., DEL. CODE ANN. tit. 8, § 262(h); REVISED MODEL BUS. CORP. ACT § 13.01(3). The comment to section 13.01 of the Revised Model Business Corporation Act indicates that the majority of state appraisal statutes adhere to the goal of preserving shareholders' *prior* rights as shareholders. *But cf.* 2 PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, § 7.22(c) (stating that, in certain corporate combinations, a "court may include a proportionate share of any gain reasonably to be expected to result from the combination, unless special circumstances would make such an allocation unreasonable").

³ See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1). Professor Thompson reports that, as of 1995, "[a]bout half the states (covering the great majority of public corporations) . . . [withdrew] appraisal if the corporation's stock [was] traded on a stock exchange or [was] held by 2000 shareholders." Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 29 & n.114 (1995) (citing 2 MODEL BUS. CORP. ACT § 11.01 (3d ed.

Traditionally, commentators viewed appraisal rights as necessary to protect shareholders who object to fundamental changes from being forced to invest in "new" firms against their will.⁴ Bayless Manning, however, challenged this traditional view of appraisal, as a remedy necessary to protect shareholders from the effects of fundamental change, in his famous 1962 essay on the remedy.⁵ He argued that the traditional view of appraisal had to be flawed because appraisal statutes were not broad enough to achieve that goal.⁶ In this regard, Manning observed that, although appraisal statutes applied to some fundamental changes brought on by shareholders and directors (e.g., mergers and charter amendments), they did not apply to all shareholder- or director-approved changes that might be characterized as fundamental,⁷ nor did they apply to any fundamental changes brought on by creditors, customers, suppliers or others outside the firm.⁸ From these observations, Manning concluded that drafters of appraisal statutes were not concerned with "an economic problem or with economic solutions,"⁹ but were merely concerned with "solv[ing] a purely conceptual need [under the nineteenth century view of corporations as things that lived and died]—to provide something for the shareholder who was about to undergo a *legal* trauma—a trauma deemed compensable regardless of its economic consequences upon him."¹⁰ Manning therefore left his readers with a challenge: articulate a meaningful economic function for appraisal or reject the remedy as a vestige of an outdated view of the corporation.¹¹

1985)); see also Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 835 n.21 (1984) (reporting that in 1982, 73% of U.S. corporations were incorporated in one of the 25 states including a stock market exception to the appraisal process). The drafters of the Revised Model Bus. Corp. Act, however, rejected a "market out," see REVISED MODEL BUSINESS CORPORATION ACT § 13.02, as did the drafters of the A.L.I.'s PRINCIPLES OF CORPORATE GOVERNANCE, see *supra* note 1, § 7.21 & comment d.

⁴ See, e.g., NORMAN D. LATTIN, *THE LAW OF CORPORATIONS* 591 (2d ed. 1971); see also Thompson, *supra* note 3, at 18–19 & nn.77–78 (citing cases espousing traditional view).

⁵ See Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962).

⁶ See *id.* at 241–43.

⁷ See *id.* For example, Manning noted that appraisal rights applied to transactions in which a corporation sells all or substantially all its shares to another, but not to transactions where a corporation buys all or substantially all of the assets of another.

⁸ See *id.* For instance, Manning noted that appraisal rights were not triggered by crippling labor strikes or national calamities, even though such events could have dramatic consequences for a firm or its shareholders.

⁹ *Id.* at 242.

¹⁰ Manning, *supra* note 5, at 246–47 (emphasis in original). Manning's explanation for the adoption of appraisal statutes is discussed *infra* notes 167–72 and accompanying text.

¹¹ Manning acknowledged that eliminating appraisal probably was not politically feasible. See

Several commentators have taken up Manning's challenge to explain appraisal rights, most notably Professor Fischel,¹² Professors Kanda and Levmore,¹³ and Professor Gilson.¹⁴ For the most part, these commentators have argued that the appraisal remedy should be viewed as a check on misconduct by managers and controlling shareholders. But their efforts have fallen short for three principal reasons. First, each of the theories proposed by these commentators conflicts with one or more of the basic features of the appraisal remedy (such as the triggering provisions or the valuation rules). Second, none explains the evolution of the appraisal remedy over time, particularly the introduction and expansion of the market out.¹⁵ Third, none of these theories carves out for appraisal a function that is distinct from that served by other corporate law remedies, such as the shareholders' action for breach of fiduciary duty.

This article offers a new "preference reconciliation" theory of appraisal which overcomes these problems. This theory focuses on the capacity of appraisal rights to reconcile differing shareholder preferences with respect to corporate transactions that alter the risk of the firm's shares.¹⁶ As the discussion below explains, when shareholders

id. at 262. He therefore recommended limiting appraisal to the extent possible through adoption of the market out. *See id.* at 260-62. Manning's call for a market out was widely accepted, see *supra* note 3, though not everyone agreed with his criticism of appraisal. *See, e.g.,* MELVIN A. EISENBERG, *THE STRUCTURE OF THE CORPORATION*, ch. 7 (1976). Ernest Folk, the reporter for the Delaware Corporation Law Revision Committee which prepared the major 1967 revision of the Delaware General Corporation Law, echoed Manning's criticism of appraisal. Folk wrote that "[m]uddled theory and inconsistent treatment has always been characteristic of the appraisal right in all jurisdictions: a few transactions have been singled out to trigger cash payment rights, although other events in corporate life, often more drastic in the impact, create no such right." ERNEST FOLK, *REPORT ON DELAWARE CORPORATION LAW 196* (1968). The Report therefore recommended that "the traditional appraisal right should be substantially abolished in Delaware" by, "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 Act Amendments of 1964." *Id.* at 196, 198; *see also* Folk, *De Facto Mergers in Delaware: Hariton v. Arco Electronics, Inc.*, 49 VA. L. REV. 1261 (1963) (setting forth in full Folk's argument for substantially abolishing appraisal rights).

¹² *See* Daniel R. Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875.

¹³ *See* Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985).

¹⁴ *See* RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 714-22 (2d ed. 1995). The explanation of the appraisal remedy in the Gilson and Black casebook is attributed only to Professor Gilson because it originally appeared in the casebook's first edition, which was written by Gilson alone. *See* RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 573-80 (1986).

¹⁵ *See supra* note 3 and accompanying text.

¹⁶ "Risk" refers to the extent to which a security's returns can be expected to vary over time.

lack effective access to capital markets, risk-altering transactions (particularly those that alter the firm's *market risk*)¹⁷ can make some shareholders better off, while leaving others worse off.¹⁸ Appraisal rights require the corporation to compensate shareholders who may be harmed by such transactions and place the net costs of providing that compensation on shareholders who otherwise gain.¹⁹ As a result, shareholders who gain from appraisal triggering transactions will only vote in favor of those transactions if their gains more than offset the net costs of compensating objectors. Appraisal rights therefore decrease the probability of risk-altering transactions that result in net losses to shareholders, causing *all* shares to trade at higher prices *ex ante*.²⁰

The analysis that follows is divided into three parts. Part I examines and criticizes the principal post-Manning efforts to explain appraisal. Part II explores in greater detail the preference reconciliation theory of appraisal, including the ability of that theory to explain the structure and evolution of appraisal statutes. Part III explores the main implications of the new theory for the future development of appraisal statutes.

I. PREVIOUS EFFORTS TO EXPLAIN APPRAISAL

This Part examines three previous attempts to solve the appraisal puzzle posed by Manning. It focuses on (1) Fischel's 1983 paper, *The*

Risk comes in two forms: (1) *market, systematic, or undiversifiable risk*, which refers to the sensitivity of the security's returns to movements in the market as a whole; and (2) *unique, unsystematic, or diversifiable risk*, which refers to the sensitivity of the security's returns to firm-specific events (i.e., perils which are peculiar to the particular company). See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 156 & nn.14-15 (5th ed. 1996).

¹⁷ For a definition of *market risk*, see *supra* note 16.

¹⁸ Transactions that alter a firm's unique risk will not ordinarily have any impact on investors because investors can eliminate the unique risk associated with a particular security by holding a diversified portfolio of investments. See BREALEY & MYERS, *supra* note 16, at 160. So most investors care only about transactions which alter the firm's market risk (i.e., the firm's sensitivity to movements in the market as a whole). But some investors are precluded from fully diversifying their investment portfolios because they are required by practical or legal considerations to invest a substantial portion of their wealth in a small number of companies. These investors will be affected by changes in unique risk, as well as by changes in market risk.

¹⁹ As is explained *infra*, the cost of compensating objectors is equal to the excess of: (a) the value of the claims the corporation must issue to obtain the cash necessary to compensate objectors; over (b) the value of the shares that the objectors sell to the corporation.

²⁰ The capacity of appraisal rights to protect shareholders from the effects of risk-altering transactions was noted by Professor MacIntosh in his excellent article on Canadian appraisal rights. See Jeffrey G. MacIntosh, *The Shareholders' Appraisal Rights in Canada: A Critical Reappraisal*, 24 OSGOODE HALL L.J. 201, 209-10 (1986). But Professor MacIntosh fails to note the link between appraisal rights, on the one hand, and voting behavior by shareholders, on the other. It is through this link that appraisal rights serve their primary purpose of reducing the *ex ante* risk of transactions that result in net losses to shareholders.

Appraisal Remedy in Corporate Law;²¹ (2) Kanda and Levmore's 1985 paper, *The Appraisal Remedy and the Goals of Corporate Law*;²² and (3) Gilson's discussion of the de facto merger doctrine in *The Law and Finance of Corporate Acquisitions*.²³ The analysis presented in this Part concludes that none of these works adequately explains the appraisal remedy.

A. Fischel's Wealth Appropriation Theory

Fischel offers the most popular post-Manning explanation of appraisal rights. Fischel views appraisal as an implied term of the corporate contract "that sets the minimum price at which the firm, or a part of it, can be sold in situations where certain groups are more likely to attempt to appropriate wealth from other groups than to maximize the value of the firm."²⁴ Fischel gives two examples of instances where wealth appropriation is more likely than wealth maximization: (1) "when shareholders of one firm attempt to exploit the coordination problems of shareholders of another firm" by making a coercive, two-tiered tender offer at blended price which may be lower than the current market value of the latter firm's shares;²⁵ and (2) when a majority shareholder attempts to "confiscate the pro rata share of the minority in a freeze-out merger"—that is, where a majority shareholder uses its control to approve a merger which provides minority shareholders with less than the fair value of their shares.²⁶ Fischel suggests that, by setting a minimum price which must be paid to objecting shareholders in the second step of a two-tiered tender offer or in a freeze-out merger, appraisal rights minimize the likelihood that two-tiered tender offers and freeze-out mergers will be used to appropriate shareholder wealth. He therefore concludes that the appraisal remedy benefits all shareholders by causing shares to trade at higher prices *ex ante*.²⁷

²¹ Fischel, *supra* note 12.

²² Kanda & Levmore, *supra* note 13.

²³ Gilson, *supra* note 14.

²⁴ Fischel, *supra* note 12, at 876.

²⁵ *Id.* For instance, a bidder might offer \$40 per share for 51% of the firm's stock in a partial tender offer and announce an intention to acquire the remaining shares for \$30 in second step merger which will follow its acquisition of control; shareholders might accept the offer, which has a blended value of slightly more than \$35 per share, even if they think their shares are worth \$37.50, because they fear being forced to accept \$30 per share in a second step merger if they fail to tender.

²⁶ *Id.* at 876-77.

²⁷ *See id.* at 878-81.

Fischel's theory overcomes Manning's principal concern regarding the traditional theory of appraisal rights by providing an explanation for why some types of "fundamental" corporate changes trigger appraisal rights while others do not. In short, Fischel argues that appraisal rights should only be triggered in cases where their application will reduce the likelihood of value-decreasing transactions. This is true when appraisal rights are applied to transactions such as coercive, two-tiered tender offers and freeze-out mergers, because, without appraisal rights, shareholders might be forced to sell their shares to a bidder or controlling shareholder at too low a price. But it is not true when appraisal rights are applied to actions of outsiders, such as a presidential heart attack or labor strife, or to actions by managers in circumstances where managers already have strong incentives to maximize firm value. This is because conferring appraisal rights on shareholders in these instances will neither reduce the likelihood that actions by outsiders will harm the corporation nor improve the quality of decisionmaking by already well-motivated managers.

But while Fischel's theory of appraisal rights at least roughly explains the pattern of appraisal statutes, the theory is far from perfect. First, Fischel's theory fails to fully explain the basic triggering provisions of appraisal statutes.²⁸ As Fischel himself concedes,²⁹ his theory cannot explain why virtually all corporate statutes provide for appraisal rights in connection with arms-length mergers,³⁰ a class of transactions where managers do not face conflicts of interest that prevent them from striking the best possible deal for shareholders.³¹ Nor can Fischel's theory explain the common application of appraisal rights to charter amendments altering the corporation's purposes³² or the frequent denial of appraisal rights for transactions such as dissolutions and reverse stock splits, even when those transactions are used by majority shareholders to effect minority freeze-outs.³³

²⁸ Other commentators have also noted this problem. See, e.g., Kanda & Levmore, *supra* note 13, at 435.

²⁹ See Fischel, *supra* note 12, at 884 n.36.

³⁰ An arms-length merger is one where two unrelated firms merge.

³¹ This problem is also noted by Kanda & Levmore, *supra* note 13, at 435. For a discussion of Gilson's solution to this problem with Fischel's theory, see *infra* text accompanying note 89.

³² The application of appraisal statutes to charter amendments is not unusual. See *supra* note 1. Under Fischel's theory, appraisal rights should only be triggered by charter amendments if the application of appraisal rights could be expected to reduce the incidence of sub-optimal amendments. But this result is unlikely since managers will ordinarily have strong incentives to endorse only those charter amendments that maximize firm value. For a general discussion of the constraints which operate on firm managers, see LARRY E. RIBSTEIN & PETER V. LETSOV, *BUSINESS ASSOCIATIONS* 295-98 (3d ed. 1996).

³³ See Thompson, *supra* note 3, at 34.

Second, Fischel's theory cannot explain the popularity of the market out which, as previously noted, generally withdraws appraisal rights when the objector's shares are publicly traded.³⁴ Fischel acknowledges this problem in Part II of his article:

A far more persuasive criticism of the [market out] is that it is inconsistent with the purpose of appraisal . . . [For example.] [w]ithdrawing the appraisal rights of the shareholders of the [minority] bloc if their shares are publicly traded . . . will not solve the problem of the majority being able to appropriate wealth from the minority *ex post* . . .³⁵

But Fischel contends that the tension between his theory and the market out is lessened, at least in Delaware, because the Delaware statute restores appraisal rights where shareholders must exchange publicly traded shares for cash or debt.³⁶ This, he says, represents "a recognition . . . that appraisal should be available when the danger of appropriation is the greatest"³⁷—i.e., in cases where the minority is completely frozen out of the firm, rather than provided with a continuing equity interest. But Fischel's reliance on a "cash-out" exception to reconcile his wealth appropriation theory of appraisal with the market out is not persuasive for at least three reasons:

³⁴ See *supra* note 3 and accompanying text.

³⁵ Fischel, *supra* note 12, at 885. Put another way, investors who hold publicly traded shares are just as susceptible to wealth appropriations through two-tiered tender offers and freeze-out mergers as are investors whose shares are not publicly traded.

³⁶ See *id.* The cash-out exception to the market out is set forth at title 8, section 262(b)(2) of the Delaware Code. That section provides as follows:

Notwithstanding paragraph (1) of this subsection, appraisal rights under this section shall be available for the shares of any class or series of stock of a constituent corporation if the holders thereof are required by the terms of an agreement of merger or consolidation pursuant to §§ 251, 252, 254, 257, 258, 263 and 264 of this title to accept for such stock anything except:

a. Shares of stock of the corporation surviving or resulting from such merger or consolidation, or depository receipts in respect thereof;

b. Shares of stock of any other corporation, or depository receipts in respect thereof, which shares of stock (or depository receipts in respect thereof) or depository receipts at the effective date of the merger or consolidation will be either listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc. or held of record by more than 2,000 holders;

c. Cash in lieu of fractional shares or fractional depository receipts described in the foregoing subparagraphs a. and b. of this paragraph; or

d. Any combination of the shares of stock, depository receipts and cash in lieu of fractional shares or fractional depository receipts described in the foregoing subparagraphs a., b. and c. of this paragraph.

DEL. CODE ANN. tit. 8, § 262 (b)(2).

³⁷ *Id.*

(1) Fischel's interpretation of the purpose underlying Delaware's cash-out exception may not be correct;³⁸ (2) the cash-out exception does not completely eliminate the dissonance between Fischel's theory and the market out, since the exception fails to restore appraisal rights where the consideration in a two-tiered tender offer or freeze-out merger takes the form of shares in the surviving corporation or other publicly traded shares; and (3) the cash-out exception to the market out is rare outside of Delaware.³⁹

Third, Fischel's theory of appraisal is inconsistent with the traditional ability of shareholders to pursue derivative suits and class actions alleging breach of fiduciary duty in cases like freeze-out mergers, even when appraisal rights are available.⁴⁰ Shareholder suits in these circumstances serve precisely the same function that Fischel assigns to appraisal rights: by assessing the adequacy of the consideration paid to the shareholders in the challenged transaction, they set a minimum price at which the firm, or a part thereof, can be sold. They therefore decrease the likelihood of value-decreasing transactions initiated by bidders and controlling shareholders. In addition, shareholder derivative suits and class actions arguably perform this function more effectively than do appraisal rights. This is because appraisal statutes typically create significant obstacles to shareholder recovery. Shareholders must properly perfect their appraisal rights by giving the corporation prior notice of their intent to seek appraisal, by failing to vote in favor of the triggering transaction, and by filing the appraisal action in a timely fashion;⁴¹ individual shareholders must file their own suits and bear their own litigation expenses;⁴² and shareholders lose their voting and dividend rights during the pendency of the proceeding.⁴³ These

³⁸ See *infra* Part II.B.7 (arguing that cash-out exception to the market out was intended to restrict the rights of minority shareholders to challenge cash-out mergers, not to expand them).

³⁹ See Thompson, *supra* note 3, at 30.

⁴⁰ See LATTIN, *supra* note 4, at 599; see also Thompson, *supra* note 3, at 21. The Delaware Supreme Court appeared to depart from the traditional rule in *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1985), where the court held that "a plaintiff's monetary remedy [in a cash-out merger] ordinarily should be confined to the more liberalized appraisal proceeding herein established." 457 A.2d at 714 (emphasis added). But the court greatly limited the reach of this aspect of its *Weinberger* decision in *Rabkin v. P.A. Hunt Chemical Corp.*, 498 A.2d 1099 (Del. 1985), where the court reversed the dismissal of a shareholder class action challenging the fairness of a merger between a corporation and its majority shareholder.

⁴¹ See Thompson, *supra* note 3, at 40 (summarizing steps that dissenting shareholders must take in most states in order to perfect appraisal rights).

⁴² See *id.* at 41 (noting that "[n]o provision is made for a class action or other means that would permit shareholders in a common situation to share an attorney and other expenses of litigation easily").

⁴³ See *id.* (noting that "[a]ppraisal litigation can drag on for a considerable time, and some

obstacles ensure that the minimum price set for a firm's shares in an appraisal proceeding will only be paid to a relatively small subset of the firm's shareholders. Bidders and controlling shareholders may therefore expect to succeed in appropriating the wealth of a substantial percentage of the firm's stockholders, even in cases where appraisal rights are available.⁴⁴ By contrast, no such bars to shareholder recovery exist in shareholder derivative suits and class actions, so bidders and controlling shareholders are more likely to be forced to compensate all shareholders who are harmed by their actions.

Finally, Fischel's wealth appropriation theory fails to adequately explain the distinctive form of the appraisal remedy—a court-ordered sale of the dissenter's shares to the corporation rather than an award of damages equal to the difference between the "fair value" of the shares and the amount offered in the challenged transaction. A "damages" remedy would serve the goal of setting a "minimum price at which a firm, or a part of it, can be sold"⁴⁵ equally as well as the traditional "buy-out" remedy. In addition, it offers one important advantage: because a damages remedy requires corporations to raise less cash than a buy-out remedy, it entails a smaller risk that the transaction costs of obtaining the necessary cash will derail otherwise profitable corporate transactions.⁴⁶

states, including Delaware, make no provision for minority shareholders to be paid until the litigation is over").

⁴⁴ Fischel recognizes this problem with his theory. See Fischel, *supra* note 12, at 901. The practical difficulties of asserting appraisal rights (and, therefore, appraisal's inability to function as an effective check on majority misconduct) have been frequently noted by commentators. See, e.g., Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 304-07 (1974); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 731 n.96 (1982); Melvin Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision Making*, 57 CALIF. L. REV. 1, 85 (1969); Manning, *supra* note 5, at 230-31; James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1201 (1964); see also PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 1, pt. VII, ch. 4, Reporter's Note 3 to Introductory Note, at 296. Cf. Thompson, *supra* note 3, at 28 (noting that "[t]he transformation of appraisal into a remedy for self-dealing does not easily fit with existing appraisal statutes").

⁴⁵ Fischel, *supra* note 12, at 876.

⁴⁶ Cf. Manning, *supra* note 5, at 234-35 (noting that "[e]ven a relatively modest number of shareholders claiming the appraisal remedy may constitute a severe economic threat to the corporate enterprise," since the "demand for a cash pay-out to shareholders often comes at a time when the enterprise is in need of every liquid dollar it can put its hands on," and that "[e]ven though the company may be economically very strong, it may be unable to go ahead with the [appraisal-triggering transaction] at all if the aggregated claim of dissenting shareholders under the appraisal statute comes to a high figure").

B. *Kanda and Levmore's Inframarginality, Reckoning and Discovery Theories*

Although Kanda and Levmore do not extensively explore the point, they recognize the lack of explanatory power of Fischel's theory of appraisal rights.⁴⁷ Accordingly, they offer three different theories of appraisal which they term "inframarginality," "reckoning" and "discovery," respectively. In Kanda and Levmore's view, one or more of these theories explains the various appraisal statutes in effect throughout the United States.

1. Inframarginality

"Inframarginality" refers to the idea that all shareholders may not "appreciate" their shares identically—i.e., some shareholders may value their shares in excess of the marginal (or market) price.⁴⁸ As a result, the marginal (or market) price of shares may understate the average value of shares. Kanda and Levmore suggest that some appraisal statutes may be designed to protect such inframarginal values since they give shareholders a remedy in cases where inframarginal values may be lost.

Kanda and Levmore offer Delaware General Corporation Law § 262 as their principal example of an inframarginality statute.⁴⁹ Delaware's version of the market out, they say, effectively restricts appraisal to transactions that are most likely to result in a net decrease in inframarginal values: (1) transactions where shareholders give up thinly traded stock and receive either widely traded securities or cash; and (2) transactions where widely traded stock is exchanged for cash.⁵⁰ In Kanda and Levmore's view, these transactions are most likely to result in a net loss of inframarginal values because inframarginal values are more likely to be present in thinly traded shares than in widely traded ones and should be completely absent in the case of cash.⁵¹

Like Fischel's theory, Kanda and Levmore's inframarginality theory of appraisal suffers from several serious flaws. First, the assertion that some shareholders value their shares more highly than others (i.e., that inframarginal values exist) is doubtful, particularly for widely traded shares. As Easterbrook and Fischel explain, it is unlikely that

⁴⁷ See Kanda & Levmore, *supra* note 13, at 435.

⁴⁸ *Id.* at 437-38.

⁴⁹ See *id.* at 446-51.

⁵⁰ See *id.* at 447.

⁵¹ See *id.* at 439-40.

different shareholders will place different values on the same investment because "[i]nvestors can make mutually beneficial trades until those holding any given firm's stock have reasonably homogeneous expectations about its performance."⁵²

Second, even assuming that some shareholders value their shares more highly than the market price, Kanda and Levmore's theory fails to fully explain the triggering provisions of even those statutes that they identify as inframarginality statutes. For instance, Delaware's appraisal statute permits appraisal rights to be asserted where shareholders surrender widely traded shares and receive thinly traded ones and where shareholders trade thinly traded stock for thinly traded stock.⁵³ These transactions, however, pose little risk that inframarginal values will be lost.⁵⁴

Third, Kanda and Levmore's inframarginality theory conflicts with the valuation principles traditionally applied in appraisal proceedings. To protect inframarginal values, the appraiser must be allowed to award some premium over the marginal (or market) value of the dissenter's shares.⁵⁵ But, as the commentators note, cases that award

⁵² Easterbrook & Fischel, *supra* note 44, at 726-27.

⁵³ See DEL. CODE ANN. tit. 8, § 262(b).

⁵⁴ Kanda and Levmore's theory is also arguably inconsistent with Delaware's treatment of dissolutions and sales of substantially all the firm's assets: both dissolutions and asset sales can arguably result in the loss of inframarginal values, if, for instance, shares are exchanged for cash, but appraisal rights are denied. *But cf.* DEL. CODE ANN. tit. 8, § 262(c) (providing that "[a]ny corporation may provide in its certificate of incorporation that appraisal rights . . . shall be available for the shares . . . of its stock as a result of . . . the sale of all or substantially all of the assets of the corporation"). Kanda and Levmore offer somewhat unsatisfactory explanations for these anomalies in the Delaware statute. With respect to transactions where publicly traded shares are exchanged for thinly traded ones, Kanda and Levmore say "[such transactions] must be so rare that the statute can be expected either to ignore [them] or to be suspicious enough to grant appraisal." Kanda & Levmore, *supra* note 13, at 448. Clearly the drafters of the Delaware statute did not ignore these transactions, as the exception is explicit; why the drafters might be suspicious of these transactions (apart from their relative rarity) is not explained. With respect to transactions where thinly traded stock is exchanged for thinly traded stock, Kanda and Levmore write as follows: "appraisal statutes may well reflect a variety of goals even while one goal alone makes them most comprehensible." *Id.* at 451. This explanation would be more convincing if Kanda and Levmore identified other provisions of the Delaware statute which furthered goals other than inframarginality.

⁵⁵ See Kanda & Levmore, *supra* note 13, at 451. A pure inframarginality statute would authorize the appraiser to measure each dissenter's idiosyncratic estimation of a share's value. *See id.* But Kanda and Levmore contend that inframarginality statutes are unlikely to include such broad authorizations "because no objective evidence exists regarding an individual's subjective valuation." *Id.* at 439. The authors then attempt to rescue their inframarginality theory by arguing that "shareholders, legislators, and judges simply could understand that an incantation which yielded an appraised value somewhat greater than the marginal market value would do the job" of protecting inframarginal values, albeit "in only an inexact way." *Id.* Thus, Kanda and Levmore conclude, "some power to give more than marginal value would be reassuring." *Id.* at 451.

dissenting shareholders more than the pre-transaction market value for their shares are rare.⁵⁶ This traditional view is hardly surprising since most states (including Delaware) define fair value in an appraisal proceeding as the value of the shares on the day before the transaction *exclusive* of any appreciation or depreciation attributable to the merger.⁵⁷

Finally, like Fischel's theory, Kanda and Levmore's inframarginality theory fails to adequately explain the distinctive form of the appraisal remedy. As noted above, the traditional remedy in an appraisal proceeding is a court-ordered buy-out of the dissenter's shares, rather than an award of damages equal to the difference between the fair value of the shares and the consideration offered in the challenged transaction. A damages remedy would protect inframarginal values just as well as a buy-out remedy, but, for the reasons noted earlier,⁵⁸ would expose corporations to a diminished risk of large cash drains that could impede otherwise value-increasing transactions.

2. Reckoning

The second goal that Kanda and Levmore suggest for appraisal statutes is "reckoning." Kanda and Levmore begin their explanation of reckoning by noting that shareholders must monitor corporations in order to evaluate managerial performance. Such monitoring, they

⁵⁶ See, e.g., Brudney & Chirelstein, *supra* note 44, at 307 n.28 (noting that a portion of the gain attributable to the merger "has never been included in valuation in appraisal proceedings"); Manning, *supra* note 5, at 292 (noting that, at least where widely traded shares are concerned, "courts have virtually refused to go beyond an inquiry as to the market price on the date determined to be relevant"); see also Thompson, *supra* note 3, at 20 & n.86, 35-36 & n.149 (citing REV. MODEL BUS. CORP. ACT § 13.01 comment (1985) for the proposition that a majority of states adhere to the goal of preserving minority shareholders *prior* rights as shareholders).

⁵⁷ Since the early 1980s, some states, including Delaware, have modified their appraisal procedures to allow appraisers to award a premium over the pre-merger value of the dissenter's shares. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1983) (authorizing courts to consider "elements of future value, including the nature of the enterprise, which are known or susceptible of proof as of the date of the merger and not the product of speculation"). This change is consistent with the view of Delaware General Corporation Law section 262 as an inframarginality statute. However, at least two problems remain: first, the extent to which Delaware law actually authorizes the award of a premium over the pre-merger value of shares remains unclear; see *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996); and, second, because the current version of the Delaware appraisal statute pre-dates the change in valuation rules by 15 years, it is difficult to conclude, as Kanda and Levmore do, that the provisions of the Delaware statute are in any way motivated by a desire to protect inframarginal shareholders. Cf. William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69, 116-17 (arguing that appraisal is an inadequate check on conduct of controlling shareholders because appraisal fails to protect inframarginal values).

⁵⁸ See *supra* note 46 and accompanying text.

contend, becomes difficult when fundamental change occurs in the middle of an accounting period because "[t]he entity that emerges after the change may be different enough from that managed before the change that much information about the managers will be lost if the two experiences are evaluated as one."⁵⁹ Appraisal, in their view, provides a potential solution to this monitoring problem: "since appraisal of some shares requires appraisal of the enterprise's value as a whole,"⁶⁰ "appraisal at the time of the change . . . may serve as a point of 'reckoning;' prior performance is reckoned and future performance can be judged from the benchmark determined at appraisal."⁶¹

Kanda and Levmore offer the Michigan and New Jersey appraisal statutes as their principal examples of reckoning statutes.⁶² Both statutes allow shareholders of a target corporation in an acquisition to enjoy appraisal rights unless the shares they surrender are widely traded, or they receive either widely traded shares or cash.⁶³ Kanda and Levmore argue that this pattern of appraisal rights is entirely consistent with a reckoning goal. An acquisition, they suggest, is an appropriate point to reckon the performance of target managers since the acquisition may so change the target firm that it will be difficult to evaluate prior and future performance without the benchmark established through an appraisal proceeding. But they reason that appraisal rights are unnecessary when target shareholders either surrender widely traded shares or receive widely traded shares or cash because the benchmark for evaluating prior and future performance can be easily established from the market value of the shares surrendered or the consideration received.⁶⁴

But while the reckoning theory of appraisal does a good job explaining some basic features of the Michigan and New Jersey appraisal statutes, the theory is undermined by its inconsistency with many of the procedural aspects of those statutes. The reckoning theory, as explicated by Kanda and Levmore, suggests that appraisal is designed to benefit shareholders as a group by facilitating investor monitoring of managerial performance. Accordingly, one would ex-

⁵⁹ Kanda & Levmore, *supra* note 13, at 441.

⁶⁰ *Id.* at 442.

⁶¹ *Id.* at 441.

⁶² See *id.* at 442-43 (Michigan), 452-55 (New Jersey).

⁶³ See *id.* at 442 (Michigan), 453 (New Jersey). The market out under the Delaware statute only applies in cases where dissenting shareholders give up widely traded shares; unlike the New Jersey and Michigan statutes under consideration here, it would not apply when thinly traded shares are exchanged for cash or widely traded shares.

⁶⁴ See Kanda & Levmore, *supra* note 12, at 442 (Michigan), 453 (New Jersey).

pect shareholders as a group to be required to bear the costs of prosecuting appraisal actions and, perhaps, to have the power to block or terminate appraisal actions if they determined that the costs to the firm of a reckoning exceeded the benefits. Instead, however, the Michigan and New Jersey statutes, like appraisal statutes generally, vest all decisionmaking authority vis-a-vis the appraisal proceeding in the dissenters and generally require dissenters to bear their own expenses.⁶⁵ This leads to a result which is difficult to reconcile with Kanda and Levmore's theory: reckonings of firm value may be pursued when they impose net costs on shareholders and may be foregone when they offer net benefits.⁶⁶

In addition, the reckoning theory cannot explain the more common form of appraisal statute which includes a market out that applies when shareholders surrender widely traded shares, but not when they simply receive them. These statutes would provide for appraisal in many instances when a reckoning through appraisal was unnecessary—that is, when a benchmark for evaluating prior and future performance could be easily established from the market value of the consideration received.

Finally, like the other theories considered so far, the reckoning theory of appraisal cannot explain why the remedy in appraisal takes the form of a transition-threatening buy-out, rather than a damages award.⁶⁷

3. Discovery

The third goal that Kanda and Levmore suggest for appraisal is discovery. Kanda and Levmore assert that, while managerial and shareholder interests are never perfectly aligned, mergers and other fundamental changes may magnify the opportunities for managerial misbehavior.⁶⁸ In particular, they contend that, "[i]n the context of fundamental corporate changes, which often trigger the appraisal remedy,"⁶⁹ managers may be tempted to sell corporate secrets to outsiders

⁶⁵ MICH. STAT. ANN. § 450.1774 (Callaghan 1997); N.J. STAT. ANN. § 14A:11-10 (West 1997).

⁶⁶ Kanda and Levmore note the latter problem—that appraisal procedures might lead reckonings to be foregone when they offer net benefits to shareholders. But they conclude, "it may be that as an empirical matter the statutes' disinclination to force appraisal is no obstacle to the reckoning theme; there may always be at least one feisty or selfless shareholder who does the job." Kanda & Levmore, *supra* note 13, at 455. However, Kanda and Levmore do not address the possibility that appraisal procedures will lead to the overuse of the appraisal remedy.

⁶⁷ See *supra* note 46 and accompanying text.

⁶⁸ See Kanda & Levmore, *supra* note 13, at 443.

⁶⁹ *Id.* at 456.

"in return for attractive employment contracts or other consideration"⁷⁰ instead of "bargain[ing] for bigger stakes on behalf of all shareholders."⁷¹ Appraisal, they argue, may operate as a check on such misbehavior:

While the law probably should not aim to discover and reveal the secrets [managers] may harbor, because often the revelation will injure all shareholders and ultimately the economy as a whole, it may hope, through threat of appraisal, to force from management and the acquirer a large enough premium over market price to dissuade potential dissenters, discourage inefficient transactions, and roughly compensate shareholders for the secrets that are theirs.⁷²

Kanda and Levmore offer the New York appraisal statute as their principal example of a discovery statute. Under New York law, "appraisal is available, *with no market exception*, to the target's shareholders in a merger, as well as in [most] . . . sale[s] of assets . . .," and is available "to the shareholders of a corporation that undergoes a charter amendment seriously affecting shareholder rights."⁷³ This broad trigger, Kanda and Levmore assert, ensures that appraisal will be available to shareholders whenever "there is reason to worry both that managers are not serving shareholders well as bargaining agents and that managers have secrets about future opportunities or hidden values."⁷⁴ But, Kanda and Levmore note, New York law withdraws appraisal rights when the assets of targets are sold for cash and the sales are followed by liquidations. This, they argue, is consistent with their theory because a "[cash sale followed by a liquidation] is less prone to managerial exploitation since it involves dispersing the target's assets and terminating the employment of the target's management."⁷⁵ In Kanda and Levmore's view, when target management retire rather than continue in the surviving business, there is little reason to doubt "their reliability as bargaining agents for the target against the acquirer."⁷⁶

⁷⁰ *Id.*

⁷¹ *Id.* at 443.

⁷² *Id.* at 457.

⁷³ Kanda & Levmore, *supra* note 13, at 460-61 (emphasis in original). Kanda and Levmore argue that a market out should not be expected in a discovery statute like New York's because, when an appraisal statute is based on the potential misuse of corporate secrets, "marketability is hardly relevant since the market is unaware of these secrets and therefore offers little help." *Id.* at 459-60.

⁷⁴ *Id.* at 460.

⁷⁵ *Id.*

⁷⁶ *Id.*

Kanda and Levmore's discovery theory of appraisal suffers from two principal flaws. First, the discovery theory of appraisal lacks explanatory power, even when applied to the triggering provision of the New York appraisal statute. As noted, the New York statute withdraws appraisal rights from target shareholders when assets are sold for cash and the sale is followed by a liquidation. Kanda and Levmore base their defense of this withdrawal of appraisal rights on two premises: first, that a transaction is more prone to exploitation if managers do not retire, presumably because side payments for corporate secrets can be more easily concealed in such cases; and second, that managers of firms that liquidate are more likely to retire than managers of ones that do not.⁷⁷ As Kanda and Levmore themselves acknowledge, this second premise (for which Kanda and Levmore offer no evidentiary support) is highly suspect.⁷⁸ In other words, asset sales followed by liquidations seem at least as susceptible to managerial exploitation as asset sales not followed by liquidations. In addition, the New York statute provides for appraisal rights in cases of charter amendments that seriously affect shareholder rights.⁷⁹ This, too, is arguably inconsistent with a discovery goal for appraisal because managers cannot easily use charter amendments, alone, as vehicles for converting corporate secrets into personal wealth.⁸⁰

Indeed, even if the triggers of the New York statute more closely matched Kanda and Levmore's theory, a discovery goal for appraisal would still be doubtful. For appraisal statutes to serve a discovery goal, they must effectively deter the kind of managerial misconduct that is the focus of Kanda and Levmore's analysis—i.e., the sale of corporate secrets to outsiders in exchange for attractive employment contracts or other consideration. This, however, is unlikely. As noted above, appraisal statutes typically create significant obstacles to shareholder recovery: shareholders must properly perfect their appraisal rights by giving the corporation prior notice of their intent to seek appraisal, by failing to vote in favor of the triggering transaction and by filing the appraisal action in a timely fashion; individual shareholders must file their own suits and bear their own litigation expenses; and shareholders lose their voting and dividend rights during the pendency of the

⁷⁷ See *id.*

⁷⁸ See Kanda & Levmore, *supra* note 13, at 460 (noting that the "correlation between the firm's liquidation and its managers' retirement" may not be strong).

⁷⁹ See N.Y. BUS. CORP. LAW § 806(d)(6) (Consol. 1997).

⁸⁰ Kanda and Levmore assert that New York's appraisal trigger for charter amendments is consistent with their discovery theory, but fail to explain the point. See Kanda & Levmore, *supra* note 13, at 461.

proceeding.⁸¹ These obstacles ensure that only a relatively small subset of the firm's shareholders will be able to obtain compensation for the value of the corporate secrets sold by the firm's managers. Accordingly, appraisal rights, alone, are unlikely to prevent managers from diverting most of the value of corporate secrets to themselves.⁸²

As Kanda and Levmore acknowledge, none of the three theories they offer can, by itself, explain the provisions of even a single appraisal statute.⁸³ In addition, each of their theories conflicts with at least one of the basic provisions of the typical appraisal statute: inframarginality is inconsistent with valuation principles that focus on pre-transaction market value; reckoning is inconsistent with basic procedural rules that give dissenters control over, and force dissenters to bear the costs of, appraisal proceedings; and the discovery goal conflicts with the market out. Accordingly, the likelihood that any of these concerns played a large role in motivating drafters of appraisal statutes is small.

C. Gilson's Managerial Incentives Theory

Gilson attempts to explain appraisal by focusing on the characteristics of the transactions that typically trigger the appraisal remedy. In his view, appraisal triggering transactions generally share two characteristics: (1) the ability, "by altering the asset makeup or leverage of the company, or the businesses in which the company is engaged, to alter the company's beta in a fashion that the shareholders could not have anticipated;"⁸⁴ and (2) the presence of "final period" problems that render market constraints on managerial self-dealing inoperative.⁸⁵ Gilson infers from these characteristics that the purpose of ap-

⁸¹ See *supra* notes 41-43 and accompanying text.

⁸² Kanda and Levmore suggest that appraisal might nonetheless deter managerial misconduct because "appraisal itself will threaten to drain the corporation's funds and therefore may deter misbehavior by managers whose plans require the presence of these funds." Kanda & Levmore, *supra* note 13, at 444. Accordingly, unlike the other theories considered so far, Kanda and Levmore's discovery theory arguably explains why the appraisal remedy takes the form of a buy-out rather than a damages award: a buy-out maximizes the cash drain from appraisal and therefore increases the remedy's deterrent effect. But since transactions where the cash drain from appraisal is large enough to derail the entire transaction are the exception rather than the rule, appraisal rights, by themselves, still seem unlikely to prevent managers from diverting the value of corporate secrets to themselves.

⁸³ See *id.* at 463.

⁸⁴ GILSON & BLACK, *supra* note 14, at 718. "Beta" measures the sensitivity of the firm's returns to market risk (i.e., the extent to which returns to the firm's shareholders fluctuate with movements in the market as a whole). See BREALEY & MYERS, *supra* note 16, at 160-62. So a change in a company's beta means a change in the market risk associated with an investment in that firm. See *supra* note 16.

⁸⁵ Gilson offers the following explanation of the final period problem: "[s]imply put, in a

praisal is to "create a substantial *ex ante* incentive for management to avoid uncompensated alterations in beta" in circumstances where market constraints on managerial misconduct may not function.⁸⁶ This protection, Gilson argues, is important because shareholders are not paid to take the risk of unanticipated alterations in beta and that risk cannot be fully diversified away.

Gilson's theory of appraisal more effectively explains the triggering provisions of the typical appraisal statute than competing theories. Gilson's theory explains why appraisal rights are triggered by fundamental changes brought on by managers but not by fundamental changes brought on by outsiders (the role of appraisal rights is to provide managers with *ex ante* incentives to avoid misconduct, not to insulate shareholders from risks they have been paid to take or can entirely diversify away);⁸⁷ it explains why shareholders of firms that *sell* substantially all their assets ordinarily get appraisal rights, while shareholders of firms that *purchase* those assets do not (managers of selling firms are in their final period, where market constraints on behavior may not function, while managers of purchasing firms are not);⁸⁸ and, unlike Fischel's theory,⁸⁹ it explains why appraisal rights might be made

situation where parties expect to have repeated transactions, the recognition that a party who cheats in one transaction will be penalized by the other party in subsequent transactions reduces the incentive to cheat. However, when the transaction is the last (or only) in a series—that is, the final period—the incentive to cheat reappears because, by definition, the penalty for doing so has disappeared." GILSON, *supra* note 14, at 720. Translated into the corporate context, managers are ordinarily constrained to act in the interests of shareholders because a failure to do so will trigger post-transaction penalties in product markets, capital markets, the market for managers and the market for corporate control. But when managers are in their final period, post-transaction market penalties are no longer of concern. So managers in their final period are more likely to ignore shareholder interests.

⁸⁶ *Id.* at 720.

⁸⁷ *See id.* at 718.

⁸⁸ *See id.* at 720–21 ("In the context of an acquisition nothing stops target management from selling out the shareholders in return for side payments from the acquiring company because target management, by definition, will no longer be subject to the constraints of the product, capital and control markets after the acquisition. Perhaps more importantly, if the remaining professional careers of target management are getting short, the size of the side payment may more than compensate them for any *ex post* penalty imposed by the market for managers.") This analysis also explains provisions like Delaware General Corporation Law section 251(f), which generally deny appraisal rights to shareholders of the firm that survives a merger if those shareholders end up owning at least 5/6 of the combined firm. *Cf.* Thompson, *supra* note 3, at 10 (noting most states now have provisions similar to Delaware General Corporation Law section 251(f)). This allocation of ownership interests suggests that the surviving firm is the acquiror and, therefore, that the managers of the surviving firm are not in their final period. Accordingly, surviving firm shareholders have no need for appraisal rights.

⁸⁹ *See supra* notes 28–31 and accompanying text.

available even in connection with arms-length transactions (managers of one or both firms may be in their final period).

Gilson's managerial incentives theory, however, shares many of the same problems that plague competing theories of appraisal. First, like Fischel's theory and Kanda and Levmore's discovery analysis, Gilson's theory of appraisal rights cannot account for the popularity of the market out. Under the typical market out, appraisal rights are withdrawn from a firm's shareholders when their shares are publicly traded. This means that shareholders of a publicly held firm that sells substantially all its assets to another firm (or that merges with another firm) generally would be denied appraisal even though the transaction has the hallmarks of an appraisal-triggering event—the ability to alter the company's beta in a fashion that the shareholders may not have anticipated and the presence of final period problems that render market constraints on managerial conduct largely inoperative.⁹⁰

Second, like Fischel's theory and Kanda and Levmore's discovery analysis, Gilson's theory of appraisal is inconsistent with procedural limitations on the appraisal remedy. As noted earlier, appraisal statutes typically create significant obstacles to shareholder recovery so that only a small number of shareholders can be expected to successfully assert appraisal rights.⁹¹ Accordingly, since the threat of appraisal is small, the remedy's capacity to deter managerial misconduct is likewise small.

Third, like all the theories considered thus far (other than Kanda and Levmore's discovery theory), Gilson's theory cannot explain why the appraisal remedy takes the form of a buy-out, rather than a damages award. A damages remedy would serve the goal of "creat[ing] a substantial *ex ante* incentive for management to avoid uncompensated alterations in beta"⁹² equally as well as the traditional buy-out remedy, but, as has been noted previously,⁹³ would do so without exposing corporations to an increased risk of large cash drains that could impede otherwise value-increasing transactions.

⁹⁰ The market out is not the only aspect of the triggering provisions of the typical appraisal statute that Gilson's theory fails to explain. In addition, Gilson's theory cannot explain why appraisal statutes are often triggered by charter amendments that alter the purpose for which a corporation is organized: although such charter amendments clearly pose a risk of altering the beta of a firm's shares (if, for instance, they authorize the firm to engage in a very different type of business from that authorized by the corporation's original charter), those amendments do not appear to involve final period problems.

⁹¹ See *supra* notes 41–44 and accompanying text.

⁹² GILSON & BLACK, *supra* note 14, at 720.

⁹³ See *supra* note 46 and accompanying text.

Finally, Gilson's theory faces one problem not shared by other theories of appraisal considered above: although Gilson correctly notes that the appraisal remedy is limited to transactions that pose a risk of substantially altering beta,⁹⁴ he fails to provide a satisfactory theoretical explanation for that limitation. Other final period transactions, apart from the beta-altering transactions that trigger appraisal, can benefit managers at the expense of shareholders. For instance, managers can simply dissolve the firm and distribute an excessive portion of the assets to themselves. Why provide shareholders with an appraisal remedy to check one type of final period problem but not the other?

II. THE ROLE OF APPRAISAL RECONSIDERED

A. *A Preference Reconciliation Theory of Appraisal*

The discussion in Part I leads directly to the basic question that is the focus of the remainder of this article: if appraisal statutes are not about solving the problems identified by Fischel, Kanda and Levmore, and Gilson, what are they about? The answer offered here focuses on the capacity of appraisal rights to reconcile differing shareholder preferences with respect to transactions that alter the risk of the firm's shares.⁹⁵ As the discussion below explains, when shareholders lack effective access to capital markets, risk-altering transactions (particularly those which alter the firm's market risk⁹⁶) can make some shareholders better off while leaving others worse off.⁹⁷ Appraisal rights require the corporation to compensate shareholders who may be harmed by such transactions and place the net costs of providing that compensation on shareholders who otherwise gain. As a result, shareholders who otherwise gain from appraisal-triggering transactions will only vote in favor of those transactions if their gains more than offset the net costs of compensating objectors. Appraisal rights therefore decrease the

⁹⁴ See *infra* Part II.B.1.

⁹⁵ For a definition of "risk," see *supra* note 16.

⁹⁶ For a definition of "market risk," see *supra* note 16.

⁹⁷ As was explained earlier, see *supra* note 18, transactions that alter a firm's unique risk will not ordinarily have any impact on investors because investors can eliminate the unique risk associated with a particular security by holding a diversified portfolio of investments. See BREALEY & MYERS, *supra* note 16, at 160. So most investors care only about transactions which alter the firm's market risk (i.e., the firm's sensitivity to movements in the market as a whole). But some investors are precluded from fully diversifying their investment portfolios because they are required by practical or legal considerations to invest a substantial portion of their wealth in a small number of companies. These investors will be affected by changes in unique risk, as well as by changes in market risk. For purposes of the analysis that follows, a "risk-altering" transaction is one that alters the type of risk (market risk and/or unique risk) that affects the firm's investors.

probability of risk-altering transactions that result in net losses to shareholders, causing *all* shares to trade at higher prices *ex ante*.⁹⁸

1. The Impact of Appraisal on Risk-Altering Transactions

To see how appraisal rights decrease the probability of risk-altering transactions that result in net losses to shareholders, consider first a world where shareholders who lack effective access to capital markets are denied appraisal rights. In that world, the value of shares held by particular investors, following a risk-altering transaction, will depend on the investor's personal taste for risk. Assume, for instance, that a transaction increases both the risk of a firm's shares and the firm's expected returns. Relatively less risk-averse shareholders may be made better off by that transaction since those shareholders require relatively modest increases in the firm's expected returns to compensate for increased risk. In other words, these shareholders may prefer the new combination of risk and return to the old. At the same time, relatively more risk-averse shareholders, who require greater compensation for increased risk, may be made worse off by the transaction. If, however, these relatively more risk-averse shareholders do not own a majority of the firm's shares, they will be unable to prevent the risk-increasing transaction from taking place. Accordingly, the transaction may be approved, even though some shareholders are made worse off and the aggregate losses to shareholders exceed the gains.

The point can be illustrated with an example. Firm A is considering undertaking a risk-increasing transaction. Assume Firm A has two groups of shareholders: Group 1 consists of relatively less risk-averse shareholders who own 51 of the firm's 100 outstanding shares and believe that the risk-increasing transaction will increase the value of their shares from \$100 per share to \$105 per share; Group 2 consists of relatively more risk-averse shareholders who own the remaining 49 shares of the firm's stock and believe that the risk-increasing transaction will decrease the value of their shares from \$100 per share to \$90 per share. Assume further that the shareholders are precluded from selling their shares in secondary markets, either because resales are legally restricted or because the transaction costs of accessing secondary markets are prohibitive. In addition, assume that the corporation is unwilling to repurchase the 49 shares held by the members of Group

⁹⁸ The preference reconciliation theory explains why appraisal might ordinarily be in the interests of shareholders as a group; the theory does not, however, support the proposition that appraisal rights should be mandatory for all firms.

2 at a price greater than \$90 per share because the transaction costs of issuing new shares to obtain the necessary cash would make such a purchase unprofitable for the firm (i.e., the firm would have to issue more than 49 new shares in order to obtain the cash necessary to repurchase the 49 old shares at a price greater than \$90 per share). In these circumstances, Group 1 shareholders will favor the risk-increasing transaction, while Group 2 shareholders will oppose it. But since Group 1's shareholders own a majority of the firm's stock, the transaction may well be approved even though Group 2 shareholders are made worse off and the aggregate losses to shareholders from the risk-altering transaction exceed the gains.⁹⁹

But in a world with appraisal rights for risk-altering transactions, the risk of this result is greatly reduced. Appraisal rights require the corporation to purchase the shares of investors who object to the transaction for a judicially determined "fair value," which corporation statutes generally define to mean the value of the shares *before* the announcement of the transaction from which the shareholders dissent (i.e., the *pre-transaction* value). By requiring the corporation to buy back shares of objectors for their pre-transaction value, appraisal rights, in effect, force the corporation to compensate objectors for their losses. The net cost to the corporation of providing this compensation is equal to the excess of: (a) the present value of the claims the firm must issue to obtain the necessary cash to buy back the objectors' shares; over (b) the present value of the shares the objectors surrender. This net cost necessarily falls on the shareholders who elect not to exercise appraisal rights—i.e., those shareholders who will keep their shares because they expect to gain from the risk-altering transaction. Appraisal rights therefore ensure that those who expect to gain from risk-altering transactions (or their representatives) will only vote in favor of such transactions when their gains are sufficient to cover the net costs of compensating the losers.¹⁰⁰

⁹⁹ Group 2 shareholders could, of course, try to convince Group 1 shareholders to forego the risk-increasing transaction, which would provide \$255 of gains to the Group 1 shareholders (51 shares times gain of \$5 per share), by offering Group 1 shareholders a side payment greater than \$255. But the collective action problems of organizing such an offer could cause the total cost to Group 1 shareholders to exceed the \$490 loss that would be avoided (49 times the potential loss of \$10 per share if the transaction is consummated). So the possibility of bargaining among groups of shareholders does not eliminate the possibility of risk-altering transactions where losses exceed gains.

¹⁰⁰ Shareholders who lack effective access to securities markets could behave strategically with respect to appraisal rights. For example, a shareholder who might be harmed by a risk-altering transaction if he had to retain his shares might nonetheless vote in favor of the transaction so as to increase the likelihood of the appraisal-triggering transaction and the corresponding oppor-

These effects of appraisal rights can be illustrated by returning to the example considered above. In a world where shareholders who lack effective access to securities markets are provided with appraisal rights, Group 2 shareholders can be expected to exercise those rights and demand payment equal to the pre-transaction value of their shares—\$100 per share. If the least expensive way for Firm A to obtain the necessary cash to repurchase the objectors' 49 shares is to issue new shares, the firm will have to issue enough shares to raise a net amount of \$4900 (49 shares times \$100 per share). Assuming that new investors attach the same value to the firm as the Group 1 investors (100 times \$105 or \$10,500) and that the transaction costs of issuance amount to 20% of the gross proceeds of the offering, this means that the firm must sell 71.39 new shares to obtain the \$4900 necessary to compensate objectors. [71.39 shares will give the new shareholders 58.33% of the firm (71.39/122.39). The new shareholders will be willing to pay \$6125, or \$85.79 per share, for this stake (58.33% of \$10,500), and the firm will net \$4900 (80% of \$6125) from the offering after expenses.]¹⁰¹

The cost to the corporation of compensating objectors in this fashion is equal to the excess of: (1) the value of the new claims issued (\$6125); over (2) the present value of the objectors' shares following the risk-altering transaction (49 shares times \$105 per share or \$5145); or \$980. This \$980 cost to the corporation translates into a \$980 expense for the Group 1 shareholders: if the Group 1 shareholders wish to retain a 51% stake in the firm (and therefore avoid the dilution in the value of their investment that would otherwise result from the new stock issuance), they must purchase 11.42 of the 71.39 newly

tunity to liquidate his investment. As a result of this strategic behavior, the appraisal-triggering transaction might be approved by the firm's shareholders even though the losses to shareholders exceed the gains. But appraisal statutes typically block such strategic voting behavior by requiring shareholders who seek appraisal rights to either vote against the triggering transaction or abstain from voting. (Since transactions that trigger appraisal typically require a vote of a majority of all the outstanding shares, an abstention is the functional equivalent of a "no" vote.)

¹⁰¹ These amounts are computed in the following fashion. The first step is to compute the percentage of the firm that must be sold to new investors to net \$4900, assuming that new investors attach a \$10,500 value to the firm. That percentage is computed by solving the following equation: $X * (\$10,500) [\text{the gross proceeds raised by the offering}] - .2 * X * (\$10,500) [\text{the costs of the offering}] = \4900 . Solving for X yields a value .5833 or 58.33%. This means that, following the offering, the 51 shares held by the Group 1 shareholders must represent 41.67% of the total outstanding [100% - 58.33%], which means that: (1) the total number of shares outstanding after the offering is 122.39 [.4167 times 122.39 equals 51]; (2) 71.39 new shares have been issued [122.39 minus the 51 retained by the Group 1 shareholders]; (3) the price per share of the newly issued shares is \$85.79 [\$10,500 divided by 122.39 shares]; (4) the gross proceeds from the offering are \$6125 [\$85.79 per share times 71.39 shares]; and (5) the net proceeds from the offering are \$4900 [.8 times \$6125].

issued shares;¹⁰² this means a new investment of \$980 (11.42 shares times a market price of \$85.79 per share). Group 1 shareholders will therefore take the cost of compensating objectors into account in deciding whether to undertake the risk-altering transaction: if, as here, these costs (\$980) are greater than the benefits to the Group 1 shareholders (51 shares times a gain of \$5 per share for a total of \$255), the Group 1 shareholders will vote against the risk-altering transaction, thereby guaranteeing its defeat (since Group 1 investors own a majority of the shares). So, by ensuring that objectors will be compensated for their losses and placing the net cost of providing that compensation on shareholders who otherwise gain, appraisal rights ensure that risk-altering transactions will only be undertaken when they are value-increasing.¹⁰³

2. The Impact of Shareholder Access to Perfectly Competitive Capital Markets

The problem that this article suggests appraisal rights are designed to address—dealing with transactions whose effects on shareholders differ depending on the shareholders' preferences for risk—however, only arises when shareholders lack access to perfectly competitive capital markets.¹⁰⁴ When shareholders have access to perfectly competitive capital markets, financial theory tells us that *all* shareholders will assess a risk-altering transaction according to the same criterion: is the expected rate of return on the investment required for the risk-altering transaction greater than the opportunity cost of capital, where the opportunity cost of capital is defined as the rate of return on publicly traded securities that have the same risk as the transaction under consideration.¹⁰⁵ If the answer to this question

¹⁰² This will give the Group 1 shareholders a total of 62.42 of the 122.39 outstanding shares after the new stock issuance, or 51% of the total.

¹⁰³ It should be noted that the benefits of appraisal rights come at a cost. Although appraisal rights should prevent all risk-altering transactions that are value-decreasing, they can also be expected to block some risk-altering transactions that are value-increasing. This will happen if the benefits to shareholders who gain from a risk-altering transaction exceed the costs to those who lose, but these benefits are not sufficient to fully offset the net costs of compensating objectors.

¹⁰⁴ A perfectly competitive capital market is characterized by the following conditions: (1) there are no barriers preventing access to the capital market and no participant is sufficiently dominant as to have a significant effect on price; (2) access to the capital market is costless and there are no frictions preventing the free trading of securities; (3) relevant information about the price and quality of each security is widely and freely available; and (4) there are no distorting taxes. See BREALEY & MYERS, *supra* note 16, at 22.

¹⁰⁵ See *id.* at 14, 16, 17–24.

is yes, then all shareholders will agree that the risk-altering transaction makes them better off. If, on the other hand, the answer is no, then all will agree that the risk-altering transaction makes them worse off. The explanation for these results follows.

If a new project offers a return for risk that is superior to the market rate of return (and therefore leads to an increase in the market price of the firm's shares), then even shareholders who *personally* prefer the old combination of risk and return to the new will benefit from the transaction. This is because these shareholders can sell their shares at the increased market price which results when the new project is undertaken, purchase a different investment that has the risk and return features of the pre-transaction firm for a lower price, and keep the difference for themselves.¹⁰⁶ If, on the other hand, a new project offers a return for risk that is less than the market rate of return (and therefore leads to a decrease in the market price of the firm's shares), then even those shareholders who *personally* prefer the new combination of risk and return to the old will lose. This result follows because, had the transaction not taken place, these shareholders could have sold their shares for the higher pre-transaction market price, purchased a new investment with risk and return characteristics of the post-transaction firm for a lower price, and retained the difference as profit.¹⁰⁷ Thus, when shareholders have access to perfectly competitive capital markets, there is no possibility that differing personal tastes for risk will result in differing shareholder preferences with respect to risk-altering transactions. In other words, access to perfect capital markets ensures that all shareholders will benefit from transactions that increase the market value of their shares and all will be harmed by transactions that decrease the market value of their shares.¹⁰⁸ Therefore, under the preference reconciliation theory advanced in this article, there is no potential problem for appraisal rights to address.

This result (i.e., identical shareholder preferences for risk-altering transactions) however, only holds for perfectly competitive capital mar-

¹⁰⁶ This result depends on the fact that access to perfectly competitive capital markets is costless. See *supra* note 104 (setting forth the conditions that must be satisfied for capital markets to be perfectly competitive). If access to capital markets is not costless, then there is no guarantee that investors will *net* a sufficient amount (after deducting access costs) from selling their post-transaction shares to purchase new investments with the risk and return features of the pre-transaction firm. In other words, there is no guarantee that the net post-transaction sales price to shareholders will exceed the pre-transaction market value of the firm's shares.

¹⁰⁷ This result also depends on the fact that access to perfectly competitive capital markets is costless. See *supra* note 106 (explaining impact of positive access costs).

¹⁰⁸ This result assumes that shareholders have no other interest in the transaction apart from their interests as shareholders.

kets. If, instead, shares of a firm are traded in capital markets that are even slightly imperfect, then the personal taste of investors for risk can again become relevant in determining the value of the shares held after a risk-altering transaction. Accordingly, a role for appraisal can re-emerge. Consider, for example, a risk-increasing transaction that offers a rate of return for risk that is superior to the opportunity cost of capital and therefore increases the market value of a share (i.e., the value of a share to the marginal investor). If capital markets are imperfect (e.g., access to such markets is costly), a rise in the marginal (or market) value of shares will not necessarily translate into a *net* post-transaction sales price that exceeds pre-transaction value. In other words, if market imperfections are sufficiently large, the post-transaction market value of shares minus the cost of accessing capital markets may be less than the pre-transaction value of shares. Accordingly, there is no guarantee that sales of post-transaction shares will generate sufficient cash (net of transaction costs) to purchase new investments with risk and return features of pre-transaction shares. More risk-averse shareholders, who prefer the old combination of risk and return to the new, may therefore be made worse off by risk-increasing transactions, even though those transactions increase the market value of shares. Meanwhile, less risk-averse shareholders may be made better off. A role for appraisal under the preference reconciliation theory therefore re-emerges. As markets more closely approach perfection, however, the benefits from appraisal become smaller. This results because access to capital markets, even imperfect ones, limits the losses that particular shareholders might suffer as a result of risk-altering transactions. It, therefore, reduces the likelihood that the losses from risk-altering transactions will exceed the gains.¹⁰⁹

3. The Impact of Diversification by Shareholders

The need to reconcile differing shareholder preferences with respect to risk-altering transactions also disappears if: (1) shareholders

¹⁰⁹ For example, assume that in the example considered earlier, the market value of Firm A's shares rose from \$100 per share to \$105 per share as a result of the risk-altering transaction. If the transaction costs of accessing capital markets equaled 10% of the total sale price, then Group 2 shareholders, who personally preferred the old combination of risk and return to the new, could sell their shares for a net price of \$94.50 per share (\$105 less \$10.50 in transaction costs). These shareholders would, of course, still be harmed by the risk-altering transaction, but the harm would be reduced from \$10 per share (in the earlier example where shareholders were effectively precluded from accessing capital markets) to \$5.50 per share. If transaction costs were less than 10% of the total sales price, the harm suffered by Group 2 shareholders would be smaller still, and the harm would disappear entirely as transaction costs dropped below 5%.

hold investment portfolios that are sufficiently diversified to eliminate the unique risk of their investments (i.e., investment portfolios which include many other securities in addition to the shares in the firm undergoing the risk-altering transaction);¹¹⁰ and (2) a sufficient portion of the securities in those investment portfolios are traded in capital markets which investors can access at little or no cost. When these two conditions are satisfied, a risk-altering transaction which results in an increase in the market value of the firm's shares is certain to make all shareholders better off, regardless of the shareholders' personal preferences for risk. In these circumstances, investors who dislike the impact of the risk-altering transaction on the risk and return attributes of their investment portfolios can readjust their portfolios by buying and selling securities of *other* firms until the risk and return characteristics of their original portfolios are restored. In particular, an investor can sell securities or combinations of securities that have the same risk and return features as the *post-transaction* shares and buy securities or combinations of securities that have the same risk and return features as the *pre-transaction* shares. This series of transactions should restore the risk and return attributes of the investor's pre-transaction portfolio. At the same time, it should leave the investor better off than if the risk-altering transaction had never taken place because: (1) the securities the investor sells in order to rebalance her portfolio (securities with the risk and return characteristics of the post-transaction shares) have a higher market value than the securities the investor purchases (ones with risk and return features of the pre-transaction shares);¹¹¹ and (2) the transaction costs of trading securities are assumed to be negligible. Accordingly, when the two conditions noted at the beginning of this subsection are satisfied, risk-altering transactions that increase the market value of a firm's shares are certain to make all shareholders better off, even if the particular shares affected by the risk-altering transaction cannot be easily sold in capital markets. So appraisal rights need not be provided to ensure that the gains to some shareholders more than offset the losses to others.

¹¹⁰ See *supra* note 16 for a definition of unique risk.

¹¹¹ Note, in this regard, that we have assumed the risk-altering transaction increases the market value of the firm's shares (i.e., that shares with the risk and return features of the post-transaction firm have a higher market value than shares with the risk and return features of the pre-transaction firm). This assumption seems reasonable because: (1) managers are constrained by market and legal forces to act consistently with shareholder interests (i.e., to pursue value-increasing transactions, rather than value-decreasing ones); and (2) owners of a majority of the firm's shares cannot be expected to approve transactions that result in a decrease in share value.

Consequently, a role for appraisal in cases involving firms with shareholders who lack effective access to capital markets only remains *if* either of the two conditions noted at the beginning of this subsection are not satisfied—i.e., if (1) shareholders fail to hold investment portfolios that are sufficiently diversified to eliminate the unique risk of the investment in the firm undergoing the risk-altering transaction, or (2) a sufficient portion of the securities in the shareholders' portfolios are not traded in capital markets that investors can access at little or no cost. In fact, this may frequently be the case. Investors who hold shares that cannot be easily sold in capital markets (such as shares of a closely held family business) will often have a substantial portion of their wealth invested in those shares. As a result, these investors may not be sufficiently diversified to eliminate the unique (or firm-specific) risk of their investments. When this occurs, there can be no guarantee of a portfolio readjustment strategy that will leave the investor better off than if the risk-altering transaction had never taken place. First, if the investor has a disproportionate amount of her wealth invested in unmarketable securities of a firm undergoing a risk-altering transaction, it may not be possible for the investor to fully offset the effects of the risk-altering transactions by changing the ways in which her remaining wealth is invested. Second, even if readjustment is possible, the costs of readjustment may well exceed the gains. This is because many of the trades necessary to readjust portfolio risk of an undiversified portfolio will be designed *solely* to readjust the unique risk of that portfolio. These trades, however, are sure to generate net losses for investors, because securities with the same *market* risk, but different *unique* risk, will sell for the same price.¹¹² So the trades designed to adjust unique risk will produce no trading gains to offset their positive transaction costs.

The result, then, is that the costs of readjusting the portfolio's *unique* risk may more than offset the benefits from readjusting a portfolio's *market* risk. Accordingly, the possibility of rebalancing a portfolio after a risk-altering transaction does not eliminate the risk that some shareholders will benefit from risk-altering transactions, while others will lose. A role for appraisal in reconciling differing shareholder preferences with respect to the risk-altering transaction therefore remains.

¹¹² See BREALEY & MYERS, *supra* note 16, at 179–83 (explaining the Capital Asset Pricing Model which posits that a security's price depends only on the security's sensitivity to *market* risk).

4. The Costs of Appraisal

The benefits of appraisal in ensuring that risk-altering transactions produce net gains in cases where shareholders lack access to perfectly competitive capital markets, of course, come at a cost. As explained above,¹¹³ although appraisal rights should prevent all risk-altering transactions that are value-decreasing, they can also be expected to block some risk-altering transactions that are value-increasing. This will happen if the benefits to shareholders who gain from a risk-altering transaction exceed the costs to those who lose, but these benefits are not sufficient to fully offset the net costs of compensating objectors. In addition, since the number of shareholders who will seek appraisal (and therefore the amount of cash which must be raised) cannot be easily predicted in advance, appraisal rights introduce new uncertainty into the job of planning corporate transactions. So if the preference reconciliation theory of appraisal is correct, appraisal rights should only be available in those circumstances where the gains from appraisal are relatively large; namely, where transactions have a substantial impact on the risk of a firm's shares and the impediments blocking shareholder access to capital markets are large.

5. Summary

The foregoing thus provides a new theoretical explanation for appraisal rights. Under this theory, appraisal rights are designed as a vehicle for reconciling conflicts among shareholders with differing preferences for risk, conflicts which exist even when managers act in accordance with their fiduciary duties to shareholders by only approving transactions that result in increases in the market value of the firm's shares.¹¹⁴ Accordingly, this theory (unlike competing theories which view appraisal simply as a check on misconduct by managers or controlling shareholders) carves out for appraisal a function that the law of fiduciary duties does not, and cannot, serve: ensuring that transactions, which have differing effects on shareholders depending on their personal preferences for risk, produce net gains for shareholders.¹¹⁵

¹¹³ See *supra* note 103.

¹¹⁴ Note, in this regard, that the principal example in Part II.A.1 involved a risk-altering transaction which resulted in an increase in the market value of the firm's shares but nonetheless resulted in net losses for shareholders as a group.

¹¹⁵ To handle this problem in a breach of fiduciary duty action, the court would have to calculate the difference between pre- and post-transaction values for each of the firm's sharehold-

B. *Consistency of the Preference Reconciliation Theory with the Basic Features of Appraisal*

Despite the advantages of the preference reconciliation theory over its competitors, one basic empirical question remains: are the terms of traditional appraisal statutes consistent with the theory? An examination of the principal features of appraisal statutes suggests that the answer is yes.

1. Appraisal Triggers

As noted earlier, appraisal rights are typically triggered by mergers, sales of all or substantially all the firm's assets (other than in connection with dissolutions) and "serious" charter amendments, such as those that alter the corporation's fundamental purposes. Each of these transactions poses a significant risk of substantially altering the risk of the firm's shares: a merger will alter the risk of the firm's shares if, for instance, the merger partner's sensitivity to market risk is very different from the original firm's; a sale of all (or substantially all) the firm's assets will alter the risk of the firm's shares if the proceeds of the sale are invested in assets that differ markedly from those sold; and a charter amendment will result in the alteration of the share risk if, for example, it authorizes the firm to engage in businesses that are very different from those authorized in the original charter.¹¹⁶

At the same time, transactions that pose a lesser risk of substantially altering share risk are commonly excluded from the triggering provisions of the appraisal statutes. For instance, most appraisal statutes contain a provision similar to Delaware General Corporation Law section 251(f),¹¹⁷ which denies appraisal rights to the acquiror's shareholders when a merger leaves the acquiror's shareholders with at least 5/6th of the equity of the firm surviving the merger. This is logical because such an allocation of shares suggests that the surviving firm

ers. This could be expected to result in a proceeding of enormous complexity because in instances where appraisal rights are triggered (i.e., where transactions have a substantial impact on the risk of the firm's shares and impediments blocking shareholder access to capital markets are large), the post-transaction value of a share can be expected to vary from investor to investor depending on the particular investor's taste for risk. So a separate calculation would have to be made for each of the firm's shareholders. As is explained in Sub-Part II.B.4 below, the appraisal action overcomes this problem by providing for a buy-out remedy, rather than a damages remedy.

¹¹⁶ Gilson also argues that appraisal-triggering transactions are characterized by their capacity to alter the risk (specifically, the market risk) of the firm's shares. See *supra* note 84 and accompanying text.

¹¹⁷ See Thompson, *supra* note 3, at 10.

does not differ greatly from the acquiring firm and therefore the transaction did not greatly alter the risk of the acquiror's shares. Similarly, most appraisal statutes that grant appraisal rights to the shareholders of a firm that *sells* all (or substantially all) its assets deny appraisal rights to shareholders of the *purchasing* firm. This distinction is also consistent with the theory. Shareholders of the selling firm may see one group of assets completely replaced by another if, for instance, the proceeds of the sale are used to invest in an entirely new line of business. A substantial alteration in share risk is therefore quite possible. Shareholders of the purchasing firm, however, are less likely to see the risk of their shares substantially altered. This is because the purchasing firm's existing assets are *combined* with new assets, rather than being completely *replaced* by them.

Finally, as expected, most appraisal statutes withdraw appraisal rights in connection with dissolutions.¹¹⁸ Dissolutions will ordinarily take the form of a sale of the corporation's assets followed by a distribution to the firm's stockholders of the cash remaining after all the firm's creditors have been paid. A transaction, like the ordinary dissolution, which provides each shareholder with an identical amount of cash per share presents no risk of affecting shareholders differently depending on their preferences for risk, since each shareholder will attach the same value to the consideration (i.e., cash) received for their shares. Accordingly, under the preference reconciliation theory, there is no problem for appraisal rights to address.¹¹⁹

2. The Market Out

Most appraisal statutes now provide for a market out. Under the earliest versions of the market out, which appeared in the 1960s, appraisal rights were withdrawn with respect to shares that were listed on a national securities exchange, such as the New York Stock Exchange, or that were held of record by more than 2000 holders. More recent versions of the market out go even further, extending the market out to shares that are traded on the NASDAQ Stock Market.¹²⁰

The emergence and subsequent expansion of the market out is perfectly consistent with the preference reconciliation theory set forth in this article. As noted earlier, the benefits from appraisal become less substantial as capital markets approach perfection. In the 1890s, when

¹¹⁸ See Manning, *supra* note 5, at 250-51.

¹¹⁹ For an explanation of why Delaware nonetheless provides for appraisal rights in connection with cash-out mergers, see *infra* Part II.B.7.

¹²⁰ See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1).

appraisal rights first appeared *without market outs*, public securities markets, such as the New York Stock Exchange, were far from perfect. Accordingly, appraisal rights offered large gains, even for firms whose securities were traded in those markets. By the 1960s, national securities exchanges had achieved much higher levels of efficiency. As a result, the gains from appraisal rights for firms whose shares were traded on those securities exchanges became considerably smaller in relation to the costs and a market out withdrawing appraisal rights for those shares emerged. In more recent years, the efficiency of public securities markets, including the principal over-the-counter markets, has continued to increase. The continued expansion of the market out, to include securities traded in the NASDAQ Stock Market, can be understood as a reflection of the increasing efficiency of these markets.

3. Valuation Rules

Appraisal statutes typically provide that shareholders who opt for appraisal be awarded the pre-transaction value of their securities. This is exactly the result one would expect if, as is argued here, the goal of appraisal is to ensure the gains from appraisal-triggering transactions exceed the losses. As explained above, awarding objecting shareholders the pre-transaction value of their shares has the effect of shifting to the firm's other shareholders the cost of compensating objectors for the losses they suffer as a result of the risk-altering transaction. Accordingly, this valuation measure ensures that shareholders will vote in favor of a risk-altering transaction only if the gains to shareholders exceed the costs of making the losers whole.

By contrast, a valuation measure which gives objectors more than pre-transaction value—such as a measure that gives objectors a share of the gains that result from risk-altering transactions—risks impeding value-increasing corporate transactions, because a higher price per share for objectors translates into a higher net cost to the corporation of compensating objectors through appraisal. This, in turn, creates a greater risk that the net cost of compensating objectors will exceed the gains to non-objecting shareholders, thus leading non-objecting shareholders to vote against the transaction even though gains to shareholders from the risk-altering transaction exceed losses. For example, assume a transaction increases the market value of the firm's 100 outstanding shares from \$100 per share to \$105 per share, but the owners of 49 of the firm's shares dissent from the transaction because they believe it decreases the value of their shares from \$100 to \$99 dollars. If the appraiser ordered that the dissenters be paid \$105 per

share, rather than the pre-transaction value of \$100 per share, the transaction might nonetheless be defeated even though it clearly produces net gains for the shareholders. This would result if the transaction costs of issuing new shares in order to get the cash necessary to compensate objectors amounted to more than 4.72% of the gross proceeds of the offering, since the net costs of compensating objectors under those circumstances would more than offset the \$255 gain (i.e., 51 shares times \$5 per share) non-objecting shareholders expected to receive from the transaction.¹²¹

4. Form of the Remedy

Appraisal statutes uniformly provide for a buy-out of the objectors' shares rather than an award of damages in amount sufficient to compensate objectors for their losses. Like the other aspects of appraisal statutes already considered, the form of the remedy is easily explained if, as argued above, appraisal is designed to ensure that the gains from risk-altering transactions exceed the losses. To effectively implement a damages remedy that would serve this purpose, a court would have to calculate the difference between pre- and post-transaction values for each objecting shareholder. This could be expected to result in a proceeding of enormous complexity for at least two reasons. First, in instances where appraisal rights are triggered (i.e., where transactions have a substantial impact on the risk of the firm's shares and impediments blocking shareholder access to capital markets are large), the post-transaction value of a share can be expected to vary from investor to investor depending on the particular investor's taste for risk.¹²² Thus, a separate damages calculation would have to be undertaken for each objecting shareholder. Second, as Kanda and Levmore note, "if appraisal is meant somehow to account for [subjective] values, then appraisers are faced with a terribly difficult valuation problem, because

¹²¹ To net the \$5145 necessary to compensate objectors (49 shares times \$105 per share) after paying transaction costs equal to 4.72% of the offering, the company would have to sell new shares with a total market value of \$5400 (\$5400 minus 4.72% of \$5400 equals \$5145). This means the company would have to sell new investors 51.43% of the company (51.43% of 10,500 equals \$5400). The net cost to the company of making such an offering is equal to: (1) the market value of the new shares sold (\$5400) minus (2) the market value of shares repurchased from objectors (49 times \$105 per share or \$5145), or \$255. This net cost exactly offsets the gain that non-objecting shareholders would have received absent the exercise by objectors of appraisal rights (51 times \$5 per share or \$255). So if transaction costs exceed 4.72%, the majority of the firm's shareholders can be expected to vote against the transaction even though it offers net gains to shareholders in the absence of appraisal rights.

¹²² See *supra* Part II.A.

no objective evidence exists regarding an individual's subjective valuation."¹²³

A buy-out remedy, on the other hand, achieves the goal of compensating objectors for the losses they suffer with relative ease. To implement a buy-out remedy, a court need only calculate the pre-transaction value of the firm's shares, a task which should be relatively simple in the ordinary case since pre-transaction value can be determined by reference to the market price of the firm's shares before the announcement of the triggering transaction.¹²⁴ Unlike the damages alternative, no calculation of subjective, post-transaction values is required. Admittedly, a buy-out remedy suffers from the disadvantage of requiring a corporation to raise more cash than a damages remedy. But this disadvantage of a buy-out remedy is relatively minor when compared with the extreme calculation problems posed by the damages alternative.

5. Appraisal Exclusivity

Appraisal statutes (or court decisions interpreting those statutes) traditionally provide that the availability of an appraisal remedy in connection with a particular transaction does not preclude a shareholders' suit alleging breach of fiduciary duty from being maintained in connection with the same transaction.¹²⁵ This, too, is consistent with the preference reconciliation theory of appraisal. The breach of fiduciary duty action is designed to ensure that corporate decisionmakers—be

¹²³ Kanda & Levmore, *supra* note 13, at 439.

¹²⁴ Cf. Manning, *supra* note 5, at 232 (noting that, at least where widely traded shares are concerned, "courts [in appraisal proceedings] have virtually refused to go beyond an inquiry as to the market price on the date determined to be relevant"). Pre-transaction value should be the same for all shareholders because shareholders who elect to invest in a particular type of firm (rather than having that investment forced upon them by directors and/or other shareholders) should have relatively homogenous expectations regarding firm value. See Easterbrook & Fischel, *supra* note 44, at 726-27 (noting that "[i]nvestors can make mutually beneficial trades until those holding any given firm's stock have reasonably homogeneous expectations about its performance").

¹²⁵ See Thompson, *supra* note 3, at 43; see also LATTIN, *supra* note 4, at § 162. But cf. Thompson, *supra* note 3, at 24 (noting that courts in twelve states have held appraisal to be exclusive). In *Weinberger v. UOP Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court held that, in the absence of fraud or illegality, the appraisal remedy would "ordinarily" be exclusive. But since *Weinberger*, the Delaware courts have routinely interpreted the exception to appraisal exclusivity broadly. See, e.g., *Rabkin v. P.A. Hunt Chem. Corp.*, 498 A.2d 1099 (Del. 1985) (permitting plaintiffs to proceed with a breach of fiduciary duty action where defendants were "charged with bad faith which goes beyond issues of 'mere inadequacy of price'"). Indeed, in the decade following *Weinberger*, there were at least eleven reported Delaware decisions applying the fair dealing/fiduciary duty standard in cases where appraisal rights were available. See Thompson, *supra* note 3, at 24 & n.102.

they directors or controlling shareholders—have acted consistently with their duties to the firm's shareholders. In the context of arms-length transactions (such as a sale of the corporation to an unaffiliated firm), this duty ordinarily requires corporate decisionmakers to strive to obtain the best price reasonably attainable,¹²⁶ not simply a price that exceeds the pre-transaction market value of the firm's shares.¹²⁷ In the context of a conflict of interest transaction (such as a sale of the corporation to its controlling shareholder), this duty generally translates into an obligation to treat minority shareholders "fairly,"¹²⁸ a duty which may or may not require the sharing of gains with minority shareholders.¹²⁹ An appraisal action that is designed—as the preference reconciliation theory predicts—to ensure that gains from risk-altering transactions exceed losses does little to advance these goals. As the discussion above explains, such an appraisal action only ensures that appraisal-triggering transactions are *value-increasing*; it does not ensure that triggering transactions are *value-maximizing*—that is, that net gains are as large as possible. Nor will an appraisal action designed in accordance with the preference reconciliation theory adequately protect minority shareholders from unfair treatment by majority shareholders, since the pre-transaction value awarded to objectors will necessarily reflect the potential for unfair actions by the majority. Accordingly, since an appraisal remedy designed to reconcile differing shareholder preferences with respect to risk-altering transactions cannot ensure that corporate decisionmakers act in accordance with their fiduciary duties to shareholders, the traditional view—that the availability of appraisal does not preclude a breach of fiduciary duty action—is entirely logical.¹³⁰

¹²⁶ See, e.g., *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

¹²⁷ Cf. *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (finding that directors breached their fiduciary duty to the shareholders in connection with the sale of the company, even though a sale price of \$55 per share represented a 48% premium over the stock's last closing price).

¹²⁸ See generally RIBSTEIN & LETSOV, *supra* note 32, § 9.04.

¹²⁹ See *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289 (Del. 1996) (suggesting that the sharing of gains with minority shareholders may be required in at least some cases).

¹³⁰ By the same token, the availability of a breach of fiduciary duty action should not (and does not) preclude the exercise of appraisal rights. As is explained above, the breach of fiduciary duty action is designed to ensure that corporate decisionmakers get the best price reasonably attainable for the shareholders—that is, to ensure that corporate transactions are *value-maximizing*. But, as Part II.A. explains, in circumstances where shareholders lack effective access to capital markets, actions that maximize the market value of a firm's shares may not necessarily be

6. Appraisal Procedures

Finally, the appraisal remedy is marked by a number of procedural rules that distinguish it from the more common shareholders' derivative suit or class action. These include: (1) the obligation of individual shareholders expressly to opt-in to an appraisal action; (2) the cumbersome procedures for perfecting appraisal rights; and (3) the designation of the corporation as the respondent in the action. The discussion that follows reconciles these rules with the preference reconciliation theory of appraisal developed in this article.

a. *Opt-In*

Appraisal statutes typically permit only those shareholders who expressly elect appraisal (in the manner provided in the state appraisal statute) to share in the statutory remedy. These rules are in marked contrast to those governing shareholders' derivative suits and class actions, which permit shareholders to automatically share in judgments even if they fail to take any formal steps to join the action.¹³¹

The opt-in nature of the appraisal remedy is entirely consistent with the preference reconciliation theory of appraisal outlined above. Under this theory, the appraisal remedy is designed to deal with transactions that have differing impacts on different shareholders depending on their personal preferences for risk—i.e., transactions that make some shareholders better off, while leaving others worse off. Consequently, there is no reason to infer from the filing of an appraisal action by one shareholder that all others (or indeed any others) wish to pursue the remedy. In fact, one would expect just the opposite: those shareholders who feel they have been made better off by the transaction (i.e., those who feel that the post-transaction value of their shares exceeds the pre-transaction value) will wish to retain their shares rather than sell them back to the corporation for their pre-transaction value.

value-increasing—that is, where shareholders lack effective access to capital markets, some shareholders may be harmed by transactions that increase the market value of the firm's shares and these losses may well exceed the gains realized by others. So appraisal rights are not made obsolete by the availability of an action for breach of fiduciary duty. In short, as was noted earlier, under the view of appraisal rights advanced herein, appraisal and the law of fiduciary duties serve completely separate and distinct functions. See *supra* note 115 and accompanying text.

¹³¹ In a successful derivative suit, damages are paid to the corporation, not to the individual shareholder plaintiffs. So all shareholders share in the benefit that a derivative action produces through an increase in the value of their shares. See generally RIBSTEIN & LETSOU, *supra* note 32, at 574.

By contrast, a shareholders' derivative suit or class action alleging breach of fiduciary duty is based on the claim that the firm's managers could have taken steps to make the challenged transaction even more favorable to the corporation. If that claim is correct, then the value of *all* the firm's shares has been depressed by the managers' actions. All shareholders could therefore be expected to join in the action, assuming, of course, that the expected benefits to shareholders from pursuing the action exceed the expected costs. Accordingly, there is little reason to adopt an appraisal-like opt-in procedure which requires all shareholders to affirmatively state that they wish to join the derivative suit. This is particularly true if procedural rules ensure that shareholder derivative suits and class actions will not proceed when they are contrary to shareholder interests.¹³²

b. *Perfecting Appraisal Rights*

Appraisal statutes typically set forth a complicated and cumbersome procedure for perfecting appraisal rights. Each shareholder seeking appraisal must first notify the corporation of that desire before the triggering transaction. Then, when the time for voting on the transaction arrives, the shareholder must vote no or abstain from voting. Finally, the shareholder must file a petition requesting appraisal with the appropriate court within a relatively short period of time following the consummation of the triggering transaction. Failure to take any of the appropriate steps at the appropriate times can result in the shareholder's loss of the remedy, even if the court ultimately determines the fair value of the firm's shares in connection with a properly perfected appraisal action commenced by a different shareholder. These rules have been frequently criticized as unduly burdensome,¹³³ but the preference reconciliation theory of appraisal suggests some good explanations for their adoption.

i. Pre-Vote Notification

Pre-vote notification serves the purpose of informing managers and shareholders of the maximum number of shares that might seek appraisal rights in connection with a particular transaction. This infor-

¹³² For a discussion of procedural rules that screen out "bad" derivative suits, see RIBSTEIN & LETSOV, *supra* note 32, at §§ 10.03-10.05.

¹³³ See, e.g., 2 PRINCIPLES OF CORP. GOVERNANCE, *supra* note 1, pt. VII, at 296 ("the procedures surrounding the exercise of the appraisal remedy have long been viewed as so cumbersome and time-consuming as to deter all but the largest and most determined shareholders"); Seligman,

mation can then be used to determine the maximum cost to the corporation of compensating objectors.¹³⁴ With this cost calculated, managers and shareholders can better determine, before a vote is taken, whether the potential gains to shareholders from an appraisal-triggering transaction will more than offset the net costs of compensating objectors. Consequently, appraisal is more likely to achieve its goal of preventing risk-altering transactions that impose net costs on shareholders. For if, as a result of the pre-vote notification procedure, managers and shareholders determine that the benefits to non-objecting shareholders will be less than the net costs to the corporation of compensating objectors, either the firm's managers can abandon the transaction in advance of the vote (thus saving the expenses associated with a full-blown proxy solicitation), or shareholders not seeking appraisal rights can vote against the transaction, thereby ensuring its defeat. Without any pre-vote notification of objector intentions, managers and shareholders would face considerable uncertainty in deciding upon appraisal-triggering transactions. As a result, some risk-altering transactions that imposed net costs on shareholders might be approved, while others that provided net benefits could be defeated.

ii. Voting by Objectors

When the time for a vote on the appraisal-triggering transaction arrives, shareholders planning to assert appraisal rights with respect to their shares must ordinarily vote "no" or abstain from voting. (Since transactions that trigger appraisal rights typically require an affirmative vote of a majority of all the outstanding shares, an abstention is the functional equivalent of a "no" vote.) The reason for this voting rule was suggested earlier.¹³⁵ Without such a rule, shareholders who would be harmed by a risk-altering transaction if they had to retain their shares might nonetheless be tempted to vote in favor of the transaction so as to increase the likelihood of gaining an opportunity to liquidate their investment.¹³⁶ As a result, risk-altering transactions could often be approved even though the losses to shareholders from those transac-

supra note 3, at 829 (noting that "the costs, risks and time delays of an appraisal usually dissuade all but the wealthiest of plaintiffs from demanding a valuation").

¹³⁴ See *supra* text accompanying notes 99-100.

¹³⁵ See *supra* note 100.

¹³⁶ This temptation is particularly strong in the case of appraisal-triggering events because, as noted earlier, the appraisal remedy is only available in instances where shareholders lack effective access to capital markets—i.e., when shareholders hold relatively illiquid investments.

tions exceed the gains. A rule requiring objectors to either vote "no" or abstain from voting eliminates this risk.

iii. The Appraisal Petition

In addition to notifying the corporation of his or her intention and then voting "no" (or abstaining from voting) on the triggering transaction, the shareholder seeking appraisal must typically file a petition requesting appraisal with the appropriate court within a relatively short period of time after the triggering transaction—e.g., 120 days under Delaware law. The speed with which an appraisal action must be filed is difficult to explain if, as many of the theories discussed in Part I suggest, appraisal is designed to deter misconduct by managers or controlling shareholders. This difficulty arises because sufficient evidence of wrongdoing to justify the costs and risks of pursuing an appraisal action may not be discovered within the short time period provided for filing a petition.

A short petition period, however, poses few, if any, problems to the preference reconciliation theory of appraisal. Under this theory, shareholders considering the exercise of appraisal rights need only answer one question: are the risk and return attributes of the post-transaction firm (assuming the transaction is consummated in the manner described by the firm's managers) less desirable than the risk and return attributes of the pre-transaction firm? In answering this question, shareholders need not concern themselves with investigating the accuracy of management's statements since shareholders will have a separate remedy if managerial misstatements lead to incorrect decisions regarding appraisal rights.¹³⁷ Nor must shareholders concern themselves with the question of whether managers might have obtained a better deal for the shareholders with greater effort or diligence since, should evidence of managerial misconduct arise, objectors should be able to commence a separate action for breach of fiduciary duty.¹³⁸ Accordingly, shareholders should be able to decide whether to exercise appraisal rights relatively quickly by discounting the firm's expected returns at the appropriate rate given their personal tastes for risk.

¹³⁷ See Thompson, *supra* note 3, at 43 (noting that even those statutes that make the appraisal remedy exclusive ordinarily contain exceptions that "clearly preserve a shareholder's action for a direct misrepresentation that leads to failure to exercise appraisal rights").

¹³⁸ See, e.g., *Cede & Co. v. Technicolor, Inc.*, 542 A.2d 1182 (Del. 1988) (permitting shareholder who had commenced an appraisal action to commence a breach of fiduciary duty action when credible evidence of managerial misconduct was uncovered).

c. *Corporation as Defendant*

An appraisal action is prosecuted against the corporation, rather than against the firm's managers. If appraisal is viewed as a device for policing managerial misconduct, this aspect of the remedy, like many others discussed earlier, is difficult to explain. For instance, if as Gilson suggests, appraisal rights are designed to prevent managers from selling the firm's assets for too low a price, why not require the managers (or their liability insurers) to pay over the incremental amounts that would have been obtained by more aggressive bargaining rather than requiring a payment by the corporation to those (few) shareholders who have been lucky enough to properly perfect their appraisal rights? Requiring the firm's managers to come up with a greater amount of cash from their own pockets would undoubtedly prove a more effective deterrent than requiring a smaller payment out of corporate funds.¹³⁹

If, however, the goal of appraisal is to ensure that the gains from risk-altering transactions exceed the losses, as the preference reconciliation theory suggests, then requiring the corporation to purchase the petitioning investors' shares makes perfect sense. As explained earlier, requiring the corporation to repurchase objectors' shares has the effect of forcing shareholders who otherwise gain from risk-altering transactions to bear the net costs of compensating those who lose. It therefore ensures that shareholder approval for risk-altering transactions will only be forthcoming when those transactions are wealth-increasing.

7. The Cash-Out Exception to the Market Out

While the preference reconciliation theory effectively explains most common features of appraisal, it does have one notable flaw: it fails to explain the cash-out exception to the market out. The market out to appraisal generally withdraws appraisal rights from an objector whose shares are publicly traded. Under the cash-out exception to the market out, however, appraisal rights will ordinarily be restored if the objector is required to accept, in exchange for his or her shares, anything other than shares of the surviving corporation in a merger, shares of a publicly traded corporation, cash in lieu of fractional shares or some combination of the foregoing.¹⁴⁰ Thus, if a merger calls for an

¹³⁹ Cf. Thompson, *supra* note 3, at 46 ("If the plaintiff claims that individual defendants shuffled money out of the corporation to benefit themselves and reduce the value of the corporation, the Delaware court has said that individuals are the proper defendants, not the corporation.").

¹⁴⁰ See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(2). The text of the cash-out exception to the market out is reprinted *supra* at note 36.

objector's publicly traded shares to be converted into cash, the cash-out exception to the market out ensures that appraisal rights will continue to be available.

The cash-out exception to the market out cannot be explained by the preference reconciliation theory outlined above. Under that theory, appraisal rights are designed to deal with transactions whose effects on shareholders differ depending upon the shareholders' preferences for risk (i.e., transactions where different shareholders attach different values to the consideration received in exchange for their pre-transaction shares, depending on their preferences for risk). A transaction which provides each shareholder with an identical amount of cash per share simply does not fall into that category, since all investors will attach the same value to the cash received in exchange for their shares.¹⁴¹ Thus, assuming shareholders have no private interests in the appraisal-triggering transaction apart from their interests as shareholders, there is no risk that the cash-out merger could make some shareholders better off, while leaving others worse off. Under the preference reconciliation theory, appraisal rights should therefore be denied.¹⁴²

But while the preference reconciliation theory cannot, by itself, explain the cash-out exception to the market out, the theory is not undermined by the exception. First, as Thompson notes, the cash-out exception to the market out is rare outside of Delaware.¹⁴³ Therefore any deviation from the theory constitutes the exception rather than the rule. Second, as the discussion below explains, Delaware's adoption of the cash-out exception to the market out can be readily explained, albeit on different grounds than the rest of Delaware's appraisal statute.

The cash-out exception to the market out was added to the Delaware General Corporation Law ("Delaware General Corporation Law") (along with the market out itself) in 1967. Although Ernest Folk, the

¹⁴¹ Shareholders could, of course, have different views regarding the merits of the transaction based on the impact of the transaction on their private interests. But the structure of appraisal rights, particularly their focus on risk-altering transactions, shows that appraisal rights are not designed to provide a solution to the problem of conflicting private interests of shareholders.

¹⁴² That appraisal statutes, like Delaware's, were originally adopted without exceptions for cash-out transactions in no way undermines the preference reconciliation theory of appraisal. When appraisal statutes first appeared in the late nineteenth century, cash-out transactions were generally prohibited, see Thompson, *supra* note 3, at 19 (citing Carney, *supra* note 57, at 97), except in connection with dissolutions where, as noted earlier, appraisal rights were typically denied, see *supra* note 118 and accompanying text. So there was little reason to include general exceptions covering cash-outs in early appraisal statutes.

¹⁴³ Thompson, *supra* note 3, at 30. See, e.g., IND. CODE § 23-1-22-8 (1997); OR. REV. STAT. § 50.544 (1997).

reporter for the Delaware Corporate Law Revision Committee, does not explain the reason for the provision's adoption,¹⁴⁴ its purpose becomes clear when it is read in conjunction with (1) the Delaware Supreme Court's 1962 decision in *Stauffer v. Standard Brands, Inc.*¹⁴⁵ and (2) the 1967 modifications to Delaware General Corporation Law section 251, the provision governing long-form mergers.¹⁴⁶ In *Stauffer*, a minority shareholder challenged a short-form, cash-out merger completed under Delaware General Corporation Law section 253 on the grounds that the cash provided to minority shareholders—\$105 per share—was so grossly inadequate as to constitute constructive fraud. The Delaware Supreme Court, however, rejected the challenge. The Court held that under the circumstances the appraisal remedy was exclusive because, where "the real relief sought is the recovery of the monetary value of the plaintiff's shares[,] . . . the statutory appraisal provision provide[s] an adequate remedy."¹⁴⁷ In reaching this result, the Court did not anticipate (and therefore did not answer) the many challenges to the adequacy of appraisal as a remedy for majority misconduct.¹⁴⁸ Instead, the Court simply adopted the opinion of the Vice Chancellor, which emphasized the differences in the statutory language of Delaware General Corporation Law section 251, the long-form merger provision, and section 253, the short-form merger provision.¹⁴⁹ Delaware General Corporation Law section 251, the Vice Chancellor noted, did not (at the time) authorize "majority stockholder[s] . . . [to] eliminate minority stockholders as participants in the continuing enterprise [by the payment of cash]."¹⁵⁰ So minority

¹⁴⁴ The cash-out exception to the market out is not even mentioned in Folk's report to the committee. See FOLK, *supra* note 11, at 196-202 (1968) (discussing appraisal without considering a cash-out exception to the market out). Folk did, however, explain the operation of the cash-out exception to the market out in the first edition of his treatise on Delaware corporation law. See ERNEST L. FOLK, *THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS* (1972).

¹⁴⁵ 187 A.2d 78 (Del. 1962).

¹⁴⁶ A long-form merger is one that is completed by taking all the steps specified in Delaware General Corporation Law section 251, including obtaining the approval of the directors and shareholders of each merging corporation; a short-form merger, on the other hand, refers to a merger between a parent and a subsidiary (at least 90% of the stock of which is owned by the parent), which is completed following the abbreviated procedures specified in Delaware General Corporation Law section 253.

¹⁴⁷ 187 A.2d at 80. Delaware had amended its short-form merger provision to allow the use of cash in 1957. See Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. Rev. 624, 648 (1981). When the Delaware legislature made this change, however, it did not alter the appraisal statute to except the newly-authorized as a cash-out merger. Had it done so, the issue in *Stauffer* would never have arisen.

¹⁴⁸ See, e.g., *supra* notes 40-44 and accompanying text.

¹⁴⁹ See *id.*

¹⁵⁰ *Stauffer v. Standard Brands Inc.*, 178 A.2d 311, 314 (Del. Ch. 1962).

shareholders had to be provided with a remedy other than appraisal in order to prevent objecting minority shareholders from being forced to accept cash for their shares. In contrast, Delaware General Corporation Law section 253 expressly provided for the payment of cash in short-form mergers. Accordingly, restricting dissenting shareholders in short-form mergers to appraisal (i.e., forcing objecting shareholders to accept cash for their shares) did not permit a result not contemplated by the legislature.

Stauffer was a great victory for majority shareholders in short-form, cash-out mergers under Delaware General Corporation Law section 253. As a result of *Stauffer*, majority shareholders in such mergers would no longer have to defend themselves in breach of fiduciary duty actions brought on behalf of *all* the firm's minority shareholders, but would only have to defend themselves in appraisal proceedings brought on behalf of the relatively few minority shareholders who would successfully perfect their appraisal rights. Thus, it should not be surprising that when in 1967 the corporate bar sought an expansion of Delaware General Corporation Law section 251 to authorize long-form, cash-out mergers,¹⁵¹ the corporate bar also sought to ensure that minority shareholders challenging those mergers would be restricted to an appraisal remedy.¹⁵² This goal, of course, could only be achieved if minority shareholders in long-form, cash-out mergers under Delaware General Corporation Law section 251 had access to the appraisal remedy, a result that the cash-out exception to the market out ensured.¹⁵³

¹⁵¹ The expansion of Delaware General Corporation Law section 251 to allow the payment of cash in exchange for the shares of a constituent corporation in a merger was proposed by McCutchen, Doyle, Brown, Trautman & Emersen of San Francisco. See FOLK, *supra* note 11, at 195-D.

¹⁵² This result may have been consistent with the interests of shareholders if the cost to the firm of the existing fiduciary duty check on mergers exceeded the benefits. Cf. Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that state chartering of corporations leads to a "race for the top" in corporate law, as states compete with one another to provide managers with the ability to raise capital at the lowest possible cost). The result, however, might simply have advanced the private interests of corporate managers. Cf. Geoffrey P. Miller & Jonathan R. Macey, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (using interest group theory to show that state competition for corporate charters will sometimes produce laws that conflict with shareholder interests).

¹⁵³ This understanding of the cash-out exception to the market out is consistent with the refusal of the 1967 Delaware Legislature to extend the market out to short-form mergers under Delaware General Corporation Law section 253, even though Folk apparently recommended that course of action. See FOLK, *supra* note 11, at 193. The refusal to apply the market out to short-form mergers ensured that appraisal would continue to be the minority's exclusive remedy under *Stauffer* when the majority used Delaware General Corporation Law section 253 to effect a cash-out.

The proponents of the cash-out exception to the market out achieved their goal in 1971 when the Delaware Chancery Court extended the *Stauffer* appraisal-exclusivity rule to long-form mergers.¹⁵⁴ That victory, however, proved to be short-lived.¹⁵⁵ Thus, although the cash-out exception to the market out initially appears to undermine the preference reconciliation theory of appraisal, its adoption in Delaware can be readily explained.¹⁵⁶

C. Consistency of Theory with History

The preference reconciliation theory of appraisal is also consistent with much of the history of the remedy. As noted earlier, appraisal statutes have long been defended as necessary to protect shareholders from being forced to invest in fundamentally altered or, in effect, new firms against their will. As Thompson notes, for example, a 1902 treatise explained appraisal rights as necessary "to give [the minority shareholder] the privilege of selling out instead of embarking in the new enterprise."¹⁵⁷ The preference reconciliation theory explains why shareholders might benefit if the majority's power to force the corporation to "embark[] on a new enterprise" is limited by appraisal rights, particularly in circumstances where capital markets are not well developed. The preference reconciliation theory therefore is consistent with the early justifications of the remedy.

In addition, the preference reconciliation theory of appraisal is consistent with the timing of the adoption of appraisal statutes. Prior to the adoption of the first appraisal statutes in the late 19th century, shareholders could be assured that risk-altering transactions would not

¹⁵⁴ See *David J. Greene & Co. v. Schenley Indus., Inc.*, 281 A.2d 30 (Del. Ch. 1971).

¹⁵⁵ See *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977) (holding that courts "will scrutinize the circumstances [of a cash-out merger under § 251] for compliance with the *Sterling* rule of 'entire fairness' and, if it finds a violation thereof, will grant such relief as equity may require;" the court then concluded that "[a]ny statement in *Stauffer* inconsistent herewith is held inapplicable to a § 251 merger"); see also *Roland Int'l Corp. v. Najjar*, 407 A.2d 1032 (Del. 1979) (extending *Singer* to short-form mergers under Delaware General Corporation Law section 253). But see *Weinberger v. UOP, Inc.*, 457 A.2d 701, 714 (Del. 1983) (holding that "a plaintiff's monetary remedy ordinarily should be confined to the more liberalized appraisal proceeding herein established") (emphasis added).

¹⁵⁶ Others view the cash-out exception to the market as motivated by Fischel's concern about majority oppression of the minority—that is, as ensuring that shareholders will have access to an appraisal remedy in cash-out mergers where the danger of majority misconduct is greatest. See Thompson, *supra* note 3, at 30; see also Fischel, *supra* note 12, at 885. This view, however, ignores the fact that the original effect of the cash-out exception to the market out was to restrict minority shareholders in cash-out mergers to a less effective remedy.

¹⁵⁷ Thompson, *supra* note 3, at 18–19 n.57 (quoting WALTER C. NOYES, A TREATISE ON THE LAW OF INTERCORPORATE RELATIONS § 51, at 84 (1902)).

impose net losses on shareholders because, under 19th century doctrine, shareholders were viewed as having "vested rights" that prevented firms from affecting fundamental changes without the consent of each and every shareholder.¹⁵⁸ Such transactions could therefore only go forward if all shareholders were made better off (and therefore consented to the transaction) or if winners adequately compensated losers. The vested rights approach to deterring value-decreasing transactions, however, became increasingly costly in the late 19th century as increases in the numbers of shareholders in firms made bargaining with hold-outs more difficult¹⁵⁹ and as technological advances made risk-altering transactions like mergers more desirable.¹⁶⁰ As a result, courts and legislatures began to alter the law (first with respect to railroad corporations and then with respect to private corporations generally), authorizing corporations to effect risk-altering transactions such as mergers without obtaining unanimous shareholder consent.¹⁶¹ As Thompson shows,¹⁶² the adoption of appraisal statutes generally followed closely upon the abandonment of the unanimity rule, a result which makes perfect sense if, as is argued here, appraisal rights serve the same purpose as a shareholder veto: ensuring that the gains from risk-altering transactions exceed the losses.¹⁶³

Finally, as the earlier discussion of the market out reveals, the preference reconciliation theory of appraisal explains, at least in part, the evolution of the appraisal remedy over time. In particular, the theory explains the emergence of the appraisal right *without a market out* in the late 19th century, the introduction of the market out in the 1960s and the continued expansion of the market out over the last forty years.¹⁶⁴

¹⁵⁸ See Carney, *supra* note 57, at 79-81.

¹⁵⁹ See Thompson, *supra* note 3, at 12 (citing HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937, at 253 (1991)) (noting that "[t]hroughout the 1880s, most manufacturing firms were family owned or otherwise closely held"); see also Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173, 209, 210 (1985) (stating that railroads constituted the only group of large publicly held companies prior to 1890).

¹⁶⁰ See Carney, *supra* note 57, at 79.

¹⁶¹ See *id.* at 79-97.

¹⁶² See Thompson, *supra* note 3, at 14-15.

¹⁶³ Cf. *Voeller v. Neilston Co.*, 311 U.S. 531, 535 n.6 (1941) (explaining the lag between the abandonment of the unanimity rule and the adoption of appraisal rights as follows: "[u]nanimous shareholder consent was a prerequisite to fundamental changes To meet the situation, legislatures authorized . . . changes by majority vote. This, however, opened the door to victimization of the minority. To solve the dilemma, statutes permitting a dissenting minority to recover the appraised value of its shares were widely adopted.").

¹⁶⁴ See *supra* Part II.B.2.

By contrast, the theories of other commentators are quite difficult to reconcile with the history of appraisal. Fischel, for instance, focuses on the ability of appraisal rights to police situations where wealth appropriation is more likely than wealth maximization, such as "when shareholders of one firm attempt to exploit the coordination problems of shareholders of another firm" by making a coercive, two-tiered tender offer, or when a majority shareholder attempts to "confiscate the pro rata share of the minority in a freeze-out merger."¹⁶⁵ Two-tiered, coercive tender offers, however, were unknown in the late 19th century when appraisal rights first appeared and, as Thompson points out, "[nineteenth century] limits on corporate authority and the judicial use of fiduciary duty to check self-dealing [greatly] restricted the majority's ability to implement [freeze-out] transaction[s]."¹⁶⁶ Accordingly, that appraisal was originally designed as a check on two-tiered tender offers and minority freeze-outs seems doubtful.

Indeed, of the principal commentators criticizing the traditional justification for appraisal, only Manning attempts to explain why appraisal rights emerged in the late 19th century after the unanimity rule for fundamental change was abandoned.¹⁶⁷ Manning suggests that "early appraisal statutes [may have been] promoted by perspicacious legislative agents of management, who saw in these statutes a way to consolidate and liberate their own condition"—that is, as a way to entice courts and legislatures "to soften the rigor of the [traditional] judicial rule which protected the shareholder by requiring unanimous shareholder approval [for fundamental corporate changes]."¹⁶⁸ Manning further suggests that such enticement was necessary because of the 19th century view that corporations were things that lived and died, rather than mere forms of organization.¹⁶⁹ He therefore concludes that courts and legislatures may not have permitted the abandonment of the unanimity rule for *legal* traumas, like mergers (which involve the death of a corporation), "serious" charter amendments and sales of substantially all the firm's assets, without substituting some alternative form of protection such as the appraisal remedy.¹⁷⁰

¹⁶⁵ See *supra* Part I.A.

¹⁶⁶ Thompson, *supra* note 3, at 19 (citing Carney, *supra* note 57, at 97).

¹⁶⁷ Most commentators do not greatly concern themselves with the history of appraisal or with reconciling their explanations of appraisal with traditional views of the remedy. Instead, most commentators "have preferred to rebuild from first principles and to ask why appraisal has survived in an evolving world and under what circumstances parties would bargain for it." Kanda & Levmore, *supra* note 13, at 431. Fischel, Kanda and Levmore, and Gilson all arguably fall into this camp.

¹⁶⁸ Manning, *supra* note 5, at 228-29.

¹⁶⁹ See *id.* at 244-46.

¹⁷⁰ See *id.* at 246-47.

Manning's historical explanation for the emergence of appraisal rights, however, has two principal flaws. First, because it views appraisal statutes as part of an effort to escape the rigors of the traditional unanimity rule, the theory suggests that appraisal statutes should generally have been adopted in tandem with statutes authorizing corporations to undertake mergers by less than a unanimous vote. The evidence, however, shows that there was often a significant time lag between the adoption of the two provisions, particularly with the earliest appraisal statutes.¹⁷¹ Second, Manning's theory suggests that appraisal rights should have been extended to all corporate transactions that could be characterized as involving *legal* traumas for shareholders. But, as Manning himself acknowledges, this never happened:

If it is serious surgery to change any part of the "corporation," it is much more serious to bring about its "death" by dissolution. By this logic, one might expect to find the appraisal remedy available to the shareholder dissenting from dissolution. *In fact, however, no statute provides for it.*¹⁷²

III. THE FUTURE OF APPRAISAL

If, as the preference reconciliation theory suggests, the purpose of appraisal is to ensure that the gains from risk-altering transactions exceed the losses, how—if at all—should modern appraisal statutes be reformed? Several of the more popular proposals for reform of existing appraisal statutes are discussed in Professor Thompson's 1995 article, *Exit, Liquidity and Majority Rule: Appraisal's Role in Corporate Law*.¹⁷³ This Part argues that these reform proposals should be rejected because, among other things, they are based on a flawed view of the purposes of appraisal.

In his article, Professor Thompson identifies all reported cases involving appraisal rights for the ten-year period following the Delaware Supreme Court's decision in *Weinberger v. UOP, Inc.*,¹⁷⁴ the case which ushered in the modern era of appraisal rights by, among other

¹⁷¹ See Thompson, *supra* note 3, at 14 ("Appraisal statutes are often presented as having been enacted in tandem with statutes authorizing consolidation or merger by less than unanimous vote, but there was a significant difference in the spread of the two statutes. By the turn of the century, a dozen states had statutes authorizing consolidation for corporations generally, but only five of those states had appraisal statutes.")

¹⁷² Manning, *supra* note 5, at 250 (emphasis added). By contrast, the preference reconciliation theory is consistent with the denial of appraisal rights in connection with dissolutions. See *supra* Part II.B.1.

¹⁷³ See Thompson, *supra* note 3.

¹⁷⁴ 457 A.2d 701 (Del. 1983).

things, modernizing the valuation standards for appraisal proceedings in Delaware. He then categorizes the transactions involved in those cases to determine the context in which appraisal most frequently occurs. This analysis reveals that: (1) of the eighty identified transactions, eighty percent involved cash-outs; (2) "the most frequently recurring context [for appraisal] . . . was that of a majority shareholder in a widely traded corporation seeking to force out the minority shareholders;" and (3) "[i]n addition, there was a significant number of cases in which a third party took over the corporation with a cash-out as the second step of an acquisition of control from dispersed shareholders."¹⁷⁵ Thompson infers from this that Fischel's explanation of appraisal—"as an implied contractual term that sets the minimum price at which the firm . . . can be sold in situations where certain groups are more likely to attempt to appropriate wealth from other groups than to maximize the value of the firm"¹⁷⁶—best describes the modern use of the remedy.¹⁷⁷ Based on this conclusion, Thompson endorses a number of popular reforms designed to ensure that appraisal serves as an effective "check against opportunism by a majority shareholder in . . . transactions [where] . . . the majority forces minority shareholders . . . to accept cash for their shares."¹⁷⁸ These reforms include the following:

1. *Eliminating the Market Out.*¹⁷⁹ Thompson suggests eliminating, or at least limiting the expansion of, the market out. He argues that the market out is inconsistent with the goal of checking opportunism by majority shareholders because "the price in an efficient market will provide no compensation for self-dealing."¹⁸⁰ Thompson explains that

if those in control of a corporation propose a transaction that is bad for the corporation but good for the other transacting entity in which the controllers have a larger interest, the market's reaction will send the price of the corporation's shares lower, giving no protection against self-serving behavior.¹⁸¹

2. *Altering Valuation Rules to Include Gains Attributable to the Triggering Transaction.* Thompson acknowledges that "[m]ost states define fair value available in appraisal to exclude any appreciation or depre-

¹⁷⁵ Thompson, *supra* note 3, at 25-26.

¹⁷⁶ Fischel, *supra* note 12, at 876.

¹⁷⁷ See Thompson, *supra* note 3, at 26-27.

¹⁷⁸ *Id.* at 4.

¹⁷⁹ See *id.* at 28-31.

¹⁸⁰ *Id.* at 29.

¹⁸¹ *Id.* at 30 (citing Fischel, *supra* note 12, at 885). If, however, a state should choose to retain

ciation attributable to the [appraisal-triggering] transaction."¹⁸² This rule, he suggests, made sense in traditional appraisal cases where the dissenter was given the option of continuing in the "new" enterprise, but did not exercise the option.¹⁸³ But, Thompson argues, such a valuation rule has no place in the vast majority of modern appraisal cases which involve cash-outs. He reasons that, "[i]f . . . the minority . . . is being forced out [in a cash-out transaction], perhaps because of an anticipated increase in value that will only become visible after the transaction, exclusion [of gains attributable to the transaction from an appraisal award] can easily become a basis for oppression of the minority."¹⁸⁴

3. *Reforming Perfection Procedures.* As noted above, state appraisal statutes typically require that the shareholder seeking appraisal notify the corporation of that desire before the triggering transaction, vote "no" or abstain from voting when the transaction is presented and file a petition requesting appraisal shortly after the triggering transaction is completed.¹⁸⁵ Thompson argues that these procedures are "ill-suited" to appraisal in the modern era because they "are a burden to full recovery when the majority has decided to eliminate an entire group of shareholders, and there is a common question about whether the price is fair."¹⁸⁶ He, therefore, suggests streamlining the traditional perfection rules to facilitate shareholder access to the remedy.¹⁸⁷

4. *Making the Appraisal Remedy Exclusive.* Generally, those who view appraisal as a device to check misconduct by majority shareholders

a market out, Thompson suggests restricting the market out by adopting a Delaware-like cash-out exception to the market out. *See id.* In addition, Thompson argues against expanding the market out to include NASDAQ stocks. *See id.* at 30-31. Other commentators share Thompson's conviction that the market out should be eliminated, at least in cases of transactions put forward by majority shareholders. *See, e.g.,* Eisenberg, *supra* note 11, § 7.3; Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 124-26 (1995).

¹⁸² Thompson, *supra* note 3, at 35-36.

¹⁸³ *See id.* at 36.

¹⁸⁴ *Id.* Several other commentators agree that the traditional valuation rules preclude appraisal from functioning as an effective check on majority misconduct. *See, e.g.,* Brudney & Chirelstein, *supra* note 44, at 304-07; Vorenberg, *supra* note 44, at 1201-04. Fischel, however, argues that the traditional rules, focusing on pre-transaction values, should be retained because gain-sharing rules threaten to stifle value-increasing corporate transactions. *See* Fischel, *supra* note 12, at 886; *see also* Easterbrook & Fischel, *supra* note 44, at 709.

¹⁸⁵ *See supra* note 41 and accompanying text.

¹⁸⁶ Thompson, *supra* note 3, at 41. For an explanation of how these perfection rules burden full recovery by the minority, *see supra* notes 41-44 and accompanying text.

¹⁸⁷ Thompson, *supra* note 3, at 41. Among other things, Thompson recommends the adoption of rules to facilitate appraisal class actions and the rejection of judicial decisions that interpret procedural rules strictly, for instance, to require the dismissal of an appraisal action when notices arrive "minutes or hours after the appointed time." *Id.* at 40. The call for simplified appraisal perfection procedures goes back more than 30 years. *See, e.g.,* Manning, *supra* note 5, at 260-62.

favor making the appraisal remedy exclusive, at least so long as the procedural problems that inhibit shareholder access to the remedy are eliminated.¹⁸⁸ They argue that, by ensuring that the majority pays a fair price for the minority's shares, appraisal, by itself, functions as an adequate check on majority misconduct. Thompson, for the most part, agrees with this view. He writes that "[t]here is no inherent reason why valuation could not emerge as a preferred response to monitoring conflict transactions," like cash-out mergers, that are the focus of modern appraisal proceedings.¹⁸⁹ But he notes that "[i]t is surprising that courts are willing to permit appraisal as the sole check on conflict when the remedy, *as it currently exists*, imposes so many procedural steps on plaintiffs and uses pro-majority valuation standards."¹⁹⁰

Thompson acknowledges that the reforms he suggests might not fit with the original purpose of appraisal,¹⁹¹ which he identifies as providing liquidity to the frozen-in shareholder after certain fundamental changes.¹⁹² But he finds this objection to reform unpersuasive because "[r]equiring appraisal to perform two quite different functions" might cause appraisal to perform "poorly" its more important, and "theoretically more defensible,"¹⁹³ job of policing conflicts.¹⁹⁴

The analysis in this article, however, suggests that these proposals for reform should be rejected. First, the proposals are based on a flawed view of the purpose of appraisal rights as a check against opportunism by majority shareholders in transactions where the majority forces the minority to accept cash for their shares. As the analysis in the preceding Parts explains, this view of appraisal does not square with the history of the remedy,¹⁹⁵ nor can it explain the basic features of appraisal.¹⁹⁶ Furthermore, as the discussion in Part I makes clear,¹⁹⁷

¹⁸⁸ See, e.g., Fischel, *supra* note 12, at 901-02.

¹⁸⁹ Thompson, *supra* note 3, at 45.

¹⁹⁰ *Id.* at 46 (emphasis added). As noted above, Fischel would differ with Thompson's criticism of the valuation standards typically used in appraisal proceedings. See *supra* note 184.

¹⁹¹ See, e.g., Thompson, *supra* note 3, at 28.

¹⁹² See *id.* at 4. Thompson's view that the original purpose of appraisal was to provide liquidity to the frozen-in shareholder after certain fundamental changes is consistent with the view of appraisal advanced in this paper. But the liquidity theory of appraisal is incomplete. Among other things, it fails to explain *why* liquidity should be provided in such cases; it therefore provides no theoretical basis for determining such matters as (1) the types of corporate transactions that should trigger appraisal rights, (2) the applicable standards of valuation, and (3) whether the appraisal remedy should be exclusive.

¹⁹³ *Id.*

¹⁹⁴ See *id.* at 34.

¹⁹⁵ See *supra* notes 165-66 and accompanying text.

¹⁹⁶ See *supra* Part I.A.

¹⁹⁷ See *supra* text accompanying notes 39-44.

a majority-checking purpose for appraisal is unnecessary given the existence of breach of fiduciary duty actions that require majority shareholders to carry the burden of establishing the fairness of challenged transactions to minority shareholders; these actions serve the same function that Thompson and others assign to appraisal rights, but do so more effectively because, among other reasons, they lack the features (e.g., cumbersome perfection procedures and market outs) that often make appraisal rights difficult or impossible to exercise. True, a number of states, including Delaware, have undercut the fiduciary duty check on majority misconduct by (mistakenly) providing that appraisal ordinarily should be the exclusive remedy in cases like cash-out mergers.¹⁹⁸ But the solution to this mistake is not to transform the appraisal remedy into a breach of fiduciary duty action (as the proposals above suggest), but rather is to simply repeal the appraisal-exclusivity rule that has forced upon appraisal a function it is ill-suited to perform.

Second, and perhaps more importantly, the reform proposals discussed above are inconsistent with the purpose of appraisal outlined in this article. For instance, eliminating the market out will result in the application of appraisal rights in situations where the benefits from appraisal are small in comparison to the costs.¹⁹⁹ Similarly, altering the traditional valuation rules and reforming appraisal's perfection procedures could impair the effectiveness of appraisal as a check on value-decreasing, risk-altering transactions for the reasons explored in Parts II.B.3 and 6 above. Thus, although adopting Thompson's proposals may make appraisal a more effective check on majority misconduct, it will at the same time make appraisal a less effective check on risk-altering transactions that make shareholders as a group worse off. Thompson suggests that this trade-off is worth making because the number of cases where appraisal functions as a check on majority misconduct greatly exceeds the number of cases where appraisal rights perform their traditional function of checking value-decreasing, risk-altering transactions. But the choice between checking majority misconduct, on the one hand, and value-decreasing, risk-altering transactions, on the other, is a false one: if appraisal exclusivity is rejected (so that shareholders remain free to challenge conflict of interest transac-

¹⁹⁸ This explains why so many of the modern appraisal cases involve minority cash-outs, even though minority shareholders would clearly prefer to bring a shareholders' derivative suit alleging breach of fiduciary duty. For a discussion of why the appraisal remedy should not be exclusive, see *supra* Part II.B.5.

¹⁹⁹ See *supra* Part II.B.2 and notes 104-13 and accompanying text.

tions like cash-out mergers on fiduciary duty grounds), we can achieve both objectives at the same time.

The analysis in this article thus suggests a very different approach to reform from that taken by Thompson and others. The principal components of this approach include:

1. *Retaining and Expanding the Market Out.* Instead of eliminating or restricting the market out, as Thompson and others suggest, the market out should (subject to the one caveat noted below) be retained and expanded as securities markets more closely approach perfection. As the analysis in Part II suggests, when securities markets more closely approach perfection, the gains from appraisal become small in comparison to the costs. This suggests a market out for widely traded shares, such as those traded on the national securities exchanges and those held of record by a sufficient number of holders to produce an active trading market. It also suggests extending the market out to the principal over-the-counter markets (such as the NASDAQ Stock Market) as those markets become more efficient. There is, however, one caveat to this analysis: although the fact that a share trades in a well-developed securities market generally equates with effective shareholder access to capital markets, that will not always be the case. For instance, shareholders holding large blocks of stock may be effectively precluded from selling their stakes by the size of their holding, while insiders and others holding "restricted stock" may be precluded from selling all, or at least some, of their shares by the federal securities laws. The preference reconciliation theory of appraisal suggests that, for such shareholders, the desirability of a risk-altering transaction will depend on their personal preferences for risk. Accordingly, when shareholders hold widely traded stock but are effectively precluded from selling that stock by either the size of their holdings or the federal securities laws, appraisal rights should be restored.

2. *Eliminating the Cash-Out Exception to the Market Out.* The cash-out exception to the market out, introduced in Delaware in 1967, should be replaced with a general provision making appraisal rights unavailable whenever the consideration offered to shareholders takes the form of cash. As explained earlier, the value of cash is independent of an individual investor's personal taste for risk, so the value of the consideration received in a cash-out transaction will not vary from investor to investor. Accordingly, under the preference reconciliation theory, appraisal has no role to play.²⁰⁰ As Thompson's analysis makes

²⁰⁰ For a discussion of why appraisal statutes were originally adopted without a general exception for cash-out transactions, see *supra* note 142.

clear, excluding cash-out transactions from appraisal will, of course, dramatically reduce the number of future appraisal cases.²⁰¹ But the success of a remedy should not be measured by the number of times it is implemented, but rather by how well it achieves its objectives.

3. *Rejecting Valuation Rules that Include Gains Attributable to the Triggering Transaction; Applying Minority Discounts; Rejecting Discounts for Illiquidity.* Traditional valuation rules requiring shareholders who elect appraisal to accept the pre-transaction value of their shares should be retained (or, for those jurisdictions that have departed from the traditional standard, restored). For the reasons explained in Part II.B.3, standards of valuation that give objectors more than the pre-transaction value of their shares can inhibit value-increasing transactions. In addition, the "fair value" of a firm's shares, for appraisal purposes, should be computed by discounting the firm's value to reflect an objecting shareholder's minority interest. This result follows because the purpose of appraisal is fully served by putting objecting shareholders in the positions they would have occupied had the triggering transaction not taken place. Giving *minority* shareholders the value of a *minority* interest accomplishes this objective.²⁰² At the same time, a discount for illiquidity is inconsistent with the purposes of appraisal. Under the preference reconciliation theory, the purpose of appraisal is to put the costs of accessing capital markets on the firm, not on the shareholders. Therefore, forcing objecting shareholders to bear the costs of accessing capital markets by applying an illiquidity discount to the pre-transaction value of their shares plainly conflicts with the remedy.

4. *Rejecting Appraisal-Exclusivity and Retaining Basic Perfection Procedures.* Finally, for the reasons discussed in Parts II.B.5 and 6, the

²⁰¹ See *supra* note 175 and accompanying text (noting that 80% of reported appraisal cases since 1984 involve cash-out transactions).

²⁰² Thompson endorses the opposite view, reasoning that "[o]nly . . . [by excluding a discount] can minority stockholders be assured that insiders in control of a company, burdened by conflicting interests, may not purchase the enterprise at a price less than that obtainable in the marketplace of qualified buyers and avoid paying a full and fair price to the minority." Thompson, *supra* note 3, at 39 (quoting *BNE Mass. Corp. v. Sims*, 588 N.E.2d 14, 19 (Mass. App. Ct. 1992)). This quotation, however, does not answer the argument that a majority shareholder *should* pay less than a third party because the majority shareholder, unlike a third party, has already purchased control. Cf. *Mendel v. Carroll*, 651 A.2d 297, 304-05 (Del. Ch. 1994) (holding that a cash-out proposal by a controlling shareholder is fundamentally different than a merger proposal from an unaffiliated third party because the "[controlling shareholder] already in fact had a committed block of controlling stock;" thus, the court concluded, "[i]t is . . . quite possible that the [controlling shareholder's] \$24.75 [offer] may have been fair, even generous, while the \$27.80 [third party offer] may be inadequate"). Despite this argument, a majority of courts hold that it would be inappropriate to apply a minority discount. See Thompson, *supra* note 3, at 38.

availability of an appraisal action should not preclude an action for breach of fiduciary duty in connection with the same transaction. Further, basic procedures, like pre-vote notification of an intention to seek appraisal and the requirement that objectors vote "no" or abstain from voting on the triggering transaction, should be retained.

CONCLUSION

Commentators have long sought to articulate a meaningful economic function for appraisal. For the most part, however, these efforts have fallen short. This article articulates a new theory of appraisal that focuses on the ability of appraisal rights to reconcile differing shareholder preferences with respect to transactions that alter the risk of a firm's shares. Unlike previous efforts to explain appraisal, this theory explains both the basic features of the remedy and the evolution of the remedy over time, particularly the introduction and expansion of the market out; it also carves out for appraisal a function that is distinct from that served by other corporate law remedies. But perhaps more significantly, this new theory of appraisal suggests a very different future for the remedy—one that includes the continued expansion of the market out, the rejection of appraisal exclusivity, and the elimination of the cash-out exception to the market out.