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A Dissent Dampened by Timing: How the Stock Market Exception Systematically Deprives Public

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A DISSENT DAMPENED BY TIMING: HOW THE STOCK MARKET EXCEPTION SYSTEMATICALLY DEPRIVES PUBLIC SHAREHOLDERS OF FAIR VALUE

*Jeff Goetz*¹

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The appraisal remedy for the dissenting shareholder is an unlikely looking topic for serious reflection. It seems narrow, technical, and of concern to the corporate specialist only. I believe this appearance is deceiving, however. The subject invites and rewards the kind of inquiry that was characteristic of Frank’s mind – the search for the important behind the unimportant, the general behind the particular.

—Bayless Manning, in dedicating his essay, *The Shareholder’s Appraisal Remedy: An Essay for Frank Coker*,
72 YALE L.J. 223 (1962).

INTRODUCTION

How David the Dissenter Is Denied Fair Value: A Hypothetical

In every U.S. state, the corporate law provides that under certain circumstances when a company engages in a merger or consolidation, dissenting shareholders² are entitled to an appraisal right to receive the fair value of their interest in the company.³ Nonetheless, in 35 states,

2. Although Delaware’s corporate law refers to the residual claimants of the corporation as “stockholders,” the term “shareholders” will be used to refer to such claimants since most states refer to these claimants as shareholders. *See, e.g.*, CONN. GEN. STAT. ANN. § 33-856 (West 2010); MISS. CODE ANN. § 79-4-13.02 (2009); N.C. GEN. STAT. §55-13-02 (2009); UTAH CODE ANN. § 16-10a-1302 (2009).

3. *See* David J. Ratway, *Delaware’s Stock Market Exception to Appraisal Rights: Dissenting Minority Stockholders of Warner Communications, Inc. Are “Market-Out” of Luck*, 28 U. TOL. L. REV. 179, 204 (1964) (noting that “[a]ll corporate statutes award the appraisal remedy.”). In fact, most states provide an appraisal right to dissenting shareholders not only from a merger or consolidation, but also from other fundamental corporate transactions, such as a sale of all or substantially all assets, liquidation, or amendment to the certificate of incorporation or bylaws. *See, e.g.*, N.Y. BUS. CORP. LAW § 910(a)(1) (Consol. 2008). Delaware, however, only provides an appraisal right

including Delaware, New York, and California, if a company's shares are publicly traded, dissenting shareholders are denied such a right and must divest their interest in the company through sale of their shares on the open market.⁴ This provision is commonly referred to as the stock market exception to appraisal rights.⁵ It was incorporated into state corporate statutes with the belief that dissenting shareholders could more efficiently receive the fair value of their publicly-traded shares through sale on the market than through appraisal.⁶ In at least one particular circumstance, though, the stock market exception fails to provide this fair value.

The majority of state corporate codes,⁷ including Delaware's General Corporate Law, may not provide dissenting shareholders of a *surviving*⁸ company in a statutory merger with adequate compensation as a result of the timing of merger information and the restraints of the

to shareholders in a statutory merger. DEL. CODE ANN. tit. 8, § 262(b)(1) (2010).

4. See ALASKA STAT. § 10.06.574(d) (2010); ARIZ. REV. STAT. § 10-1302(D) (LexisNexis 2010); CAL. CORP. CODE § 1300(b)(1) (West 2010); COLO. REV. STAT. § 7-113-102(1.3)(1) (2009); CONN. GEN. STAT. ANN. § 33-856(b)(1) (West 2010); DEL. CODE ANN. tit. 8, § 262(b)(1); FLA. STAT. ANN. § 607.1302(2)(a) (LexisNexis 2009); GA. CODE ANN. § 14-2-1302(c) (2009); IDAHO CODE ANN. § 30-1-1302(2)(a) (2009); IND. CODE ANN. § 23-1-44-8(b) (LexisNexis 2009); IOWA CODE ANN. § 490.1302(2)(a) (West 2010); KAN. STAT. ANN. § 17-6712(b)(1)(A) (2008); LA. REV. STAT. ANN. § 12:131(B)(3) (LexisNexis 2009); ME. REV. STAT. ANN. tit. 13-C, § 1303 (2009); MD. CODE ANN., CORPS. & ASS'NS § 3-202(c)(1) (LexisNexis 2010); MICH. COMP. LAWS SERV. § 450.1762(2)(a) (LexisNexis 2009); MINN. STAT. § 302A.471(3)(c)(1) (2009); MISS. CODE ANN. § 79-4-13.02(b)(2); NEV. REV. STAT. ANN. § 92A.390(1) (LexisNexis 2009); N.J. STAT. ANN. § 14A:11-1(1)(a)(i)(A) (LexisNexis 2010); N.Y. BUS. CORP. LAW § 910(a)(1); N.C. GEN. STAT. § 55-13-02(c); N.D. CENT. CODE § 10-19.1-87(6) (2009); OKLA. STAT. ANN. tit. 18, § 1091(B)(2) (2009); OR. REV. STAT. ANN. § 60.554(3) (West 2009); 15 PA. CONS. STAT. § 1571(b)(1) (West 2010); R.I. GEN. LAWS § 7-1.2-1201(c) (2010); S.C. CODE ANN. § 33-13-102(B) (2009); S.D. CODIFIED LAWS § 47-1A-1302.1(1) (2010); TENN. CODE ANN. § 48-23-102(c) (West 2010); TEX. BUS. CORP. ACT. ANN. art. 5.11(B)(1) (Vernon 2009); UTAH CODE ANN. § 16-10a-1302(3); VA. CODE ANN. § 13.1-730(B)(1) (2009); W. VA. CODE ANN. § 31D-13-1302(b)(1) (LexisNexis 2009); WIS. STAT. ANN. § 180.1302(4) (LexisNexis 2009).

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

6. See Ratway, *supra* note 3, at 204-05, 217.

7. See *supra* note 4.

8. The term "surviving company" refers to the corporate entity in a statutory merger that subsumes the position of the corporation being absorbed. The surviving company succeeds to all the assets and liabilities of the "disappearing" entity. See, e.g., DEL. CODE ANN. tit. 8, § 251(a) (2010).

stock market exception.⁹ The following hypothetical illustrates this problem:

Assume the boards of directors of a publicly-traded company, Surviving Public Co. ("SPC"), and another company, Disappearing Chemical Co. ("DCC"), adopt a resolution to merge which proposes that DCC will be merged into SPC; DCC's shareholders will receive one share of SPC for every share of DCC they own.¹⁰ On June 18th, the day before the merger is publicly announced, SPC's shares are selling at \$50 per share and DCC's shares at \$40 per share.¹¹ On June 19th the companies release a joint press statement, making the proposed merger known to the public. Finally, the resolution to merge is submitted to the shareholders of both SPC and DCC for approval,¹² and it is approved by a majority of the outstanding shares of each corporation.¹³

David the Dissenter, a 6% shareholder of SPC, hears about the proposed merger on CNN immediately after the announcement is made on June 19th. He disagrees with SPC's decision to absorb DCC in a merger because he has heard that DCC has been heavily involved in litigation as a result of alleged water pollution from its chemicals. He feels that SPC is headed in the wrong direction, both from an environmental citizenship perspective and a business perspective. As a result, David wants nothing more to do with SPC.

David immediately calls up his broker to sell his shares. His broker informs him that SPC's share price has fallen from \$50 per share to \$45 per share since the merger announcement was made ten minutes ago.¹⁴ Market analysts believe that SPC is overpaying for DCC and will not fully realize the projected synergies from the merger.¹⁵ David, a savvy

9. In the states that do not have a stock market exception, dissenting shareholders may receive adequate compensation through appraisal; however, given the costs and uncertainties of traditional appraisal proceedings, there is little guarantee shareholders will actually be adequately compensated.

10. See, e.g., DEL. CODE ANN. tit. 8, § 251(a)-(b).

11. SPC would likely have to pay a premium over market price to acquire DCC in a statutory merger. See Lawrence A. Hamermesh, *Premiums in Stock-for-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U. PA. L. REV. 881, 886 (2003) (stating that the mean premium paid by acquirers in stock-for-stock mergers between 1999 and 2002 was approximately 30 percent).

12. See, e.g., DEL. CODE ANN. tit. 8, § 251(c).

13. See, e.g., *id.*

14. In the majority of major merger announcements, the price of the surviving company's shares decreases subsequent to the announcement. See *infra* Part III.b.

15. On the other hand, the share price of DCC jumped from \$40 per share to almost

investor who is aware that shareholders frequently have an appraisal right in such transactions, puts his broker on hold, and calls his lawyer.

He tells his lawyer he would like to exercise his appraisal right so that he can receive a price for his shares that does not reflect the proposed merger. David thinks he can get \$50 for his shares rather than the current market price of \$45; David's lawyer informs David that this is not possible, however; that, under the law of David's jurisdiction, via what is known as the "stock market exception," when a publicly-traded company engages in a merger or other fundamental transaction, dissenting shareholders have no right to seek appraisal and must sell their shares on the market. David, unhappy but convinced that he has no other option for exit (he has decided not to retain his shares), reconnects with his broker and sells his shares for \$45 per share.

In this hypothetical, David, as a dissenting, minority shareholder, was not given an equitable exit opportunity in light of the merger. Under Delaware law, David should have been entitled to the "fair value" of his shares, the price pre-merger announcement, which was \$50 per share. Nonetheless, because the stock market exception prohibited David from seeking appraisal, his only option to exit was to sell his shares on the market for \$45 a share, a price which included the expected negative value of the merger between SPC and DCC.

As the above hypothetical illustrates, dissenting shareholders can be denied fair value on account of the stock market exception. Part I speculates about the frequency of this problem. Part II then explains the rationales for the stock market exception, beginning with a brief explanation of statutory appraisal rights to provide an understanding of how the stock market exception developed. Next, Part III illustrates in more detail how the corporate codes of many states frequently do not provide dissenting shareholders of publicly-traded companies surviving mergers with adequate compensation. Part IV proposes a means to remedy this unfairness. Finally, the Conclusion considers how the conceptual insights discussed in Parts III and IV can be applied to foreign corporate regimes that have adopted or are considering adopting appraisal rights and a stock market exception.

\$45 per share on the news of the proposed merger. See Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 122 (1992) ("On average, [for the company being absorbed,] there is a 20% increase over the pre-announcement market price for mergers . . .").

I. DISSENTERS BEING DENIED FAIR VALUE:
HOW FREQUENTLY MIGHT THIS OCCUR?

The opening hypothetical illustrates how a dissenting shareholder of a publicly-traded, surviving company can be denied adequate compensation on account of the stock market exception. This Part considers the likelihood that this has occurred and will continue to occur. To the author's knowledge, no method exists to identify and tabulate the number of these occurrences since dissenting shareholders do not leave a public record explaining that they sold their shares on the market in dissent from the merger announcement; as a result, the following subsections only discuss factors that may bear on the frequency with which this occurs. Overall, while one factor indicates that this circumstance may occur relatively often, there are several grounds for thinking it may actually occur less often.

A. One Factor Indicating a High Frequency: Almost All Publicly-Traded Companies are Incorporated in States with a Stock Market Exception

Almost all of the publicly-traded companies incorporated in the United States are incorporated in states that have a stock market exception. This suggests that a significant number of shareholders of publicly-traded, surviving companies are selling their shares in dissent from mergers and not receiving fair value. Roughly 91% of all publicly-traded firms incorporated in the United States are incorporated in the 35 states that have a stock market exception.¹⁶ Moreover, approximately

16. Lucian A. Bebchuck & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391 (2003). The data set used by the authors in their analysis included "all the publicly traded firms for which there were data in the Compustat database at the end of 1999 and which have both their headquarters and their incorporation in the United States." *Id.* at 388. The authors excluded all financial firms for purposes of their analysis, leaving 6,530 publicly-traded firms. *Id.* at 389. As an important note, 58% of all publicly-traded firms, 59% of Fortune 500 firms, and 68% of firms that went public between 1996 and 2000, were incorporated in Delaware. *Id.* Therefore, the prevalence of publicly-traded companies in states with a stock market exception is heavily influenced by the fact that a majority of publicly-traded corporations are incorporated in Delaware, which has a stock market exception within its corporate code. See also Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 835 n.21 (1984) ("The *New York Stock Exchange Guide* included a list, revised through March 26, 1982, of the 1,519 firms that then had

93% of Fortune 500 firms are located in these states,¹⁷ and over 95% of firms that went public from 1996 to 2000 are located in these 35 states.¹⁸ These statistics indicate that, as a result of the stock market exception, very few shareholders of publicly-traded companies in the United States have the ability to exercise appraisal rights in fundamental corporate transactions, though these transactions would often trigger appraisal if the companies were privately-held. Also, while in the 1980s and early 1990s the trend seemed to be a movement by states away from the stock market exception, this trend seems to have reversed with a number of states adopting it.¹⁹ In 1996, 22 states had the exception; in 2008, 35 did.

Considering these statistics, it seems plausible that a significant number of shareholders of publicly-traded, surviving companies are selling their shares in dissent from mergers and not receiving fair value. Since these dissenting shareholders cannot bring an appraisal proceeding before a court, no record exists that these shareholders actually sold their shares in dissent, making it rather difficult to measure the extent to which the stock market exception does impact dissenting shareholders.²⁰

securities listed on the exchange. Thirty-nine of these firms were incorporated in a foreign nation. Of the 1,480 firms incorporated in the United States, 1[,083, or 73%, were incorporated in one of the 25 states . . . having a stock market exception to the appraisal process.” (citing NEW YORK STOCK EXCHANGE GUIDE 725-96 (1982))). Therefore, it appears from a surface comparison of these statistics, one using data from 1999 and the other using data from 1982, the trend is towards a higher percentage of firms being incorporated in states with a stock market exception.

17. Bebhuck & Cohen, *supra* note 16, at 391.

18. *Id.*

19. As of 1995, 24 states had adopted a market exception. Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79, 96 n.82 (1995). In 1996, that number was only 22 states. Ratway, *supra* note 3, at 204. In 1998, Professor Wertheimer declared that “[t]oday, the market exception is applicable only in some jurisdictions, and the trend appears to be a movement away from market exceptions.” Barry M. Wertheimer, *The Shareholders’ Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 633-34 (1998). However, as of 2008, the number of states with a stock market exception stood at 35. *See supra* note 4. The trend has reversed toward a growth in the use of these exceptions.

20. The topic of the stock market exception does not arise frequently in case law given that shareholders are precluded from seeking an appraisal proceeding before a court as a result of it. Only one case was identified that involved a direct challenge to the stock market exception; the shareholders challenging the exception, however, were not dissenting shareholders of a company that would survive the merger. In *Klotz v. Warner Communications, Inc.*, 674 A.2d 878 (Del. 1995), a former owner of Warner

B. Factors Indicating a Low Frequency: The Lack of
Appraisal for Small-Scale, Cash, and Triangular Mergers
And for Non-Merger Business Combinations

There are three principal reasons to doubt that dissenting shareholders are frequently forced to sell their shares on the open market for less than fair value as a result of the stock market exception. First, in many states the stock market exception does not apply to some types of mergers because dissenting shareholders do not have an appraisal right in the first place. Second, if a company sets up a subsidiary to perform the merger, known as a triangular merger, shareholder appraisal rights are also avoided in the parent company. Third, in some states the company can engage in an entirely different form of transaction, such as an asset sale or stock swap, to eliminate appraisal rights while accomplishing a similar result in terms of economic substance.

In two types of mergers, a small-scale merger and a cash-out merger, dissenting shareholders are usually not provided an appraisal right in the first place, meaning the stock market exception does not prevent them from receiving fair value.²¹ For example, under section 262(b)(1) of Delaware's General Corporate Law, shareholders of a company surviving a merger do not have an appraisal right if the merger did not require their vote for its approval.²² Under section 251(f), a surviving company's shareholders are not entitled to vote on the merger if the merger involves issuing less than 20% of the survivor's shares outstanding immediately before the effective merger date.²³ Therefore,

common stock who was also a trustee of a trust invested in Warner stock sued Warner and Time-Warner, claiming that the stockholders of Warner had appraisal rights that arose from the merger of Warner into Time-Warner. Klotz and his fellow dissenting minority stockholders had been offered shares of the newly formed Time-Warner in exchange for their Warner stock. The court granted Warner's and Time-Warner's motion to dismiss because section 262(b)(1), Delaware's stock market exception, explicitly denies to the stockholders of a public company such as Warner appraisal rights in a share-for-share merger. In *Klotz*, the minority shareholders denied appraisal were those of the company being absorbed. As discussed later in Part III.b, *infra*, this is not likely to pose the same inequity as when shareholders of a *surviving* corporation are denied appraisal as a result of the stock market exception. See also *infra* note 93.

21. These dissenting shareholders still may not receive fair value if they sell their shares on the open market after the merger announcement; however, this would not be on account of the shareholders being denied appraisal as a result of a stock market exception.

22. DEL. CODE ANN. tit. 8, § 262(b)(1) (2010).

23. *Id.* § 251(f). Regardless of whether the shares issued under the merger are less

since the shareholders are not required to vote on this type of merger, referred to as a “small-scale” merger, they also have no appraisal right in such a merger.²⁴

Moreover, 251(f) also provides that a surviving company’s shareholders are not entitled to vote on the merger if no shares in the surviving company are issued under the merger.²⁵ In other words, if the merger is a “cash-out” merger in which the shareholders of the company being absorbed only receive cash for their interest, the shareholders of the surviving company are not entitled to vote, and under 262(b)(1), have no appraisal rights.²⁶

As a consequence of appraisal being eliminated in both small-scale and cash-out mergers, the stock market exception only applies to shareholders of publicly-traded companies surviving mergers in share-for-share mergers involving at least 20% of the surviving company’s stock. This means, at least for states like Delaware that restrict appraisal to mergers, these are the only transactions where dissenting shareholders *could* be forced by the stock market exception to sell their shares on the market for lower than fair value.

Next, companies often structure business combinations as triangular mergers, avoiding a shareholder vote and appraisal rights,²⁷ meaning, again, the stock market exception would not prevent them from

than 20% of the surviving corporation’s shares, shareholders of a corporation surviving a merger will still have a vote on the merger if the merger either amends the certificate of incorporation of the surviving corporation or modifies the rights and characteristics of the existing shares. *See id.*

24. In terms of a small-scale merger, some variation has existed among the states regarding the threshold percentage of shares that can be issued and still qualify. Most states, including Delaware, now track the New York Stock Exchange rule of 20%; however, a few states, including New York and Michigan, have no such provision. *See, e.g., id.; infra* note 83.

25. DEL. CODE ANN. tit. 8, § 251(f) (“no vote of stockholders of a constituent corporation surviving a merger shall be necessary to authorize a merger if . . . (3) either no shares of common stock of the surviving corporation and no shares, securities or obligations convertible into such stock are to be issued or delivered under the plan of merger . . .”). Similar to a small-scale merger, regardless of whether the merger is a cash-out merger, shareholders of a corporation surviving that merger will still have a vote on the merger if the merger either amends the certificate of incorporation of the surviving corporation or modifies the rights and characteristics of the existing shares. *See id.*

26. *Id.* at § 262(b)(1).

27. Whether companies should be allowed to use triangular mergers to circumvent shareholder voting and appraisal is another story. *See infra* note 29.

receiving fair value.²⁸ To perform a triangular merger, a company creates a subsidiary and transfers some of its stock to the subsidiary in exchange for all of the subsidiary's stock. Then the subsidiary and the target company engage in a statutory merger in which the subsidiary issues the shares it holds of the parent to the target shareholders in exchange for the target's stock held by the target's shareholders. As a result, the target's business is absorbed into the subsidiary, owned entirely by the parent, and the target's shareholders now own part of the parent. Companies commonly choose to structure business combinations as triangular mergers because setting up a merger in this way provides the benefits of both a stock-for-assets transaction, in that it limits exposure to the target's liabilities, and a statutory merger, in that it provides a relatively straightforward transaction involving only the transfer of shares. In addition, through the transaction, the shareholders of the surviving parent company do not have a vote on the transaction since they are not the direct shareholders of the subsidiary that is absorbing the target; consequently, they cannot exercise appraisal rights either. The common use by companies of triangular mergers provides another reason to doubt that dissenting shareholders are frequently forced to sell their shares on the open market for lower than fair value as a result of the stock market exception.²⁹

Third, in states such as Delaware, where appraisal is limited to mergers and consolidations, the use of other mechanisms to carry out

28. In other words, since the use of a triangular merger eliminates appraisal rights for shareholders of the parent corporation, those shareholders would not be impacted by the stock market exception even if the parent was a public company, since the stock market exception only applies if appraisal rights otherwise would have been available.

29. While it has been argued that recognizing triangular mergers allows companies to subvert shareholder voting and appraisal rights, courts in the United States have continued to recognize the triangular merger as legitimate. *See, e.g., Lewis v. Ward*, No. 15255, 2003 Del. Ch. LEXIS 111, *16 (Del. Ch. Oct. 29, 2003) ("The mere fact that a merger was structured as a 'triangular merger' provides no rational basis to infer that the merger was a fraud . . ."). The soundness of allowing the use of triangular mergers will not be discussed at length herein. Notably, though, it has been argued that triangular mergers should trigger voting and appraisal rights in the parent corporation's shareholders on the theory of a "de facto merger" between the parent corporation and the disappearing "target" corporation, or because that result is necessary to prevent subversion of merger statutes. Despite these arguments, many jurisdictions, including Delaware, reject the de facto merger doctrine and justify triangular mergers based on the independent legal significance doctrine. *See, e.g., Hariton v. Arco Elecs., Inc.*, 188 A.2d 123 (Del. 1963) (holding that the form of transaction should be respected).

business combinations, such as a sale of substantially all the target's assets, also reduces the number of dissenting shareholders forced to sell their shares on the open market for less than fair value as a result of the stock market exception. Companies in states such as Delaware wishing to engage in a business combination may choose not to engage in a statutory merger at all, either to purposely avoid shareholder voting and appraisal rights,³⁰ or more likely, because another form is more suited to the transaction.³¹ Consequently, this is another reason the stock market exception may not deny dissenting shareholders fair value.

At the onset of the financial crisis there was a drastic decrease in the number of mergers taking place nationwide.³² Some industries went almost completely without mergers. Substantial merger activity occurred only in distressed industries, such as banking, where companies on the verge of insolvency were absorbed into other companies. In the short term, fewer shareholders may be selling their shares at below fair value as a result of the stock market exception.

Overall, it appears that in jurisdictions such as Delaware, where the stock market exception only applies to dissenting shareholders of surviving companies when those companies engage in large share-for-share mergers, the stock market exception may only cause shareholders to sell their shares below fair value in a fairly concentrated number of transactions. On the other hand, the stock market exception may have more far-reaching consequences in states where appraisal is not limited to mergers though fewer public companies exist in those states.

30. For example, if a Delaware corporation, instead of engaging in a statutory merger, purchases substantially all the assets of the other company, the shareholders of the Delaware corporation would be deprived of their appraisal right in the first instance. As a result, they would no longer be impacted by the stock market exception, even if the Delaware corporation was publicly traded.

31. For example, in a purchase of assets, the acquiring corporation does not necessarily assume the transferor corporation's liabilities, allowing the acquiring corporation to avoid taking on unknown liabilities of the transferor corporation. A statutory merger does have a number of advantages over other forms, such as an asset purchase, though. For example, for a statutory merger less paperwork is usually required, sales tax is avoided, and the surviving corporation has more liberality as to the consideration that can be given.

32. Ben Harrington, *Dealmaking Suffers from Squeeze*, DAILY TELEGRAPH (London), Mar. 28, 2008, at City 5 ("According to Thomson Financial, the amount of deals announced globally tumbled 31% from \$962bn to \$661bn . . . in the first quarter of 2008.").

II. RATIONALES FOR THE STOCK MARKET EXCEPTION

The stock market exception may prohibit dissenting shareholders from receiving fair value; nonetheless, states initially adopted this exception for rational reasons. Part II explains those reasons and outlines the structure of current stock market exception provisions. This Part begins with a short explanation of statutory appraisal rights, which is critical to understanding how the stock market exception developed and why its rationales do not completely hold up when applied to dissenting shareholders of publicly-traded, surviving companies.

A. The Adoption of the Stock Market Exception in
Reaction to the Failures of Appraisal

To understand the rationales for the stock market exception, one must understand the problems inherent in traditional appraisal proceedings. Appraisal is a statutorily-created right which provides that a shareholder dissenting from a fundamental change in a company's structure has the ability to withdraw his ownership stake.³³ The shareholder, to exercise his appraisal right, must file with the company a timely, written objection and demand payment.³⁴ If the company and the shareholder are unable to reach a settlement, an appraisal proceeding is brought to determine the fair value.³⁵ The company is then required to

33. See *Loeb v. Schenley Indus., Inc.*, 285 A.2d 829, 830 (Del. Ch. 1971) ("The provisions of [DEL. CODE ANN. tit. 8,] § 262 furnish an orderly method for withdrawal from a corporation by shareholders who dissent from a merger or consolidation . . ."). See also Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 226 (1962)

These statutes provide that in some situations, the holders of some kinds of shares of a corporation may at their option, through some specified procedure, turn in their shares and force the corporation to pay them cash out of the corporate treasury in an amount usually stated as equal to the "value" of the shares. These are bail-out provisions; when certain events occur, some shareholders are given a put against the corporation. The statutes vary considerably in scope and form. All, however, include a merger as a transaction that will trigger the remedy for all or some shareholders.

Id.

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

35. *Id.* Subsection 262(d) of Delaware's General Corporation Law outlines the typical procedure a dissenting shareholder must follow to be entitled to an appraisal right. Like most state appraisal provisions, a shareholder wishing to dissent from a transaction must notify the corporation before the shareholders' meeting authorizing the transaction and then surrender his or her share certificates to the corporation. DEL.

buy back the dissenting shareholder's shares for that fair value.³⁶ Within the United States, the appraisal remedy has become a hallmark protection of minority shareholders and is available in the state corporate codes of every American jurisdiction.³⁷

The appraisal remedy was originally crafted to compensate shareholders for the loss of their common law right to prevent a merger or consolidation.³⁸ The idea was that shareholders should not be forced to join an entirely different enterprise.³⁹ Today, the appraisal remedy serves more "to preserve the value and liquidity of the shareholder's investment."⁴⁰ The remedy, by providing an exit opportunity for minority shareholders, is meant to protect those minority shareholders from either being locked into ownership of a company that by decision of the majority plans to undergo a fundamental change, or from being squeezed out by the majority and receiving inadequate compensation for their shares.⁴¹

CODE ANN. tit. 8, § 262(d) (2010). Once a dissenting shareholder has tendered his or her shares to the corporation, he or she has no right to vote on the transaction or any subsequent transaction, and his or her rights as a shareholder cease other than the right to be compensated for the shares. *Id.* § 262(k). If the shareholder is unsatisfied with the amount offered by the corporation, he or she has the right to commence an appraisal proceeding with the relevant court. *Id.* § 262(e).

36. Kanda & Levmore, *supra* note 34, at 429.

37. *See id.* at 431.

38. Under the common law, unanimous consent of the shareholders was required to permit such transactions. However, as business enterprises grew larger and unanimous consent became impractical, the requirement of unanimous consent was replaced by statutory provisions providing that the consent of only a majority or supermajority vote of shareholders was required. *See, e.g.,* Ala. By-Prods. Corp. v. Cede & Co. *ex rel.* Shearson Lehman Bros., 657 A.2d 254, 258 (Del. 1995); Heilbrunn v. Sun Chem. Corp., 150 A.2d 755, 758 (Del. 1959) ("[T]he appraisal right is given to the stockholder in compensation for his former right at common law to prevent a merger.").

39. Note, *A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Right of Appraisal*, 74 MICH. L. REV. 1023, 1032 (1976) [hereinafter *Reconsideration*].

40. *Id.* at 1032.

41. *See* Manning, *supra* note 33, at 226 ("In political terms these statutes fill a basic democratic need to protect a dissident minority from the overwhelming power of the majority."). An example of a state corporate code's appraisal remedy is section 262(a) of Delaware's General Corporation Law, which provides that "[a]ny stockholder of a corporation of this State who holds shares of stock on the date of making a demand pursuant to subsection (d) [for appraisal] . . . who continuously holds such shares through the effective date of the merger or consolidation . . . shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock

Despite the appraisal remedy's intended purpose to protect minority shareholders, appraisal provisions are frequently criticized for creating lengthy, costly, and unpredictable court proceedings.⁴² The principal problem is that valuing a company is an inherently speculative process, based upon estimates of the company's future earnings and cost of capital.⁴³ When modified, these estimates can greatly change the company's projected value. Consequently, the range of values a court may accept in an appraisal proceeding for the value of dissenting shareholders' stock may vary considerably.⁴⁴

In a 1962 essay, Professor Bayless Manning, former Stanford Law School dean, argued that the average shareholder actually had little to

... ." DEL. CODE ANN. tit. 8, § 262(a) (2010).

42. See Manning, *supra* note 33, at 233.

Where there is no active market for the stock, the situation is different, for the shareholder cannot easily get a "fair" price by selling his shares. Still, the appraisal statute may not be much help to him. The problem of unpredictability remains. After months of litigation and expense, the court may find a high valuation for the dissenter's stock. Or it may find a low one. *The only things certain are the uncertainty, the delay, and the expense.*

Id. (emphasis added). See also Michael R. Schwenk, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 651 (1994); Seligman, *supra* note 16, at 830.

43. The model used to calculate a company's value through a prediction of its future earnings is commonly referred to as the Discounted Cash Flow (DCF) model. For an explanation of the DCF model, see *Cede & Co. v. Technicolor, Inc.*, Civil Action No. 7129, 1990 Del. Ch. LEXIS 259, at *24 (Del. Ch. Oct. 19, 1990) ("The DCF model entails . . . an estimation of net cash flows that the firm will generate . . . [and] a cost of capital with which to discount to a present value . . .").

44. Notably, many courts still use the judicially-created "Delaware Block Method" to calculate a company's value in appraisal. Under the Delaware Block Method, the court determines three values—the company's net asset value, its earnings value, and its market price, and then gives each value a relative weight. The sum of these weighted values provides the overall company value used to determine the value of dissenters' shares. This method has often been criticized as "arbitrary," particularly since the outcome depends heavily on the weight the court assigns to each value. See Michael R. Schwenk, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649, 659-60 (1994). See also Manning, *supra* note 33, at 232.

Where there is no continuous active market, the courts have had to pull out of the air a single hard figure as "the value." They have tried all the usual textbook techniques for valuation. They have capitalized earnings, inventoried break-up value, gone after the going-concern value, totted up replacement costs, and compared other corporations said to be comparable. In the absence of a solid market, share evaluation has proved no easier and no more predictable for purposes of dissenters' appraisal than for other purposes.

Id.

gain from appraisal when the company was a listed company or its shares were actively traded.⁴⁵ He observed that, in appraisal, “courts have virtually refused to go beyond an inquiry as to the market price.”⁴⁶ Shareholders were better off, then, avoiding appraisal and selling on the market.⁴⁷ As a result, Professor Manning suggested that appraisal rights were an unnecessary and inefficient mechanism to protect minority shareholders when a company was listed on a stock exchange because the stock exchange already provided a reasonable means of exit.⁴⁸ Importantly, the price of the shares had already been determined in the market, and therefore, according to Professor Manning, an appraisal proceeding to value those shares was superfluous.⁴⁹ As a consequence of Professor Manning’s reasoning, many states adopted what have come to be known as “stock market exception” provisions,⁵⁰ which exclude appraisal rights for publicly-traded shares.⁵¹

B. Structure and Function of Current Stock Market Exception Provisions

The first state to enact a stock market exception was Delaware in

45. See Manning, *supra* note 33, at 232-33 (“If the corporation is a listed company, or if its shares are actively traded, it is hard to see that the average shareholder—that fellow the New York Stock Exchange insists makes \$7000 per year—can hope to gain anything from the [appraisal] statutes.”).

46. *Id.* at 232.

47. See *id.* at 233.

48. *Id.* at 261 (“If we are to have the remedy at all, the key point on which it should turn is the presence or absence of a market. If the remedy has any function, it is to provide a way for an unhappy investor to get out when he has no other feasible way to get out Appraisal should be considered an economic substitute for the stock exchange and its use should be limited to situations in which the exchange, or some kind of a reasonable market, is not available.”).

49. *Id.* at 233 (reasoning that if a shareholder “files the dissenter’s claim, he will certainly encounter delay in payment, he may encounter substantial litigation costs, he may make a procedural gaff that will cost him his option—and in the end he will be awarded the market price of the shares. He could have gotten that in the first place by the rather simpler method of calling his broker.”).

50. These provisions are also referred to as the market exception, the market-out exception, and the securities exchange exception.

51. See Wertheimer, *supra* note 19, at 632-33 (“The ultimate extension of Manning’s argument is found in statutory market exceptions to the availability of the appraisal remedy. These exceptions, found in the statutes of some states, provide that the appraisal remedy is not available to shareholders owning publicly-traded shares.”). See *supra* note 4 (list of states with statutory market exceptions to the availability of the appraisal remedy).

1967.⁵² Delaware's current appraisal provision states that "appraisal rights shall be available for the shares of any class or series of stock of a constituent corporation in a merger or consolidation . . . (1) [p]rovided, however, that no appraisal rights . . . shall be available for the shares of any class or series of stock, which stock . . . were either (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders"⁵³ Similarly, New York's appraisal provision provides that a dissenting shareholder has an appraisal right in "[a]ny plan of merger or consolidation to which the corporation is a party[,] except that the right . . . shall not be available . . . [when] (iii) . . . [the] shares . . . were 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."⁵⁴

Most state provisions of the stock market exception provide that appraisal is unavailable to a company's shareholders if the company's shares are listed on a "national securities exchange."⁵⁵ In addition, most states that have a stock market exception, including Delaware, also invoke that exception when the stock is held by a certain number of record holders, usually two thousand.⁵⁶ This minimum shareholder requirement was designed to apply the exception to certain stocks traded over-the-counter.⁵⁷

52. See Ratway, *supra* note 3, at 204.

53. DEL. CODE ANN. tit. 8, § 262(b)(1)(A) (2010) (emphasis added).

54. N.Y. BUS. CORP. LAW. § 910(a)(1) (Consol. 2008) (emphasis added).

55. In 17 C.F.R. § 230.153(c)(1) (2009), the term "national securities exchange" is defined as a securities exchange registered as a national securities exchange under section 6 of the Securities Exchange Act of 1934. As of January 6, 2009, there were 10 exchanges so registered: American Stock Exchange, Boston Stock Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, International Securities Exchange, National Stock Exchange, The NASDAQ Stock Market LLC, New York Stock Exchange, NYSE Arca, and Philadelphia Stock Exchange.

56. Of the 35 states with a stock market exception, 22 invoke that exception when the stock is held by a certain number of record holders. Some of these states also have a threshold requirement that the outstanding shares have a certain asset value, usually \$20 million. See, e.g., ARIZ. REV. STAT. § 10-1302(D) (LexisNexis 2010); COLO. REV. STAT. ANN. § 7-113-102(1.3)(1) (2008). See also N.J. STAT. ANN. § 14A:11-1(1)(a)(i)(A) (LexisNexis 2010) (requiring that the stock only be held by 1,000 record holders).

57. *Reconsideration*, *supra* note 39, at 1025 n.5.

C. Rationales behind the Stock Market Exception

Proponents of the stock market exception have articulated three general rationales for its use in corporate statutes: (1) the justifications for appraisal do not apply to publicly-traded securities; (2) forced sale in the market eliminates the corporate cash drain of buying out dissenters; and (3) forced sale in the market eliminates litigation costs.

i. The Justifications for Appraisal Do Not Apply to Publicly-Traded Securities

Proponents of the stock market exception maintain that the justifications for appraisal do not apply to shareholders of publicly-traded securities who are seeking to withdraw their ownership stake. To begin, proponents argue, as Professor Manning did, that the market adequately values stock;⁵⁸ valuation through appraisal is unnecessary because dissenting shareholders can sell their shares on the market for

58. Ratway, *supra* note 3, at 205 (“Proponents of the ‘market-out’ exception claim that with a publicly-traded stock, the stock market price is an accurate and fair valuation of the stock. Therefore, expensive judicial determination of the fair value would be redundant.”). Nevertheless, this rationale for the stock market exception has been highly criticized, principally on the basis that the assumptions underlying the Efficient Market Hypothesis do not reflect reality. See Schwenk, *supra* note 44, at 682. For example, Professor Schwenk argues that a significant amount of “noise trading” occurs in the market via ill-informed investors and that such trading “keeps prices from reflecting fundamental values accurately” *Id.* at 686. In fact, in light of the bear market of the 1970s, the drafters of the Revised Model Business Corporations Act rejected the stock market exception based on the belief that the market may systematically undervalue stocks. Alfred F. Conard, *Amendments of Model Business Corporation Act Affecting Dissenters’ Rights (Sections 73, 74, 80 and 81)*, 33 BUS. LAW. 2587, 2595 (1978).

Whether or not the market value accurately represents the intrinsic value of a public company’s shares, however, it would be inappropriate to award owners of such publicly-traded shares anything but that price in appraisal. The shareholders paid the market price in the first place to obtain the shares (assuming they were not the founders of the company or other pre-IPO investors), and therefore, if corporate statutes allow shareholders to receive a “fair value” that is higher than the market price, the shareholders would receive a windfall. An investor could buy at market price and then if an appraisal-triggering transaction occurred, he could dissent and exercise his appraisal right, receiving compensation for his shares that would be greater than market price (that is, appraisal arbitrage). See Seligman, *supra* note 16, at 837-38, 842-46 (asserting that an appraisal valuation greater than market value would award a windfall to dissenting shareholders).

the appropriate price.⁵⁹ This argument is based on the Efficient Capital Markets Hypothesis (“ECMH”).⁶⁰ If the Semi-Strong Form of ECMH is accepted, which posits that share prices rapidly adjust to new information made public to investors,⁶¹ then “market prices reflect investors’ estimates of the intrinsic value of securities.”⁶² Consequently, proponents contend that appraisal is redundant for shares of publicly-traded companies because the shareholders of those companies may obtain the appropriate value by selling on the market.⁶³

Next, proponents argue that from a liquidity standpoint the appraisal remedy is unnecessary for shareholders of publicly-traded shares. The appraisal remedy is justified on the basis of a liquidity rationale in that minority shareholders dissenting from a fundamental change to a company need a means of exit.⁶⁴ For minority shareholders of a closely-held company, finding a buyer willing to pay fair value for the shares is usually difficult and often impossible. Appraisal provides a

59. See Wertheimer, *supra* note 19, at 633. See also Schwenk, *supra* note 44, at 681-82 (“If the shareholder can receive the fair value of his or her stock by selling it in the market, then there is no need for a judicial proceeding to determine this value. It has already been set with the best source of information regarding values: a competitive market.”). This rationale—that a dissenting shareholder could receive the fair value of his shares by selling on the market—was the most convincing to state legislatures that passed these statutes initially. *Reconsideration*, *supra* note 39, at 1032. See, e.g., Cal Corp. Code § 1300, Legislative Committee of the Assembly of California, Comment to the Assembly of 1975, at 4303 (“On the theory that a shareholder may cash out by selling his shares in the market if a liquid market for his shares exists, this section generally eliminates dissenters’ rights in any case where the shares are listed on certain national securities exchanges or the OTC margin stocks list issued by the Federal Reserve Board.”).

60. See Schwenk, *supra* note 44, at 683.

61. *Id.*

62. Wertheimer, *supra* note 19, at 633 n.103; see also Seligman, *supra* note 16, at 837-38.

Given the widely recognized validity of the “semi-strong” form of the efficient-market hypothesis on the New York Stock Exchange, it is reasonable to believe that the market price of a security fairly reflects all publicly known material information about the underlying firm. An appraisal in such circumstances is superfluous. It substitutes an unpredictable and subjective result for an evaluation of the firm’s worth by all investors then following that security.

Id.

63. Wertheimer, *supra* note 19, at 633 n.103. See also *Reconsideration*, *supra* note 39, at 1030 (“[Critics of appraisal] concluded that the existence of a market where the dissenter’s stock was widely traded obviated the need for valuation by a court.”).

64. See *Reconsideration*, *supra* note 39, at 1032.

means for these shareholders to exit in an illiquid market; however, appraisal is unnecessary for stockholders of a publicly-traded company because they can easily sell on the market.⁶⁵

ii. Forced Sale in the Market Eliminates the Corporate Cash Drain of Buying Out Dissenters

Proponents of the stock market exception also contend that appraisal has the potential to frustrate an efficient corporate transaction by requiring the company to pay out cash to dissenters.⁶⁶ In appraisal, the company is required to pay dissenting shareholders for the value of their shares as determined through a court proceeding. If the number of dissenters is sufficiently high, such payments could create a cash drain sufficient to force the company to reconsider the appraisal-triggering transaction altogether.⁶⁷ On the other hand, if dissenting shareholders are forced to sell their shares on the market, the company's cash problem does not arise.⁶⁸

iii. Forced Sale in the Market Eliminates Litigation Costs

Along with eliminating corporate cash drain, proponents of the stock market exception argue that it produces more efficient decision-making by reducing, for both dissenting shareholders and companies, the high litigation costs generally associated with appraisal rights. Dissenting shareholders with an appraisal right frequently do not exercise that right because participating in an appraisal proceeding is so expensive that it completely negates the benefit of obtaining a court-determined valuation.⁶⁹ In fact, appraisal is only a worthwhile option for dissenting shareholders that own a large number of shares or who are

65. See Wertheimer, *supra* note 19, at 633. Wertheimer indicates, though, that the focus of the appraisal remedy has shifted in that it is being used less frequently to provide liquidity to shareholders and more frequently to obtain a higher value for shares when minority shareholders are eliminated through a cash-out merger by controlling shareholders. *Id.* at 615-16. Therefore, since the appraisal remedy is "no longer motivated principally by a liquidity rationale," the liquidity rationale for the stock market exception is no longer as persuasive. *See id.* at 633.

66. *Reconsideration*, *supra* note 39, at 1030.

67. *Id.* See also Seligman, *supra* note 16, at 866.

68. *But see infra* Part IV.c and note 118, regarding how states and corporations can minimize such cash drain even if appraisal were provided.

69. See *Reconsideration*, *supra* note 39, at 1030-31.

offered a price by the company that is much lower than fair value.⁷⁰ Proponents of the stock market exception urge that selling on the market provides a means for dissenters holding publicly-traded shares to receive fair value without incurring litigation costs.

The cost of appraisal proceedings can also frustrate a company's goals by making transactions that trigger appraisal too expensive,⁷¹ moreover, even if these transactions are still worth pursuing, the costs of appraisal proceedings will greatly increase the company's legal expenses.⁷² This, in turn, increases the ability of dissenting shareholders to harass the company by subjecting it to costly suits.⁷³ As such, the stock market exception is advocated as a means to facilitate efficient corporate transactions and reduce corporate transaction costs.⁷⁴

The principal justifications for the stock market exception, therefore, are that the rationales behind appraisal are absent when a company's stock is publicly traded; appraisal is a drain on corporate cash; and appraisal proceedings produce litigation costs which cause both dissenting shareholders and companies to avoid otherwise efficient decisions. Part III explains why the justifications for the stock market exception do not hold up, however, when applied to dissenting shareholders of a company surviving a merger.

III. HOW DISSENTING SHAREHOLDERS OF A PUBLICLY-TRADED COMPANY SURVIVING A MERGER ARE DENIED FAIR VALUE

In some circumstances, forcing dissenting shareholders to exit via the market may be superior to allowing appraisal proceedings. Where dissenting stockholders of a publicly-traded surviving company are prohibited from seeking appraisal by the stock market exception, however the combination of the stock market exception and the timing of the provision of transaction information actually acts as a barrier to receiving fair value.⁷⁵ This section, Part III, sets out what is meant by

70. *See id.* at 1031.

71. Seligman, *supra* note 16, at 866.

72. *Id.*

73. *Reconsideration*, *supra* note 39, at 1031.

74. *See Seligman*, *supra* note 16, at 866.

75. A question not addressed here is whether dissenting shareholders of a corporation surviving a merger should even receive appraisal rights at all, regardless of whether the company's shares are publicly traded. The rationale behind these shareholders receiving an appraisal right is that appraisal provides them with an exit so

“fair value” and then outlines how dissenting shareholders of a publicly-traded company surviving a merger may not receive that value.

A. THE MEANING OF “FAIR VALUE”

One must consider what is the appropriate value dissenting shareholders should receive when forced to sell their stock in a publicly-traded company on the market as a result of the stock market exception. The appraisal provisions of almost every state explicitly provide that dissenting shareholders, upon surrendering their interest in the company through appraisal, are entitled to the “fair value” of that interest.⁷⁶ Since one of the principal rationales for the stock market exception is that the market adequately values the publicly-traded shares of dissenting shareholders so that appraisal is unnecessary, presumably, then, under the stock market exception dissenting shareholders that sell in the market should also receive “fair value.” The question then becomes: what is “fair value”?

While courts and legislatures have struggled to positively define “fair value,” most state appraisal provisions make clear that courts should determine the “fair value” of dissenters’ shares excluding any

that they are not forced to accept a significant change in the structure or business of the corporation; however, in some states such as Delaware, appraisal rights are not provided for many other events that significantly change the corporation, such as a sale of substantially all assets. See Angie Woo, *Appraisal Rights in Mergers of Publicly-Held Delaware Corporations: Something Old, Something New, Something Borrowed, and Something B.L.U.E.*, 68 S. CAL. L. REV. 719, 726-27 (1995).

Under the risk argument, appraisal rights are meant to compensate the dissenting shareholder who is forced to accept a fundamental change in risk caused by a merger . . . [however,] [u]sing appraisal rights as a mechanism to redress risk changes seems incongruous when appraisal rights are not offered for other fundamental external and internal events that also result in a fundamental change in risk for the company.

Id. Appraisal rights have also been justified on the basis that they provide protection for minority shareholders against self-dealing by a majority shareholder. Self-dealing occurs when minority shareholders, holding the same class of stock as a majority shareholder, receive less than the fair value of their shares and less per share than the majority shareholder in a “freeze-out” merger. The appraisal right provides minority shareholders a means to receive the fair value of their shares. See *Id.* at 727. Such self-dealing, though, does not affect minority shareholders of a *surviving* corporation.

76. See, e.g., ARIZ. REV. STAT. § 10-1302(D) (LexisNexis 2010); COLO. REV. STAT. ANN. § 7-113-102(1.3)(1) (2009); CONN. GEN. STAT. § 33-856(b)(1) (2010); IDAHO CODE ANN. § 30-1-1302(2)(a) (2009); IND. CODE ANN. § 23-1-44-8(b) (LexisNexis 2009); IOWA CODE § 490.1302(2)(a) (West 2010).

appreciation or depreciation on account of the appraisal-triggering transaction.⁷⁷ This means that “fair value” for publicly-traded shares should be based on the market price immediately before the announcement of the appraisal-triggering transaction when investor expectations regarding the transaction have not yet affected the price.⁷⁸ Section 262(h) of Delaware’s General Corporate Law, for instance, states that the “fair value” received by dissenting shareholders in appraisal should be the value of the dissenters’ shares “exclusive of any element of value arising from the accomplishment or expectation of the merger.”⁷⁹ To establish this value, the court should not consider any post-merger announcement appreciation or depreciation in the stock value that occurred as a result of the expected merger transaction;⁸⁰ this makes sense in that dissenting shareholders that disagree with the merger should not reap the gains of the merger nor suffer any losses on account of it.⁸¹ As a result, dissenting shareholders of a publicly-traded

77. *Reconsideration*, *supra* note 39, at 1051-52 (“Because appraisal theoretically compensates the dissenter for his share in the original corporation, appraisal statutes are nearly unanimous in stating that the dissenter is entitled to the value of his shares unaffected by any depreciation or appreciation that might be caused by the corporate action from which he dissents.”). *See, e.g.*, CAL. CORP. CODE § 1300(a) (Deering 2008) (“The fair market value shall be determined as of the day before the first announcement of the terms of the proposed reorganization or short-form merger, excluding any appreciation or depreciation in consequence of the proposed action.”); DEL. CODE ANN. tit. 8, § 262(h) (2010) (fair value should be the value of the dissenting shareholders’ shares “exclusive of any element of value arising from the accomplishment or expectation of the merger.”); MD. CODE ANN., CORPS. & ASS’NS § 3-202(b)(2) (LexisNexis 2008) (“fair value may not include any appreciation or depreciation which directly or indirectly results from the transaction objected to or from its proposal”); *Oakridge Energy, Inc. v. Clifton*, 937 P.2d 130 (Utah 1997) (holding that dissenting shareholders are “entitled to receive the value of their holdings unaffected by the corporate action”).

78. *In re Tri-Continental Corp.*, 74 A.2d 71 (Del. Ch. 1950) (“[If there is] an actual market value uninfluenced by the merger in existence, it would [be] error to disregard it [in an appraisal of stock.]”); *see also* Seligman, *supra* note 16, at 867 (“When there is an actively traded security and an interested-merger transaction, the market price of the corporation immediately before the merger announcement provides a baseline value of the firm.”).

79. DEL. CODE ANN. tit. 8, § 262(h).

80. *See* Wertheimer, *supra* note 19, at 633.

81. This notion is illustrated by the fact that most state appraisal statutes contain anti-straddle rules that prevent shareholders from dissenting from a transaction and then claiming the transaction’s benefits. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h)-(k) (“(k) . . . no stockholder who has demanded appraisal rights . . . shall be entitled to vote such

company surviving a merger should be entitled to the their shares' market price immediately before the announcement of the merger as that is most likely the "fair value" of their interest in the company.⁸²

B. How Dissenters Are Denied Fair Value

The opening hypothetical shows that, in states with a stock market exception, shareholders of a publicly-traded company surviving a merger may receive less than "fair value," as defined by appraisal statutes, for their shares when they dissent from that merger and sell on the market.⁸³ This results from the interaction of the stock market exception and the timing of the provision of information regarding the merger. These shareholders can only sell their shares on the market once they learn of the merger transaction that they dissent from. As shareholders in a publicly-held company, they will receive such information only when it is publicly announced; that is to say, most shareholders of the company will not be informed about the transaction before a public announcement by management.⁸⁴ Indeed, if management were to inform a shareholder about such a merger before making such information public and that shareholder sold his or her shares in dissent from the transaction before the public announcement, he or she would be violating insider trading laws.⁸⁵

stock for any purpose or to receive payment of dividends or other distributions").

82. This theory of fair value presumes that the Semi-Strong Form of the Efficient Market Hypothesis is valid. *See supra* note 56 and *infra* note 86.

83. As a note, in a few states that have a stock market exception dissenting shareholders of a *surviving* corporation would not even have the possibility of an appraisal right, notwithstanding the stock market exception, unless their shares were impacted in certain ways, such as if a preferential right of the shares was altered or abolished or voting rights were excluded on any matter. *See* N.Y. BUS. CORP. LAW, §§ 806(b)(6), 910(a)(1)(A)(ii) (Consol. 2008); MICH. COMP. LAWS SERV. §§ 450.1703a(e), 450.1762(1) (LexisNexis 2008).

84. Larger, more active shareholders may learn of the transaction through management before the public announcement, but they will be prohibited from selling their shares in dissent before the announcement as a result of insider trading laws. *See* 17 C.F.R. 240.10b-5 (2009) (Rule 10b-5).

85. *See Dirks v. SEC*, 463 U.S. 646, 660 (1983).

Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are as forbidden as

Next, since most shareholders that might wish to dissent from the transaction learn about the transaction when the rest of the market does – at the time of the public announcement, they can only sell their shares after that announcement. According to the Semi-Strong Form of the Efficient Market Hypothesis, as soon as the transaction announcement is made, that transaction's expected value will be reflected in the company's share price.⁸⁶ Consequently, dissenting shareholders will only be able to sell their interests in the company after the merger's value has become incorporated into the company's share price.⁸⁷ They may be unable to receive the fair value of their shares, such as described in Section 262(h) of Delaware's General Corporate Law,⁸⁸ because they cannot sell their shares at a price that does not include some value derived from the expectation of the merger.⁸⁹

For these dissenting shareholders, selling their shares on the market after the expected value of the merger has been incorporated into the

transactions on behalf of the trustee himself. Thus, the tippee's duty to disclose or abstain is derivative from that of the insider's duty.

Id.

86. Woo, *supra* note 75, at 734 (citing RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 307 (4th ed. 1991)) ("Researchers have . . . proven that specific items of news—such as forecasts of company earnings, cosmetic changes in accounting practices, and announcements of earnings, dividends, and mergers—are rapidly and accurately reflected into stock price."); *see also supra* note 59 (regarding the Efficient Market Hypothesis). As soon as the merger announcement is made, the expected value of the merger becomes immediately priced into the stock.

87. In other words, the opportunity to sell at the appropriate price is gone by the time the dissenting shareholders know to sell their shares.

88. DEL. CODE ANN. tit. 8, § 262(h) (2010).

89. For a similar but less detailed explanation of how the stock market exception can cause problems based on the timing of information to shareholders, *see Reconsideration, supra* note 39, at 1051-52.

Because appraisal theoretically compensates the dissenter for his share in the original corporation, appraisal statutes are nearly unanimous in stating that the dissenter is entitled to the value of his shares unaffected by any depreciation or appreciation that might be caused by the corporate action from which he dissents. To the extent, however, that the market price instantaneously reflects new information, a dissenter cannot sell on the market at a price unaffected by the information implicit in the new corporate action. Obviously, where a major corporate action is considered desirable by analysts, the market price will adjust itself upward; but where the action is considered improvident, the price will fall. To force the dissenter to sell in a falling market subjects him to the influence of the corporate action against which he seeks a remedy.

Id.

price of the shares is not problematic if the price of those shares increases on news of the merger or is unaffected;⁹⁰ however, empirical evidence indicates that in the majority of major merger announcements the price of the surviving company's shares *decreases* subsequent to the announcement.⁹¹ For example, one 2005 study found that during the 1990s merger wave the stock prices of acquiring firms decreased by an aggregate \$216 billion as measured right after the merger announcement.⁹² Another recent study by Professors Sara B. Moeller, Frederick P. Schlingemann, and Rene M. Stulz analyzed how merger announcements affected the stock prices of surviving firms from 1998 to 2001. They found that the value of surviving firms declined by a total of \$240 billion in the three-day periods surrounding the merger announcements.⁹³ This means that dissenting shareholders of a publicly-traded, surviving company must usually sell their shares on the market at a price *lower* than the price before the announcement.⁹⁴

90. In fact, for dissenting shareholders of the publicly-traded company being *absorbed*, the price of their shares would likely *increase* upon news of the merger. Romano, *supra* note 15, at 122. As a result, though they would also be subject to the stock market exception, it is much less likely that they would receive less than "fair value" by selling on the market after the announcement. Of course, if the price of their shares did decrease as a result of the announcement, they would face the same problem faced by dissenting shareholders of the surviving company.

91. The surviving company usually pays a premium for the company it absorbs in hopes of reaping additional profits through synergies; frequently, though, such synergies do not come to fruition.

92. Thomas A. Lambert, *Overvalued Equity and the Case for an Asymmetric Insider Trading Regime*, 41 WAKE FOREST L. REV. 1045, 1085 (2006) (citing Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 758-59, 762-63 (2005)).

93. Lambert, *supra* note 92, at 1083-84. See also F.M. Scherer, *Antitrust: New Economy, New Regime Second Annual Symposium of the American Antitrust Institute: Some Principles for Post-Chicago Antitrust Analysis*, 52 CASE W. RES. L. REV. 5, 12-13 (2001).

In a study of 100 large [merger] deals completed between 1994 and 1997, Mr. Sirower[, a professor at the Stern School of Business, New York University,] found that two thirds resulted in immediate and outright losses to shareholders and wound up underperforming their industry peers over the long haul. Repeated studies have shown that, in most mergers, the shareholders of the acquiring company suffer, and that their loss is often greater than the gain for the shareholders of the acquired company.

Id.

94. If the company was not publicly traded, these dissenting shareholders could seek fair value for their shares through an appraisal proceeding. See the suggestion by Professor Manning, *supra* note 33, at 233.

Therefore, dissenting shareholders of such a company must frequently sell their shares at a price below the price that is equitable – the price immediately before the merger announcement – as a result of both the stock market exception and their inability to sell their shares before the expected value of the merger has been incorporated into the share price.⁹⁵

IV. PROVIDING DISSENTING SHAREHOLDERS AN APPRAISAL RIGHT WITH A PRESUMPTION OF THE PRICE TO BE AWARDED IN APPRAISAL

If dissenting shareholders of a company surviving a merger are precluded from seeking appraisal as a result of the stock market exception and must therefore sell their shares on the market post-merger announcement, they are likely to get less than “fair value” since the price of the surviving company’s shares frequently drops upon the merger’s announcement.

States with a stock market exception should enact a provision that eliminates the exception under this circumstance.⁹⁶ Specifically, the

One situation springs to mind in which the dissenter has a clear incentive to pursue his statutory [appraisal] remedy. If the stock is traded actively so that a market value is known, and if that market value drops precipitately in demonstrable reaction to the transaction the shareholder finds objectionable, the appraisal statute can be substantially and predictably helpful. The shareholder will be entitled to the value of his shares without taking into account the effect brought about by the transaction; the figures are, in general, already known; and the company, having little to argue about, is apt to pay up promptly.

Id. In this instance, though, the shareholders are now barred from seeking appraisal because their shares fall within the stock market exception.

95. Importantly, while Delaware only provides shareholders an appraisal right in mergers, some states provide appraisal rights for a variety of other transactions, such as a sale of substantially all assets. In states with broader appraisal rights, the likelihood that dissenting shareholders do not receive fair value may be increased because the stock market exception is applied under more circumstances. This author focuses primarily on the problem as applied to mergers, though, since a majority of publicly-traded companies are incorporated in Delaware.

96. The stock market exception has been rationalized on the basis that the market accurately values publicly-traded shares; however, in this case, the market’s valuation of the shares at the time the dissenting shareholder could sell, while perhaps accurate in terms of the intrinsic value of the company at that time, is not the appropriate valuation for dissenting shareholders because it includes the merger value; as a result, the stock market exception should not be used under these circumstances. As a note, the 15 states that do not have a stock market exception should consider adopting such an exception with the provision proposed in this section. Dissenting shareholders of publicly-traded

provision would provide that dissenting shareholders of a publicly-traded company surviving a merger retain an appraisal right so long as they would have had an appraisal right in the absence of a stock market exception. Furthermore, the provision would require courts to presume that the correct price awarded in appraisal is the share price immediately before the merger announcement.⁹⁷ The provision could be articulated in the following manner:

If a shareholder [stockholder (Delaware)] of a corporation that will be the surviving entity in a statutory merger dissents from that merger and would have been accorded an appraisal right in the absence of a stock market exception, then he or she will be accorded such an appraisal right, and if a valuation proceeding is commenced to fulfill that right, the court shall presume that the appropriate price of the dissenting shareholder's shares in appraisal is the average of the market prices on the last trading day preceding announcement of the merger.⁹⁸ This presumption is overcome only if either party, the shareholder or surviving corporation, can prove with clear and

companies who exercise their appraisal rights in those 15 states and who cannot come to a settlement with the corporation must currently undergo an appraisal proceeding in its traditional form with all the uncertainties and costs that accompany it.

97. See *Reconsideration*, *supra* note 39, at 1052 ("Appraisal can control for such abnormal price fluctuations by using the price that prevailed before the market began to adjust for the action."). See also David Cohen, *Valuation in the Context of Share Appraisal*, 34 EMORY L.J. 117, 122 n.24 (1985) ("the market price series prior to the merger provides valuable information for determining the going concern value of dissenters' shares"). The question arises, then, exactly how does one calculate the price "immediately before the merger announcement." The price could, for example, be an average of the stock's price over the day or three days before the announcement is made. One court has suggested that a proper market price pre-merger could be determined by taking the "average of prices on the last trading day preceding announcement of the merger." *Levin v. Midland-Ross Corp.*, 194 A.2d 50, 53 (Del. Ch. 1963).

98. One could also consider modifying the provision to state that appraisal would be provided to dissenting shareholders of the surviving company unless the price of the stock after the merger announcement increased, in which case the shareholders would again be forced to sell on the market. This proposal would ensure that dissenting shareholders received *at least* "fair value" for their shares. The problem with this proposal is that dissenting shareholders are not supposed to receive any appreciation in value on account of merger from which they dissent; this proposal might allow them to receive a higher price than "fair value"; nonetheless, such a modification might reduce the possibility of corporations attempting to manipulate the stock price pre-merger announcement, and the modification might be less administratively burdensome than the proposed provision as written above.

convincing evidence⁹⁹ that a different price should be awarded in appraisal.¹⁰⁰ All costs of the appraisal proceeding, including attorney fees of the shareholder(s), shall be assessed against the corporation if the fair value of the shares, as determined by the court, exceeds the amount which the corporation offered to pay the shareholder. All costs of the appraisal proceeding, including attorney fees of the corporation, shall be assessed against the shareholder if the fair value of the shares, as determined by the court, is lower than the amount the corporation offered to pay the shareholder. A shareholder that exercises his appraisal right under this statute may not repurchase shares in the surviving corporation for 90 days.¹⁰¹

The remainder of Part IV examines this proposal's potential effectiveness. It first discusses the proposal's primary advantages and then examines potential problems that may arise if the proposal is enacted.

A. Advantages of Providing Appraisal with a
Presumption Regarding Fair Value

The proposed provision has advantages over both the status quo, in which the stock market exception eliminates appraisal, and over traditional appraisal proceedings. First, it makes more certain that dissenting shareholders of a publicly-traded company surviving a merger

99. The "clear and convincing evidence" burden of proof (the standard of proof in equity) is less onerous than the normal criminal standard of "proof beyond a reasonable doubt" and more onerous than the normal civil standard of "proof by a preponderance of the evidence."

100. In a traditional appraisal proceeding, "both sides have the burden of proving their respective valuation positions by a preponderance of the evidence." *Doft & Co. v. Travelocity.com Inc.*, C.A. No. 19734, 2004 Del. Ch. LEXIS 75, at *18 (Del. Ch. May 21, 2004). If neither party meets that burden, "[t]he court may exercise independent judgment to assess the fair value." *Id.* *But see* *Atl. States Constr., Inc. v. Beavers*, 314 S.E.2d 245, 249 (Ga. Ct. App. 1984) ("the initial burden of proof of 'fair value' rests with the corporation"). If, based on the proposed provision, the court makes a presumption that the price awarded in appraisal will be the price immediately before the merger announcement, a party will have to overcome that presumption to receive a different price.

101. The 90-day waiting period for repurchasing shares is meant to prevent a shareholder from "gaming" the statute by, first, exercising his appraisal right under the statute, receiving a higher price for his shares than the current price post-merger, and then, second, repurchasing shares in the corporation at the lower, current price immediately afterward, performing a sort of "appraisal" arbitrage.

receive “fair value” for their interest in the company. Second, it eliminates, in most cases, the relatively high costs associated with traditional appraisal proceedings by sharply reducing the likelihood that the matter will be litigated.

i. Advantage #1: Dissenting Shareholders Receive “Fair Value”

The most important advantage that this provision provides is that a surviving company’s dissenting shareholders would be more certain to receive “fair value” for their shares. As explained in Part III, currently in the 35 states in which the stock market exception exists, dissenting shareholders of the surviving company in a statutory merger may not be able to receive “fair value” because as soon as they know about the merger, the merger’s expected value has already been incorporated into the stock price, and for the surviving company’s shareholders this often means that the price of their shares has dropped. The proposed provision, on the other hand, would provide dissenting shareholders with the price of the stock immediately before the merger announcement, when the likelihood of the merger has not yet influenced the share price.

ii. Advantage #2: Efficient Pre-Appraisal Settlement

The provision’s second advantage is that it would strongly encourage pre-appraisal settlement. As a result, dissenting shareholders would not have to make a choice between enduring a traditional appraisal proceeding or selling on the market and receiving less than fair value. The provision encourages pre-appraisal settlement in three ways: (1) by increasing the predictability of the price to be awarded in appraisal; (2) by increasing the risks of undergoing an appraisal proceeding; and (3) by penalizing bad faith efforts to settle.

First, the provision encourages pre-appraisal settlement by increasing the predictability of the price to be awarded in appraisal. Under the provision, courts would presume that the price to be awarded in appraisal is the market price immediately preceding the merger announcement. Since the parties, to a high degree, could predict that this price would be the one awarded in appraisal, dissenting shareholders and the surviving companies would likely just settle¹⁰² at that price

102. It has been noted that pre-appraisal settlement is facilitated by mechanisms that encourage bargaining between the corporation and the dissenter. For example, all appraisal statutes require that the corporation and dissenting shareholders, before going

rather than endure appraisal proceedings.¹⁰³ As mentioned earlier, appraisal proceedings have frequently been criticized as time-consuming, costly, and unpredictable.¹⁰⁴

Second, the provision promotes pre-appraisal settlement by increasing the risks to both the company and the shareholder of choosing court appraisal over settlement. Under the provision, the losing party in the proceeding is assessed all the costs, including the other side's attorney fees. Both the company and the shareholder, faced with the prospect of paying the other side's legal costs, will be more inclined to act in good

to court, attempt to agree on a price. *Reconsideration*, *supra* note 39, at 1062.

103. See *Armstrong v. Marathon Oil Co.*, 513 N.E.2d 776, 787-88 (Ohio 1987) (explaining that if courts utilize the stock market price as the beginning point in valuing dissenting shares, they will allow parties to predict the outcome of the proceedings, making pre-appraisal a better alternative than litigation); *Reconsideration*, *supra* note 39, at 1061 ("If the appraisal statute is framed to encourage pre-appraisal settlement, and if the substantive factors used by appraisers to reach decisions are sufficiently clear to enable the parties reasonably to predict the outcomes, appraisal proceedings may rarely occur.").

In the circumstances where settlement does not occur, likely the corporation or dissenting shareholders will have sufficiently strong evidence that another price is more appropriate. In this case, the presumption will be overcome, but the court will have strong evidence from which to make its decision. Therefore, the appraisal proceeding should still be quicker and more predictable than traditional appraisal proceedings.

104. For example, Professor Schwenk outlines the problems through a succinct description of the process a court undertakes in such a proceeding.

The current standard requires trial courts to use any technique or method generally accepted by the financial community, allowing investment bankers and economists to use the most contemporary theories to assist courts in making valuation determinations. The result is proceedings directed entirely by expert witnesses, forcing courts to choose between two or more contradictory valuations with little legal guidance. A remedy created to facilitate shareholder exit at a fair price has become a time-consuming and expensive process filled with litigation risks and the concurrent possibility of harassment.

Schwenk, *supra* note 44, at 651. See also Manning, *supra* note 33, at 234 ("From the perspective of the company, these statutes can be a frightful nuisance, drain, and burden The corporate managers are as uncertain as the stockholders about the 'value' that will be assigned to each share by some appraiser or court six months after the transaction."); Seligman, *supra* note 16, at 830 (articulating that one reason for the low frequency of reported opinions on appraisal is "highly unpredictable standards for valuation, which make it difficult for either side in an appraisal proceeding to predict the outcome of the proceeding accurately."). See *Highfields Capital, Ltd. v. AXA Financial, Inc.*, 939 A.2d 34 (Del. Ch. 2007), for a recent example of a Delaware appraisal proceeding. It illustrates that the appraisal process remains long and uncertain.

faith to settle.¹⁰⁵

Third, in this same line, the provision encourages pre-appraisal settlement by discouraging companies from making bad faith offers and shareholders from bringing bad faith appraisal proceedings when the price offered by the company is reasonable. Many appraisal statutes provide that if a dissenter presents a claim in bad faith, the court can assess the full costs of the proceeding on him. Likewise, many appraisal statutes also provide that the court can assess the full costs on the corporation, which gives an incentive for the corporation to offer a fair settlement and avoid actions that might depress the stock price. The proposed provision takes this one step further by *mandating* that the court assess the costs of the proceeding on the losing party. For example, if the shareholder strongly believes the company has made a bad faith offer, such as if the company made an offer below the provision's presumed price without any apparent reason, he or she can bring an appraisal proceeding with the knowledge that the company will likely have to pay all the proceedings' costs. Additionally, the company can rest assured that if a shareholder brings a bad faith appraisal proceeding, the shareholder will have to pay all the proceedings' costs.¹⁰⁶

The fact that the provision promotes pre-appraisal settlement may also produce an additional advantage over traditional appraisal proceedings in that it may encourage shareholders who otherwise would not have exercised appraisal rights for fear of being enveloped in costly appraisal proceedings, to exercise their rights.¹⁰⁷ Shareholders fre-

105. See *Reconsideration*, *supra* note 39, at 1061.

106. This protects corporations from the threat of appraisal litigation by professional shareholders meaning to "hold-up" the corporation for increased leverage. See Manning, *supra* note 33, at 238 (providing an explanation of how a professional shareholder might abuse an appraisal statute to leverage a relatively small interest in the corporation).

107. Dissenting shareholders often do not exercise their appraisal rights because the cost of maintaining an appraisal action exceeds any benefit they might receive in terms of more accurately-valued shares. See, e.g., *Dun's Review*, Jan. 1975, at 64 ("The [appraisal] proceedings take years . . . and the investors do not even collect dividends while the appraisal is in the courts. Unless a shareholder has at least 20,000 shares, most attorneys believe it rarely pays off financially."); see also *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1297 n.4 (2d Cir. 1976) (Mansfield, J., concurring) ("In light of a variety of factors common to state appraisal laws, it is generally agreed that they provide an unrealistic remedy."); *Reconsideration*, *supra* note 39, at 1033 ("But it is not the small shareholder who is likely to exercise his appraisal right; rather, it is the

quently do not seek appraisal because of the costs; however, if there is a high likelihood of pre-appraisal settlement, more shareholders may choose the appraisal route with the expectation that the company will settle.

B. Two Scenarios where the Pre-Merger Announcement
Price would not be Fair Value

Though the proposed provision would encourage pre-appraisal settlement and would largely ensure that dissenting shareholders receive fair value for their shares, in at least two scenarios, the stock price immediately before the merger announcement would not be fair value. Dissenting shareholders would have to overcome the presumption in the provision to receive a different, more appropriate, price.

First, if the possibility of the merger leaks into the market before the official merger announcement, the leak of information would have an impact on the share price of the surviving company before the merger announcement, likely driving that price downward.¹⁰⁸ Therefore, dissenting shareholders would not receive fair value if the court awarded them the presumed price.

Second, if corporate insiders managed the company's affairs in a manner to depress the share price, such as by fraudulently delaying revenue recognition or waiting to disclose positive, material news until after the merger announcement,¹⁰⁹ the price of the shares before the merger announcement would not represent the "fair value" of those shares.¹¹⁰ For example, in *Berkowitz v. Power/Mate Corp.*, the insiders

larger shareholder who might have played an active role in the governance of the corporation.").

108. Companies have an incentive, however, to keep merger negotiations secret because if information leaks about a merger, such leakage may cause speculation in the market by investors, raise the share price of the company being absorbed, and provoke competing offers.

109. As a note, public companies have a *periodic*, not a continuous disclosure requirement. They are entitled to keep silent about both good or bad news unless positive law creates a duty to disclose, such as when a very significant event occurs that is required to be reported in a Form 8-K; that is, updates are due not when something material occurs, "but on the next prescribed filing date." *Gallagher v. Abbott Laboratories*, 269 F.3d 806 (7th Cir. 2001).

110. See *Wertheimer*, *supra* note 19, at 636 (discussing the potential that insiders may conduct corporate affairs in a manner that depresses share prices in the period leading up to a proposed merger).

timed a cash-out merger to take place before an improvement in operating results had been adequately disclosed to the public.¹¹¹ If dissenting shareholders sold their shares on the market after the merger announcement when the positive information had been disclosed, such a market price would still likely not be sufficiently high to be “fair value” as it would contain both the positive information that should have been disclosed before the merger announcement and the likely negative effects of the merger announcement itself on the share price.¹¹²

As a result of the possibility of these scenarios, the proposed provision only *presumes* that the price awarded in appraisal should be the price immediately before the merger announcement. Dissenting shareholders or the surviving company have the ability to challenge that price as inappropriate.¹¹³ Of course, either party would have to overcome a relatively high evidentiary hurdle to make the presumption fall out, but if there is, for example, clear evidence that information leaked to the public before the announcement, the dissenting shareholder would be able to overcome the presumption, receiving the market price

111. 342 A.2d 566, 573 (N.J. Super. Ct. Ch. Div. 1975).

112. If an appraisal right with the proposed price presumption was enacted, there is also the possibility that corporate officials would attempt to time a merger announcement so that it corresponds with a relatively low market price for the company. These officials would make the merger announcement when the stock is at a low in the hopes of reducing the amount dissenting shareholders receive under the proposed provision. Courts would be forced to presume, according to the proposed provision, that dissenting shareholders of the surviving entity should receive this “lower” market price. This scenario is relatively unlikely to occur, however, and even if it does occur, without manipulation of the market price, it is unclear that such an action would be unfair to dissenting shareholders. To begin, it is highly unlikely that corporate insiders would attempt to speed up or slow down a merger announcement for the sole purpose of timing it to correspond to a relatively low market price. In fact, in a share-for-share transaction, corporate insiders are likely to push to raise the share price so that the shareholders of the company being absorbed receive less of an interest in the surviving corporation; it has been argued, though, that “[t]he ability of insiders to time a transaction to their benefit counsels against reliance on market price in an appraisal proceeding.” Wertheimer, *supra* note 19, at 636. Even so, it is unclear that if insiders timed the transaction to correspond with a low market price, assuming no manipulation, that such timing would actually hurt dissenting shareholders since they still would be awarded the unadulterated market price.

113. See *Reconsideration*, *supra* note 39, at 1062-63 (“One way of clarifying the substantive law of appraisal in the context of widely traded stocks is . . . to place a presumption of accuracy on the market price and to allow the dissenter to show what special factors, if any, distorted the accuracy of the market valuation.”).

before that information leaked.

C. A Response to the Cash Flow Argument for
Retaining the Stock Market Exception

One criticism that may be leveled against the proposed appraisal provision is that it protects the company's cash reserves less than the stock market exception.¹¹⁴ If shareholders sell their shares on the market in dissent from a merger, the company's cash position will be unaffected; on the other hand, if those same shareholders seek appraisal instead, the company will have to payout a "sudden and largely unpredictable" amount of cash.¹¹⁵

This concern, however, is less problematic than it appears. First, if a strong presumption exists that the price awarded in appraisal will be the price immediately before the merger announcement, then a surviving company would not need to worry about an *unpredictable* drain on cash. Shareholders are required to give notice that they are dissenting under all state appraisal statutes¹¹⁶ and the likely price to be awarded by the court would be the presumed price. This means the company would be able to figure out precisely how much cash it would need to pay dissenting shareholders in appraisal.

More importantly, the company could, at the same time it acquires the dissenters' shares in appraisal, issue the same number of new shares.¹¹⁷ As a result, the company's cash reserves would decrease only by the number of dissenting shares multiplied by the differential between the post-merger announcement share price and the pre-merger announcement share price. In this way, the company could minimize the cash drain while maintaining the same number of outstanding shares.¹¹⁸

114. See *supra* Part II.c.ii (explaining that one of the rationales behind the stock market exception is to limit corporate cash drain).

115. Manning, *supra* note 33, at 234.

116. See, e.g., DEL. CODE ANN. tit. 8, § 262(d)(1) (2010).

117. The company could also issue more new shares, if needed, to cover the differential, but this would dilute the interests of current owners.

118. In a similar vein, it has been proposed that the appraisal statute be amended to force dissenting shareholders to sell their shares in the market but then allow them to seek the difference between the market price received and the price they would have received in appraisal. Such an amendment, though it would require an additional change to appraisal statutes, might be even more effective than if the company issued new shares to compensate for the loss of cash. Once such an amendment was passed, it

CONCLUSION

Under some circumstances, the stock market exception causes dissenting shareholders of a company surviving a merger to receive less than fair value for their shares. While this may occur only in a concentrated number of transactions in states such as Delaware where appraisal only applies to mergers, it may occur more frequently in states where appraisal rights are more broadly applied to transactions.

To ensure these dissenting shareholders receive fair value, legislatures should enact a provision eliminating the stock market exception when shareholders of publicly-traded, surviving companies dissent from a statutory merger.¹¹⁹ The provision would require courts to presume that the price to be awarded in appraisal is the price immediately before the merger announcement. Such a provision would serve the principal purpose behind appraisal rights by protecting dissenting minority stockholders from receiving less than fair value for their shares.¹²⁰ The proposed provision also strongly encourages pre-appraisal settlement, greatly reducing the possibility of unpredictable, time-consuming appraisal proceedings.

Finally, the foregoing analysis illustrates the inherent conceptual problems that exist as a result of the stock market exception and the

would be easier for companies to force shareholders to sell on the market than for the companies to issue new shares. Furthermore, it would provide additional benefits like ensuring that shareholder investment would not be tied up throughout the appraisal proceeding. *Reconsideration, supra* note 39, at 1035.

Current appraisal statutes require the corporation to pay in cash the full appraised value of the dissenters' shares. This procedure could be amended to give the corporation the power to demand that the dissenters sell their shares on the market, with the corporation paying only the difference between the appraised value of the shares and the market price realized on the sale. Such an amendment would produce several benefits. The smaller cash payment would reduce any cash-flow problems faced by the corporation and thereby lessen the inhibiting effect of the appraisal right on managerial decision-making. Moreover, since a dissenter might sell his shares immediately, his entire investment would not be tied up for the duration of the appraisal proceeding. Finally, and perhaps most importantly, the amended procedure would reduce the leverage of dissenting shareholders and, consequently, the incidence of vexatious suits.

Id.

119. This provision is only a model and could also be expanded to apply to other appraisal-triggering transactions in states that provide appraisal rights under more circumstances than Delaware.

120. See Ratway, *supra* note 3, at 205.

timing of information to public shareholders. Other countries that have adopted or are considering adopting Delaware-style appraisal rights should consider the consequences of a stock market exception for dissenting shareholders of publicly-traded companies. This is especially true because the problem caused by the stock market exception may be greater in foreign countries where appraisal rights are more expansive¹²¹ or where certain transactions, such as triangular mergers, are prohibited.¹²²

121. For example, China recently amended its company law to include appraisal rights for minority shareholders. Appraisal rights can be exercised by minority shareholders under three circumstances. First, any shareholder who casts a negative vote against a resolution may require the company to purchase his stock ownership at a reasonable price. Second, if the company is profitable for five consecutive years but fails to distribute any profits, shareholders may seek appraisal. Finally, where the company merges or divides or transfers its substantial assets, shareholders can exercise their appraisal rights. Currently, though, China has not adopted a stock market exception. 2006 Amendments to the PRC Company Law, Article 75.

122. Triangular mergers are currently prohibited in many countries, including Germany and China.