2022

Shareholder Appraisal Rights: Delaware's Flawed Market-Out Exception

Lin (Lynn) Bai
University of Cincinnati College of Law, lin.bai@uc.edu

William A. Murphy
University of Cincinnati College of Law, murphywi@mail.uc.edu

Shareholder Appraisal Rights: Delaware's Flawed Market-Out Exception

Lynn Bai[*] and William A. Murphy*

Historically, certain corporate transactions such as mergers and acquisitions required unanimous shareholder approval. The requirement effectively gave shareholders the power to veto highly valuable transactions.[1] Modern-day corporate statutes lower that requirement to an affirmative vote by a majority or supermajority of shareholders.[2]

When a merger is ultimately approved, shareholders sell their shares to the acquirer for cash, securities, or any combination of the two. Section 262(a) of the Delaware General Corporation Law ("DGCL") allows dissenting shareholders, who believe their shares are undervalued in the deal, to obtain an appraisal at court. The appraised value will be paid in cash, providing liquidity to shareholders when the merger consideration is in whole or part securities that do not have a ready market.

The Market-Out Exception

Appraisal rights are not absolute. A market-out exception, now adopted in most jurisdictions, was first enacted by Delaware in 1967. With varying specifics, the market-out exception denies appraisal rights to shareholders of public companies. Delaware, for example, does not extend appraisal rights to any class of stock listed on a national exchange or held of record by at least 2,000 shareholders.[3] When a stock is listed on a national exchange, appraisal is believed unnecessary because a fair, efficient, and liquid market already exists. Shareholders who are displeased with the merger compensation can sell their shares in the open market conveniently and receive fair market values without delay.[4] In addition, public companies are subject to the periodic reporting requirements of the Securities Exchange Act of 1934, so information about their operations and financial conditions are readily available.[5] Reporting supposedly provides shareholders with the information needed to value their shares and hence obviates the need for a court-determined fair value. Since private companies with 2,000 or more shareholders are subject to the same periodic reporting, their shareholders are also denied an appraisal right under Delaware's market-out exception. Information asymmetry in nonreporting companies was a justification acknowledged by Delaware for appraisal.[6]

---

[*] Lynn Bai is Professor of Law at University of Cincinnati College of Law; William A. Murphy is a J.D. candidate (2023) at the University of Cincinnati College of Law.

[1] CLAIRE A. HILL ET AL., MERGERS & ACQUISITIONS LAW, THEORY, AND PRACTICE, 63 (2nd ed. 2019).

[2] DEL. CODE ANN. tit. 8, § 251(c) (2020).

[3] DEL. CODE ANN. tit. 8, § 262(b)(1) (2020).

[4] HILL ET AL., *supra* note 1, at 73. *See also* Jeff Goetz, *A Dissent Dampened by Timing: How the Stock Market Exception Systematically Deprives Public Shareholders of Fair Value*, 15 Fordham J. of Fin. and Corp. L. 771, 777-79 (2009).

[5] Securities Exchange Act of 1934 §12(a), 15 U.S.C. § 78m.

[6] Samuel Arsht and Walter Stapleton, *Analysis of the New Delaware Corporation Law,* p. 341 (1967).

The Model Business Corporation Act ("MBCA") includes a market-out provision that offers considerably more protection to shareholders. The MBCA only denies appraisal rights for shares that are traded in an organized market, have at least a $20 million market capitalization, *and* have at least 2,000 record shareholders.[7] The MBCA upholds shareholders' appraisal rights if the company is a private company, regardless of how many shareholders the company has.

The presumption that the market price reflects the true value of shares has been challenged where a conflict of interest exists. For example, prior to a management-led buyout, management may elect to downplay financial projections or delay valuable investments until after the deal is effective, suppressing the share value. Although insider trading restrictions prevent the most egregious forms of this kind of opportunism, management may be able to take advantage of smaller pieces of nonpublic information, which individually do not meet the test for materiality, but collectively give the management greater insight than the public minority shareholders about the intrinsic value of the company. Management can maximize the effect of information asymmetries by executing a freeze-out at a time it perceives the market price is less than the company's true value. Academic research has found a correlation between management-led buyouts and measures that reduce the apparent performance of a company during periods before the announcement of the buyout.[8]

Three Categories of the Market-Out Exception

States' various market-out provisions can be divided into three categories. Eleven states deny appraisal rights to shareholders of public companies, full-stop, ignoring the concern about inadequate market prices in interested transactions.[9] Fourteen states follow the MBCA; they permit appraisal where shareholders receive anything other than cash or stocks of public corporations to compensate for the illiquidity. Appraisal is likewise permitted in interested transactions, regardless of the merger consideration.[10] Interested transactions are those involving anyone who owns 20% or more of voting shares, has the power to elect 25% or more of directors to the board, or is a senior director or executive of the company or its affiliates.[11] The MBCA's provision on interested transactions acknowledges that these deals may be subject to influences where a corporation's management, controlling shareholders or directors have conflicting interests that could, if not dealt with appropriately, adversely affect the consideration that otherwise could have been expected. Thirteen states, including Delaware, deny appraisal to shareholders that receive shares of a public company in a stock-for-stock transaction, but allow appraisal rights if such holders receive cash or debt.[12]

[7] MODEL BUS. CORP. ACT § 13.02 (AM. BAR ASS'N 2021).
[8] *In re Dole Food,* 2015 WL 5052214 (Del. Ch. 2015). *See also* Guhan Subramanian *DEAL PROCESS DESIGN IN MANAGEMENT BUYOUTS*, 130 HARV. L. REV., 590-658, at 618 (2016).
[9] Gil Matthews, *The "Market Exception" in Appraisal Statutes*, HARV. L. SCH. F. CORP. GOVERNANCE (Mar. 30, 2020), https://corpgov.law.harvard.edu/2020/03/30/the-market-exception-in-appraisal-statues/#:~:text=First%2C%2011%20states%20have%20virtually,shareholders%20of%20publicly%20traded%20companies.
[10] Id.
[11] MODEL BUS. CORP. ACT § 13.01(b) (AM. BAR ASS'N 2021).
[12] DEL. CODE ANN. tit. 8, § 262(b)(2) (2020).

Delaware's Failure to Address Concerns of Inadequate Market Prices

Delaware's approach is perplexing. Restoring appraisal for shareholders of public companies who receive cash does not fully address the primary challenge to the market-out exception, i.e., inadequate market prices due to information asymmetry in interested transactions. The following example illustrates the problem:

> Jerry owns 1 million shares of ABC Corp., whose shares are publicly traded on the New York Stock Exchange for $20 per share. The company's controlling shareholder is XYZ Corp., which is also a public company whose shares are trading at $24 per share. XYZ nominates the majority of ABC's board of directors. XYZ proposes to acquire the shares from Jerry and other minority shareholders at the price of $24 per share. Although this price is at a 20% premium to ABC's current market price, it is much lower than $30 per share immediately before ABC's board gave a pessimistic projection of the company's growth potential about a month ago. Jerry suspects that the ABC board deliberately painted a gloomy picture to suppress the market price before the buyout. If his suspicion is true, Jerry is under-compensated by $6 per share, regardless of the form of the buyout compensation: If the buyout is paid in cash, Jerry is paid only $24 million instead of $30 million; if the buyout is through a 1-1 share exchange, Jerry receives only 1 million XYZ shares instead of 1.25 million. However, Delaware grants appraisal if Jerry receives cash and denies appraisal if Jerry receives shares.

The official commentary and legislative history of the DGCL fail to provide any justification for the above differential treatment. Moreover, if the goal of appraisal is to give dissenting shareholders a fair value in cash, so they are not forced to take the shares of the surviving or another entity, then Delaware seems backwards. In a clear contrast to Delaware's baffling inversion, the MBCA permits appraisal when shareholders receive anything other than cash or publicly traded stocks, catering to shareholders' need for liquidity when merger considerations include shares that do not have a ready market.

How Should Delaware Change?

Delaware could revise its market-out provision by eliminating the confusing exceptions contained in DGCL 262(b)(2) entirely, following the other eleven states in simply denying appraisal in public companies as opposed to the heightened protection of the MBCA. Proponents of this approach would argue that shareholders of Delaware companies enjoy common law-derived protections from the types of conflicts of interest identified by the MBCA. Pragmatically, that argument is unconvincing.

Revlon duties imposed by the Delaware court on directors of for-sale companies require them to seek the highest available price;[13] arguably, any latent value of the company would be revealed

[13] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

through due diligence by third-party bidders. However, third parties may be reluctant to bid against insider directors or controlling shareholders for fear of the winner's curse: that is if a third-party is able to outbid insiders, it is probably overpaying. The deterrence effect is exacerbated where a deal includes a right of first refusal. If insiders refuse to match an outside bid, the bid is likely too high.[14]

Directors have a fiduciary duty to act in the best interest of shareholders. Shareholders maintain their standing to sue for any fiduciary breach that is related to the merger even though they stop being shareholders after the merger is consummated.[15] Where the merger involves a potential conflict of interest, and in absence of procedural safeguards such as the approval by both an independent special committee and the majority of disinterested shareholders, directors must satisfy the entire fairness test that includes fair price and fair dealing.[16] Although the fair price standard serves a similar purpose to appraisal, shareholders must overcome the double hurdle of heightened pleading requirements and difficulty in gathering corporate information. For example, to bring an action under *Revlon*, plaintiffs must plead in sufficient specificity making it reasonably conceivable that directors ignored their Revlon duties.[17] Minority investors often lack the information to plead those facts. If a shareholder wants to inspect corporate books to find the necessary facts, they must provide a "credible basis" that permits an inference of mismanagement; mere suspicion of wrongdoing is insufficient.[18] So, Delaware requires shareholders to show specific facts to plead the directors' breach, while requiring evidence of the breach to reach those facts. This circular relationship means that a fiduciary breach claim is often beyond the reach of dissenting shareholders. Thus, granting shareholders appraisal rights in interested transactions (as the MBCA already does) when the market price may be artificially suppressed by management or controlling shareholders helps minority shareholders get fair compensation for their investments without jumping inhibitive procedural hurdles.

In sum, Delaware's market-out exception and its "exceptions to the market-out exception" appear flawed in logic and inadequate in protecting dissenting shareholders in interested transactions. The MBCA's approach provides a better liquidity to shareholders and safeguards their interests when the market is susceptible to the management's chicanery. It is time for Delaware to follow the lead of the MBCA in crafting a more sensible market-out exception to appraisal.

[14] Subramanian, *supra* note 8 at 614.
[15] *Lewis v. Anderson*, 477 A.2d 1040, 1046 (Del. 1984).
[16] *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
[17] *Houseman v. Sagerman, C.A. No. 8898-VCG*, 2014 WL 1478511 (Del. Ch. Apr. 16, 2014).
[18] *Seinfield v. Verizon Commc'ns, Inc.*, 909 A.2d 117 (Del. 2007).