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# The High Cost of Fewer Appraisal Claims in 2017: Premia Down, Agency Costs Up

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Abstract

This Article considers the preliminary results of an ongoing effort to discourage appraisal litigation. Since the August 2016 reforms to the Delaware appraisal statute, Chancery has issued a slew of at-or-below merger price appraisal opinions in cases such as *Clearwire* and *PetSmart*, while simultaneously pinioning fiduciary litigation by reiterating the principles of *Corwin*. The result—as one would expect when costs are raised and benefits are reduced—has been that fewer deals are being challenged via appraisal: In 1H 2017, the number of deals challenged fell by 33%. Those who successfully advocated for curbs on the practice had argued that appraisal claims lowered deal premia by incenting buyers to withhold top dollar, thereby hurting non-appraising shareholders. On their view, curtailment of appraisal should have sent premia upwards. But year-to-date the average U.S. target premium of 22.4% is the lowest of any year in recent history. The average target premium in 2Q 2017 of 19.3% was the single-lowest of the fifty prior quarterly observations; thus far, 3Q 2017, at 19.6%, is tracking as the second-lowest. Amid the pronounced decline in merger premia, change-in-control payouts have expanded as a percentage of transaction value. When analyzed in concert with other measures indicative of agent rent-seeking—such as target premium to 52-week high over varying periods—the evidence points to a substantial transfer of value from target shareholders to selling chief executive officers (CEOs), who have adapted to an environment rendered more permissive by the weakening of the shareholder litigation "check" that had formerly restrained such behavior.

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## I. As Shareholder Litigation Weakens, M&A Premiums Fall

It has been a year since the August 2016 reforms to the Delaware appraisal statute—intended to make appraisal less economically attractive[1]—took effect. Over that period, Chancery has further clamped down on shareholder litigation using a two-pronged approach. It has issued a slew of at-or-below merger price appraisal opinions in cases such as *Clearwire*[2] and *PetSmart*,[3] while simultaneously pinioning fiduciary litigation by reiterating the principles of *Corwin*[4]—a 2015 decision that limited the number of transactions subject to enhanced scrutiny under *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*[5]—in cases such as *Singh v. Attenborough*[6] (May 2016), *In re OM Group, Inc. Stockholders Litig.*[7] (October 2016), and *In re Volcano Corp. Stockholders Litig.*[8] (June 2016).[9]

The result—as one would expect when costs are raised and benefits are reduced—has been that fewer deals are being challenged via appraisal. During the first half of 2017, eighteen deals were challenged, one-third fewer than the twenty-seven challenged during the same period in 2016.[10] One might argue that a year-over-year decline in M&A is responsible for the fall—but this seems a bit beside the point given that the 33% year-over-year *contraction* in such claims (from twenty-seven to eighteen) during the first half of 2017 compares to a more than 20% annual growth rate from 2013 to 2016.[11] To be sure, M&A volume is down in 1H 2017. But declines in M&A volume had not tempered appraisal claims in recent years. Namely, in 1H 2016, M&A was also down,[12] but the number of deals challenged grew by 42%.

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[1] Guhan Subramanian, *Using the Deal Price for Determining "Fair Value" in Appraisal Proceedings* (February 6, 2017 draft), *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? (U. Chi. Press 2017).

[2] ACP Master, Ltd. v. Sprint Corp., Nos. 8508-VCL, 9042-VCL, 2017 Del. Ch. LEXIS 125 (Ch. July 21, 2017).

[3] In re PetSmart, Inc., No. 10782-VCS, 2017 Del. Ch. LEXIS 89 (Ch. May 26, 2017).

[4] Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015).

[5] 506 A.2d 173 (Del. 1986).

[6] 137 A.3d 151 (Del. 2016).

[7] 2016 Del. Ch. LEXIS 155 (Ch. Oct. 12, 2016).

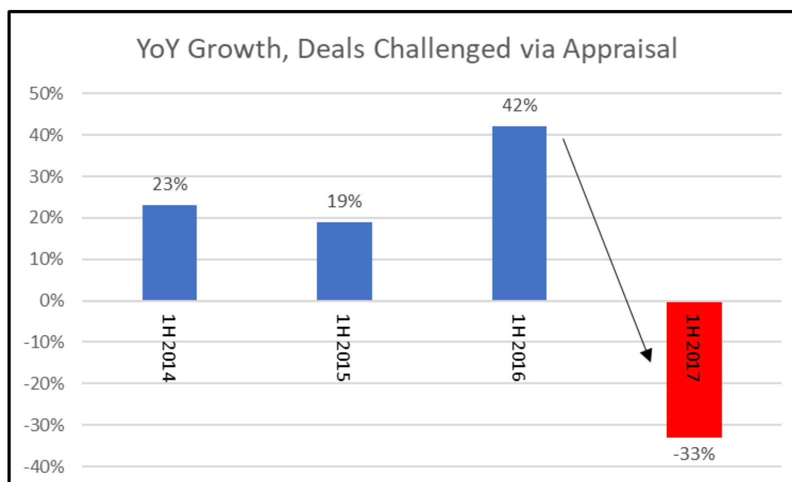
[8] 143 A.3d 727 (Del. Ch. 2016).

[9] Steven M. Haas, *The* Corwin *Effect: Stockholder Approval of M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Feb. 21, 2017), https://corpgov.law.harvard.edu/2017/02/21/the-corwin-effect-stockholder-approval-of-ma-transactions/.

[10] Berton Ashman Jr., Christopher Kelly & Mathew Golden, *Appraisal Practice Tips 1 Year After Prepayment Amendment*, LAW360 (July 31, 2017, 10:44 AM), https://www.law360.com/articles/944765?utm_source=rss&utm_medium=rss&utm_campaign=articles_search.

[11] *Id.*

[12] Market Data, BLOOMBERG (Bloomberg Terminal, 'MA' Function, select 12-Year Trailing Quarterly U.S. M&A Transaction Data, narrow by Transactions >$1 billion USD), (last searched Aug. 9, 2017).




So what has happened to deal premia? Those seeking curtailment of the appraisal remedy in Delaware argued that the presence of appraisal-seeking holdouts induces buyers to withhold top dollar, thereby harming non-appraising shareholders. That is, acquirers would maintain dry powder *ex ante* for payments to purported rent-seekers in the form of appraisal arbitrageurs *ex post*. In the words of one highly respected deal lawyer: "This [appraisal] risk is one that troubles buyers of Delaware companies (especially private equity firms), preventing them from paying the highest prices they can pay . . . ."[13] On their view, curtailment of appraisal should have sent premia upwards as buyers used more of their powder for bids.

But year-to-date the average U.S. target premium of 22.4% is the lowest of any year since at least 2005.[14] In fact, the target premium in 2Q 2017 of 19.3% was the single lowest of the fifty quarterly observations dating to 1Q 2005.[15] What is more, if the quarter to date average premium for 3Q 2017 holds, it will be the second-lowest quarterly observation since at least 2005 at 19.6%.[16]

The devil's advocate might say that flagging premia for target shareholders in 2017 can be attributed to the late-cycle nature of the current expansion and already-inflated equity valuations. That may be correct, although 2015 and 2016 could have been described similarly, and even 2007—the archetypal late-cycle sample—yielded an average premium of 26%, about 360bps better for target shareholders.[17]

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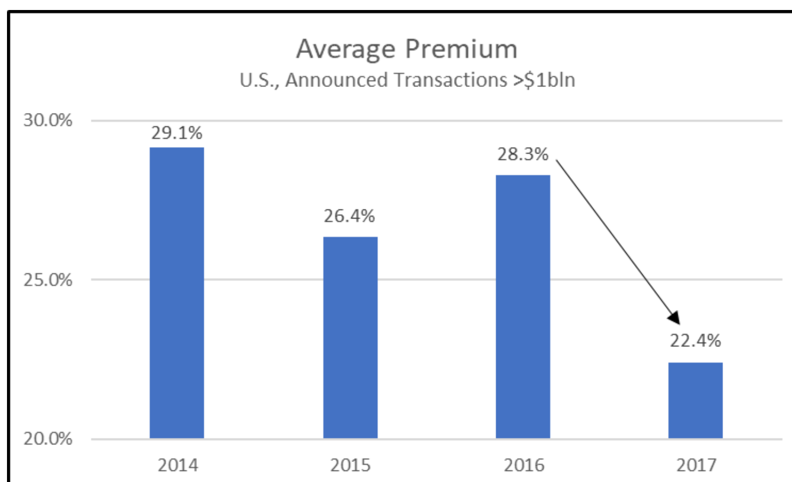
[13] Trevor Norwitz, *A Debate: Is the Appraisal Rights Remedy in Need of Repair?*, Remarks at the Delaware Business Law Forum (Nov. 2016) (transcript available at https://www.americanbar.org/publications/blt/2017/01/03_norwitz.html).

[14] Market Data, BLOOMBERG (Bloomberg Terminal, 'MA' Function, select 12-Year Trailing U.S. M&A Transaction Data, narrow by Transactions >$1 billion USD) (last searched Aug. 9, 2017).

[15] *Id.*

[16] *Id.*

[17] *Id.*




## II. Parachutes Trump Paranoia

CEOs typically have substantially lower personal reservation prices in sell-side M&A than do their respective disinterested minority shareholders. This reservation price disparity stems not only from CEOs' ability to internalize 100% of their change-in-control package (CIC) while externalizing most "costs" of a lower transaction price, but also from any additional rents they are able to extract—via transaction-related bonuses or *ex post* parachute augmentations—at the expense of disinterested shareholders. The threat of appraisal, and resultant discovery, can serve as a check on such rent-seeking value transfers.[18]

Amid the recent enfeeblement of germane shareholder litigation, it is perhaps not surprising then that as premia have fallen, parachutes and related bonuses have burgeoned. In 1H 2017, the average named executive officer's (NEO) CIC, or "golden parachute," in deals substantial enough to warrant an Institutional Shareholder Services (ISS) recommendation, was 2.1% of transaction equity value, up 52% from its 2012-2016 average of 1.36%.[19] And it does not appear that a handful of outlier transactions are responsible for the surge—the median 1H 2017 parachute was 1.83% of transaction value, nearly triple the 2012 to 2016 median of 0.69%.[20]

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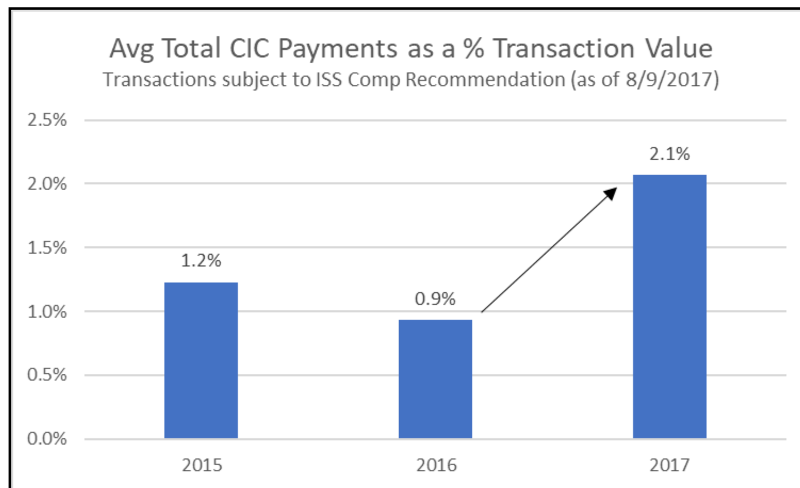
[18] *See* Albert H. Choi and Eric L. Talley, *Appraising the "Merger Price" Appraisal Rule* (Va. L. and Econ. Research Paper No. 2017-01, 2017), https://ssrn.com/abstract=2888420.

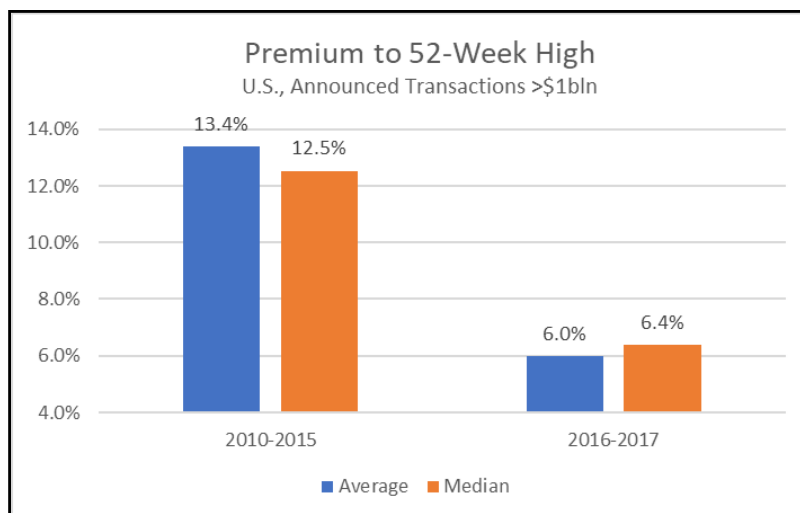
[19] ISS, Advisory Votes on Golden Parachutes (Aug. 9, 2017) (on file with author).

[20] *Id.*




Perhaps the best way to measure the impact of this rent-seeking, from shareholders' perspective, is via target M&A premium to trailing 52-week high. This measure is better suited to gauge the value siphoned off by rent-seeking—versus simple pre-announcement, T-1, premium—because it tends to eliminate noise engendered by CEOs "talking-down" share prices, or "sandbagging," ahead of deal announcement to "create space" for an acceptable T-1 premium, and thus avail themselves of CIC payouts.

Per the figure below, from 2010 to 2015, the average and median premium to 52-week high were 13.4% and 12.5%, respectively[21]—but since 2016, as shareholders' ability to challenge transactions waned, the average and median premium to 52-week high have dropped to 6.0% and 6.4%, respectively[22]:




[21] *See* BLOOMBERG, *supra* note 12.
[22] *Id.*

The notion that CEOs—when afforded the opportunity—will sacrifice merger premia to secure parachute payouts is not a novel one. A study of 851 acquisitions from 1999 to 2007 found that:

> A 1-standard-deviation increase in parachute importance [relative size] raises the probability of merger completion by 6.9 percentage points but lowers the takeover premium by 2.6 percentage points. . . . Our results are consistent with the following interpretation: As the importance of the parachute to target CEOs increases, they negotiate an offer up to their own *reservation premium* . . . .[23]

The fact that this underlying tendency has recently shifted into overdrive—and adopted a more value-destructive form[24]—isn't probative of unique avarice among today's CEOs. They are simply rational actors adapting to an environment rendered more permissive by the weakening of the shareholder litigation "check" that had formerly restrained such behavior.

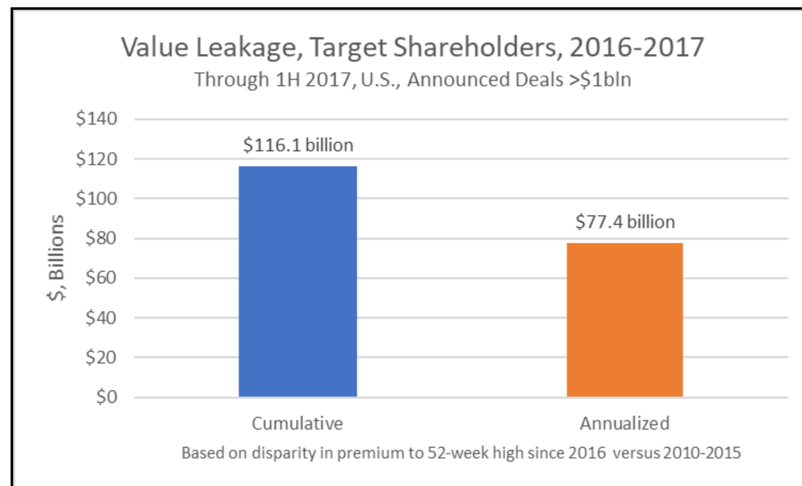
## III. A Billion Here, a Billion There, and Pretty Soon You're Talking Real Money

Had the average premium to 52-week high remained at historical norms since 2016, target shareholders would have received an additional $116.1 billion in cumulative merger consideration, or an additional $77.4 billion per year on an annualized basis[25]:

[23] Eliezer M. Fich, Anh L. Tran & Ralph A. Walkling, *On the Importance of Golden Parachutes*, 48 J. OF FIN. AND QUANTITATIVE ANALYSIS 1717, 1719–20 (2013).

[24] Fich et al. found that the increased implied probability of completion engendered by increased relative parachute importance roughly offset the decline in premium, on a net basis, from the standpoint of target shareholders on an *ex ante* "unaffected" price basis. *Id.* Two key differences today, among others, are: 1) T-1 premiums have dipped substantially, decreasing the probability-adjusted expected value of completion, assuming T-1 to be "unaffected," and 2) Premium to 52-week high data has dipped even more markedly, undermining the credibility of T-1 as a genuine proxy for "unaffected." *Id.*

[25] *See* BLOOMBERG, *supra* note 12 (calculating the product of average premium differential of 2010 to 2015 vs. 2016 to 1H 2017, and volume of M&A subset during latter period).




It is important to note that CEO rent-seeking need not necessarily involve an explicit "bribe" or *quid pro quo* via transaction bonus or continuing employment. For CEOs with relatively substantial CICs, this prospective payout may not require additional "sweeteners" to incentivize the pursuit of a value-destructive sale, at least from the perspective of the disinterested shareholder.

Granted, this temptation to "cash-in" by consummating even a below-fair-value sale might be tempered by the monitoring capabilities of independent members of a respective firm's board of directors. Unfortunately, there is compelling evidence that even this restraint has been substantially eroded.[26]

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[26] A recent study finds that boards' monitoring capabilities may have been eroded by attempts to strengthen them in the aftermath of Sarbanes-Oxley. *See* Michelle L. Zorn, Christine Shropshire, John A. Martin, James G. Combs, & David J. Ketchen, Jr., *Home Alone: The Effects of Lone-Insider Boards on CEO Pay, Financial Misconduct, and Firm Performance*, Strategic Mgmt. J. (2017). To summarize some of the study's key points: One of the tenets of post-Sarbanes effort was pressuring companies to jettison insiders from the boardroom and replace them with independent directors. As a result, most companies in the S&P 1500 are now overseen by "lone-insider" boards, in which the CEO is the only executive director. Lone-insider boards hamper the monitoring capabilities of independent board members by a) restricting their access to critical information given that the lone-insider CEO is generally their only well-informed source and such dissemination is implicitly tainted by self-interest, and b) limiting their ability to find viable internal CEO succession options. The result of this diminished oversight is rent-seeking and underperformance: Per the study, Lone-insider CEOs are paid 81% more than their non-lone-insider peers while "firms with lone-insider boards have net incomes approximately $54 million less, on average, than non-lone-insider firms, given the mean net income of $544 million in [the] sample." *Id.* As it relates to the subject matter at hand, it seems quixotic to believe that the same rent-seeking and value destruction doesn't extend itself to M&A when these same firms put themselves up for sale. Nearly three-quarters of the companies that sold themselves in 1H 2017 were overseen by "lone-insider" CEOs. In fact, a prospective sale is likely far more challenging from an oversight perspective. To check prospectively perverse incentives engendered by CICs, setting a reservation price *ex ante* is crucial. But any such *ex ante* valuation would stem directly from financial forecasts crafted by the "lone-insider" CEO. Given the CEO's considerably deeper knowledge of the business, it is difficult for independent directors to credibly challenge such projections. Furthermore, the CEO maintains considerable optionality to revise such forecasts downward during the pendency of the sales process to justify a lower reservation price, *ex post*, if needed, given such revisions will be equally inscrutable.

## IV. (Re)Defining the "Self-Interested" Transaction: Reasonable Person Test

Considering the accelerating imbalances delineated above, it may be worth re-evaluating the definitional lens of the "self-interested" transaction.

Private equity firm Lone Star's acquisition of DFC Global could be considered an archetype of the pristine sales process.[27] In its ruling on the appraisal action which followed the DFC Global sale, the Chancery Court noted, "The deal did not involve the potential conflicts of interest inherent in a management buyout or negotiations to retain existing management—indeed, Lone Star took the opposite approach, replacing most key executives."[28] On appeal, the Delaware Supreme Court remarked that "[t]here was no hint of self-interest that compromised the market check."[29]

Now, for a moment, consider the lens of DFC Global's then-CEO—who stood to receive a $17.1 million golden parachute payout,[30] more than 1,200% his trailing-twelve-month cash compensation,[31] but only if a sale of the company was consummated. The size of his payout varied little based on the price at which the company was sold—just 21% of the parachute was equity-derived and thus sensitive to transaction price; the remaining 79%, or $13.5 million, consisted of direct cash severance[32]—but it disappeared entirely if he failed to consummate a sale. He presumably had a prominent role in deciding upon an implicitly evolving reservation price during the pendency of the sales process—which lasted two years[33] and which could continue only based on the prospect of exceeding that very reservation price.

Would a reasonable person believe this process to have been devoid of self-interest?

Amid weakened shareholder litigation, dipping premia, and ever-larger parachutes, this question should no longer be confined to management buyouts and controlling-shareholder squeeze-outs. Indeed, even the "pristine" might be fair game.

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[27] In re Appraisal of DFC Glob. Corp., 2016 WL 3753123, at *21 (Del. Ch. 2016).
[28] *Id.*
[29] DFC Glob. Corp. v. Muirfield Value Partners, L.P., 2017 WL 3261190, at *1 (Del. 2017).
[30] DFC Glob. Corp., Merger Proxy Statement (Form DEFM14A) (May 1, 2014).
[31] DFC Glob. Corp., Proxy Statement (Form DEF 14A) (Oct. 7, 2013).
[32] *See* Merger Proxy Statement, *supra* note 30.
[33] *Id.*