

## INTEREST IN APPRAISAL

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Draft of March 2016

*forthcoming* 42 J. Corp. L. \_\_ (2016)

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The interest rate awarded to appraisal petitioners has recently become a surprising source of controversy. Since 2007, Delaware has presumptively awarded dissenting stockholders prejudgment interest at a rate equal to 5% above the prevailing federal funds rate. In other work, we have documented a marked increase in appraisal activity that began in 2011. Despite evidence that petitioners target low-premium transactions and insider privatizations, some practitioner and judicial commentary has suggested that the statutory interest regime may be driving this increase. In 2015, Delaware's blue-ribbon corporate law Council proposed a sensible amendment to the statutory interest regime, but it languished through one legislative session, and the issue is again poised for reconsideration.

Selecting the appropriate interest rate is a complex and under-examined issue in the optimal design of legal remedies. We argue that the primary goal of interest in appraisal—or any form of prejudgment interest—is to make parties to the dispute indifferent to the passage of time, with no incentive either to drag out or cut short the proceeding. We propose an interest rate regime that builds upon the 2015 Council proposal and promotes time-indifference and dispute resolution. Like the Council, we argue that the respondent companies should be given a unilateral option to make an initial payment to dissenting stockholders that would stop the running of interest on the amount paid. To preserve balanced risk for both sides, the initial payment should not constitute a concession about the minimum amount of fair value, and companies should be entitled to recover from petitioners if the trial judgment is lower than the initial payment.

We propose two additional and important features: First, the right to make such a payment to dissenting stockholders should be limited to a discrete 30-day window following the close of the transaction. This ensures that the prepayment right furthers time indifference and is not just a tool of tactical gamesmanship. Second, the prevailing interest rate should be equal to the target company's weighted average cost of capital. This would have beneficial effects on both parties: it would make the surviving company indifferent between paying the fair value after judgment and making an initial payment, and it would also encourage dissenters to be reasonable about litigating in hopes of obtaining more than the initial payment.

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## INTRODUCTION

Over the past five years, Delaware has experienced a substantial rise in the exercise of appraisal rights.<sup>1</sup> This longstanding statutory remedy allows minority stockholders to dissent from a merger transaction, reject the proffered merger consideration, and instead institute a proceeding in the Delaware Court of Chancery to determine the fair value of the stockholder's shares.<sup>2</sup> While we have argued that this rise in appraisal litigation is a positive development, it has sparked a backlash among an influential group of deal advisers and defendants. Citing danger to the deal market, these critics of appraisal have sought drastic changes in Delaware's appraisal statute designed to curtail the ability of minority shareholders to pursue the appraisal remedy.

One unlikely flashpoint in the battle over appraisal is the statutory interest rate awarded to petitioners in appraisal proceedings. In 2007, the Delaware legislature amended the appraisal statute to establish a presumptive interest rate equal to 5% plus the prevailing federal funds rate. Critics contend that this interest rate has been a prime driver of the increase in appraisal activity, with sophisticated "appraisal arbitrageurs" parking money in appraisal claims in order to take advantage of what critics contend is an above-market interest rate. The supposed exorbitance of the interest rate has loomed especially large in the minds of journalists,<sup>3</sup> law school students,<sup>4</sup> and transactional lawyers.<sup>5</sup> Responding to these complaints, the Council of Delaware State Bar Association's Section on Corporation Law proposed a set of amendments to the appraisal statute designed to moot the interest rate question by allowing the company to prepay an amount of its choosing, thereby avoiding the accrual of interest on that amount. This reform was itself met with criticism or indifference and died on the vine.

A striking feature of complaints about the interest rates is the failure to articulate any general principles for the role of interest in appraisal, or for determining whether the statutory rate

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<sup>1</sup> We have charted this rise in appraisal activity in our earlier work. See Charles Korsmo & Minor Myers, *Reforming Modern Appraisal Litigation*, forthcoming 41 DEL. J. CORP. L. \_\_ (2016) [hereinafter Korsmo & Myers, *Reforming Modern Appraisal*]; Charles Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M&A*, 92 WASH. U. L. REV. 1551 (2015) [hereinafter Korsmo & Myers, *Appraisal Arbitrage*]; Charles Korsmo & Minor Myers, *The Structure of Stockholder Litigation: When do the Merits Matter?*, 75 OHIO ST. L.J. 829 (2014) [hereinafter Korsmo & Myers, *Structure of Stockholder Litigation*].

<sup>2</sup> See generally D.G.C.L. § 262.

<sup>3</sup> E.g., Liz Hoffman, *Wall Street Law Firms Challenge Hedge-Fund Deal Tactic*, Wall St. J., Apr. 15, 2015 ("Also encouraging funds to mount the campaigns: They are guaranteed interest equivalent to 5.75% annually on the value of their stakes as the appraisal review takes place. That amount, established during a period of higher interest rates, is especially attractive amid today's low yields."); Tom Hals, *Hedge Funds Hot 'Appraisal' Strategy for Deals may Become a Lot Less Appealing*, Reuters, Mar. 19, 2015 ("Since an annual interest rate of 5.75 percent currently accrues while a case is pending, and a final judgment can take years, the strategy generates a solid return even when the court rules the deal price was fair.").

<sup>4</sup> E.g., Jennifer McLellan, Note, *An Appraisal of Appraisal Rights in Delaware*, 92 DENV. U.L. REV. ONLINE 109, 110 (2015) ("Even where shareholders receive only a modest improvement over the merger price, they benefit through a highly favorable interest rate mandated by statute."); Jason Mei, *Appraisal Arbitrage: Investment Strategy of Hedge Funds and Shareholder Activists*, 34 REV. BANKING & FIN. L. 83, 85-86 (2014) ("This interest rate is well above the current market rate, which is currently 0.75% and effective since February 2010. Thus, even if the court determines that the fair value is in fact equal to the merger price, 5.75% is a very profitable rate of return, making appraisal arbitrage all the more lucrative and attractive as an investment strategy.").

<sup>5</sup> E.g., Trevor S. Norwitz, *Delaware Poised to Embrace Appraisal Arbitrage*, CLS Blue Sky Blog, Mar. 9, 2015 (suggesting the existence of "perverse incentives that have afflicted Delaware companies for years, whereby even meritless appraisal claims often turn out to be good investments because of the above market compound statutory interest rate").

is, in fact, too high or low. In this Article, we identify a set of relevant principles and use them to propose reforms that would improve the functioning of Delaware’s appraisal remedy by encouraging accurate and economical resolution of disputes over fair value.

We argue that the primary policy goal in designing an interest regime should be to make the parties indifferent to the passage of time. This policy goal has deep roots in Delaware’s pre-2007 jurisprudence, where the overriding focus in setting the interest rate was on two twin ambitions: to compensate the dissenter for the lost use of the fair value of the stock and to force the surviving company to pay for the use. Chancellor Chandler captured this insight in *Gonsalves v. Straight Arrow Publishers*, where he wrote that “[i]n essence, an interest award is the Court’s attempt to put both parties in the position most closely approximating their respective positions had the fair value of the dissenting shareholder’s stock been paid on the date of the merger.”<sup>6</sup> If an interest regime is successful in accomplishing this, the parties will be time-indifferent, with no incentive to either prolong the proceeding or to give up value to secure a hasty settlement.<sup>7</sup> To this principle of time-indifference, we add the equally important condition that the interest regime should ideally not distort the incentives of minority stockholders to dissent in the first place. The decision to dissent should be driven by the merits, not by the interest rate.

Of course, the design of any dispute resolution system involves a trade-off between the accuracy of the system and its cost. The policy challenge in fashioning the appropriate interest rate in appraisal is this precise question writ small. For a generation, Delaware appraisal proceedings involved expensive pitched battles over the appropriate rate of interest to award—a situation we have no desire to replicate. From this we derive the secondary principle that the interest rate regime should economize on litigation costs and, at the margin, encourage settlement.

Using these principles, we are in a position to both critique the current interest rate regime and the Council’s proposed amendments and also to propose a new set of reforms that improves on both. Under our proposal, the respondent would have a unilateral option to prepay an amount of its choosing to the dissenting stockholder within 30 days of the effective date of the relevant transaction. The dissenting stockholder would thereafter possess the option to walk away from the litigation for the amount prepaid. The amount so paid would not prevent the respondent from arguing for a lower fair value at trial. Finally, following trial, *either* party would be liable to the other for interest on the difference between the amount prepaid and the adjudged fair value, with the interest rate set at the weighted average cost of capital of the target company. These reforms would—without creating any new issues for litigation—give the company an incentive to put its best estimate of fair value on the table at the outset, reducing the salience of the interest rate while promoting time-indifference for both parties.

This paper proceeds in four Parts. Part I introduces the Delaware appraisal statute and the historical logic and use of interest in Delaware appraisal proceedings, including the recent reforms proposed by the Council. Part II introduces and evaluates recent criticisms of Delaware’s interest rate regime, concluding that these criticisms fail to identify valid criteria by which the regime may

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<sup>6</sup> *Gonsalves v. Straight Arrow Publishers, Inc.*, 2002 WL 31057465\*9 (Del. Ch. Sept. 10, 2002); *see also* *Felder v. Anderson, Clayton & Co.*, *supra* at 159 A.2d 287 (“Interest really represents damages for the delay in payment and compensation for the use of plaintiffs’ money.”).

<sup>7</sup> Prejudgment interest is a remedy that is common to many areas of law besides stockholder appraisal. In contract, patent, admiralty, employment law, and eminent domain claims, injured parties are entitled to prejudgment interest. *See, e.g.*, Elaine W. Shoben, William Murray Taub, & Rache M. Janutis, *Remedies: Cases and Problems* 624 (5th ed. 2012) This policy goal has been noted having broader purchase to any circumstance where prejudgment interest is awarded. *See id.* at XX (noting that award of prejudgment interest eliminates any incentive the defendant has “to delay paying a valid claim or to delay engaging in good faith settlement negotiations”).

be evaluated. Part III derives and explains a set of principles for designing an interest rate regime. Part IV employs these principles to design a new interest rate regime for appraisal litigation that is superior to both the existing regime and the Council’s 2015 proposal.

## I. THE LOGIC AND HISTORY OF INTEREST IN THE DELAWARE APPRAISAL STATUTE

The sophistication of Delaware’s approach to awarding interest in appraisal has grown with experience. Delaware’s appraisal remedy is a statutory creation, and the major leaps forward in the scheme of awarding interest have come from legislative amendments. At the same time, the Court of Chancery has labored mightily to fashion rules in equity that generate sensible incentives.

### A. *The Emergence of Prejudgment Interest in Appraisal*

Delaware first adopted an appraisal statute in 1899, but that original version did not provide for interest. The Delaware Supreme Court observed that the early version of the appraisal statute “[made] no mention of interest,”<sup>8</sup> and courts concluded they thus had no authority to award prejudgment interest.<sup>9</sup> As then Vice Chancellor Seitz reasoned:

I fully appreciate the policy argument in favor of providing interest for a dissenter in order that he may receive just compensation for his shares. Apparently the legislatures in New York and Maryland have . . . seen fit to change their statutes in order to provide for interest. Since, however, I have concluded that the right to interest must be found in the statute, and since I have found that the [Delaware] appraisal statute not only does not authorize its payment but impliedly denies it, I am unable to award interest here on the basis of a so-called ‘enlightened view’. I reluctantly conclude that enlightenment must come from the legislature.<sup>10</sup>

Enlightenment arrived in 1949, when an amendment first introduced language about interest in the appraisal statute.<sup>11</sup> The revised statute provided that the court may “determine the amount of interest, if any, to be paid upon the value of the stock of the stockholders entitled thereto.”<sup>12</sup>

This mid-century version of the statute provided no guidance in choosing an appropriate interest rate, and indeed it vested the most basic discretion in the trial court: whether to award prejudgment interest at all. The Court of Chancery began to exercise its newfound discretion,<sup>13</sup> and it soon had developed a default rule in favor of awarding prejudgment interest.<sup>14</sup> The reasoning was

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<sup>8</sup> See *Meade v. Pac Gamble Robinson Co.*, 58 A.2d 415, 417 (Del. 1948). See sec. 1975.

<sup>9</sup> See *Meade v. Pac Gamble Robinson Co.*, 58 A.2d 415, 418 (Del. 1948) (“[W]e conclude that the benefits afforded stockholders who do not wish to go along with a merger do not include interest from the [effective] date of the merger.”).

<sup>10</sup> *Meade v. Pac. Gamble Robinson Co.*, 29 Del. Ch. 406, 420, 51 A.2d 313, 320 (1947) decree aff’d, 30 Del. Ch. 509, 58 A.2d 415 (1948).

<sup>11</sup> Although the appraisal statute was amended substantially in 1943, the petitioner’s entitlement to interest was unchanged. In re *Gen. Realty & Utilities Corp.*, 29 DEL. CH. 480, 500, 52 A.2d 6, 16 (1947) (“While the 1943 amendments to the appraisal statute were substantial, I can find nothing therein which would require the Corporation to pay interest from the effective date of the merger.”).

<sup>12</sup> ch. 136, sec. 7 (1949).

<sup>13</sup> E.g., *Swanton v. State Guar. Corp.*, 42 DEL. CH. 477, 485, 215 A.2d 242, 247 (1965).

<sup>14</sup> E.g., *Felder v. Anderson, Clayton & Co.*, 39 DEL. CH. 76, 89, 159 A.2d 278, 286 (1960) (“Since the corporation has had the use of the dissenting stockholders’ ‘money’ from the date of the merger, I think interest

that the interest award was necessary to compensate the petitioner for loss of use of the petitioner's resources, which remained in the unconstrained hands of the defendant during the pendency of the appraisal petition.<sup>15</sup>

This is not to suggest that the basic decision to award interest was free of controversy. In *Felder v. Anderson Clayton & Co.*, for example, the respondent argued that the Court should exercise discretion not to award interest where the "delay in payment is largely attributable to the stockholders' excessive estimate of the fair value of their stock which they persisted in demanding."<sup>16</sup> The respondent had offered to settle the case for \$395 per share, but the petitioners would not settle for less than \$1,000, and the Court ultimately found the fair value of the stock to be \$432.09. The Court rejected the argument that the high price demanded by the petitioners should deprive them of interest, noting that a "dissenting stockholder has an absolute right to an appraisal."<sup>17</sup> The stockholder was not "attempting to force a settlement by 'abuse' of the appraisal process" and thus "the undue lapse of time in conducting the appraisal proceedings cannot be ascribed to any 'legal fault' on the part of the stockholders."<sup>18</sup>

When awarding interest, the court had to confront three basic questions: what rate of interest, whether the interest was simple or compound, and if compound what compounding interval. Prior to 2007, the resolution of these issues was left wholly to the Court of Chancery, which was "empowered to award interest in an appraisal action at whatever rate (and compounding interval, where relevant) the court deem[ed] equitable."<sup>19</sup> The approach to each of these variables in Delaware has grown in sophistication over time, with statutory developments keeping pace with evolving judicial thinking on the topic.

## B. *What Rate?*<sup>2</sup>

The pre-2007 appraisal statute provided no substantive direction on how the Court should select a rate of interest to award. Instead, the Court fashioned equitable principles to guide it. The earliest judicial approaches to determining the appropriate rate of interest focused on the goal of compensation. The Court looked to make the dissenter whole for losing the use of the assets tied up in the appraisal proceeding. One Chancery opinion summarized the approach in this way: "[T]he court, in the exercise of its discretionary power, seeks to find a rate which will fairly compensate plaintiffs for the fact that they were deprived of the use of their money."<sup>20</sup> In 1975, the Delaware Supreme Court held that the "purpose of interest is to fairly compensate plaintiffs for their inability to use the money during the period in question."<sup>21</sup> By contrast, it was not relevant to

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should generally be allowed as a matter of course."). See also *Sporborg v. City Specialty Stores, Inc.*, 35 DEL. CH. 560, 571, 123 A.2d 121, 127 (1956) (ruling that interest "should be allowed here for the full period from the effective date of the merger to the date of payment").

<sup>15</sup> *Sporborg v. City Specialty Stores, Inc.*, 35 DEL. CH. 560, 571, 123 A.2d 121, 127 (1956) ("The fact is that the defendant Corporation had the use of plaintiffs' money during this period without any ownership obligation toward plaintiffs.").

<sup>16</sup> *Felder v. Anderson, Clayton & Co.*, 39 DEL. CH. 76, 89, 159 A.2d 278, 286 (1960).

<sup>17</sup> *Id.*

<sup>18</sup> *Felder v. Anderson, Clayton & Co.*, 39 DEL. CH. 76, 89, 159 A.2d 278, 286 (1960).

<sup>19</sup> *Le Beau v. MG Bancorporation, Inc.*, 1998 WL 44993, at \*12) DEL. CH. Jan. 29, 1998).

<sup>20</sup> *Felder v. Anderson, Clayton & Co.*, 39 Del. Ch. 76, 92, 159 A.2d 278, 287 (1960); *Francis I. duPont & Co. v. Universal City Studios, Inc.*, 343 A.2d 629, 634 (Del. Ch. 1975) ("Interest really represents damages for the delay in payment and compensation for the use of plaintiffs' money.").

<sup>21</sup> *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216, 222 (Del. 1975).

consider “how much it would have cost the corporation to borrow the money.”<sup>22</sup> The touchstone was the “rate of interest at which a prudent investor could have invested money.”<sup>23</sup> To calculate that prudent investor rate, courts averaged the relevant returns on a large variety of investments: short, medium, and long-term U.S. Treasury bills, commercial savings accounts, investment-grade bond returns, and the return on the Dow Jones index.<sup>24</sup>

The legislature responded in 1976 by amending the provision on interest to allow the Court to consider “all relevant factors,” including how much the corporation would have had to pay to borrow money.<sup>25</sup> This speed with which Delaware explicitly allowed courts to look to the corporation’s cost of borrowing likely reflected the importance of a second policy behind awarding interest: disgorging from the corporation the benefit of having unfettered use of the petitioner’s assets.<sup>26</sup> The task of setting the rate of interest came to be seen as vindicating both policies: compensating the petitioner and avoiding unjustly enriching the respondent.<sup>27</sup>

The practical import of this second policy goal is that it led courts to rely on a new source of evidence to select a rate. Courts continued to rely on the prudent investor rate, but they also examined the surviving corporation’s cost of borrowing.<sup>28</sup> To determine the corporation’s cost of borrowing, courts calculated the average interest rates for the corporation’s borrowing from the effective date of the merger through the trial. The court looked to both short-term and long-term borrowing. When combining the prudent investor rate and the corporation’s borrowing rate to

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<sup>22</sup> *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216, 223 (Del. 1975).

<sup>23</sup> *Universal City Studios, Inc. v. Francis I. duPont & Co.*, 334 A.2d 216, 222 (Del. 1975).

<sup>24</sup> *Lebman v. Nat’l Union Elec. Corp.*, 414 A.2d 824, 829 (Del. Ch. 1980); *Gibbons v. Schenley Indus., Inc.*, 339 A.2d 460, 474-75 (Del. Ch. 1975).

<sup>25</sup> Volume 60, Ch. 371, Sec. 8. (“[T]he Court shall determine the amount of interest, if any, to be paid upon the value of the stock of the stockholders entitled thereto. In making its determination with respect to interest, the Court may consider all relevant factors, including the rate of interest which the corporation has paid for money it has borrowed, if any, during the pendency of the proceeding.”). The section was amended with slightly different language in 1981, the principal differences being that the statute now made reference to a “fair rate of interest” and also looked to rates the corporation would have faced (presumably to account for some firms with no borrowing). Volume 63, ch. 25, Section 14 (“[T]he Court shall appraise the shares, determining their fair value . . . , together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. . . . In determining the fair rate of interest, the Court may consider all relevant factors, including the rate of interest which the corporation would have had to pay to borrow money during the pendency of the proceeding.”).

<sup>26</sup> See, e.g., *Merion Capital, L.P. v. 3M Cogent, Inc.*, Civ.A. No. 6247-VCP, 2013 WL 3793896, at \*25 (Del. Ch. Mar. 19, 2013) (interest award “serves to avoid an undeserved windfall to the respondent in an appraisal action, who would otherwise have had free use of money rightfully belonging to the petitioners . . . . the respondent derived a benefit from having the use of the petitioners’ funds at no cost.”).

<sup>27</sup> *Grimes v. Vitalink Communications Corp.*, 1997 WL 538676 (Del. Ch. Sept. 17, 1997) (“An award of interest serves two purposes. First, an award of interest recognizes that petitioners, by electing to pursue appraisal rather than accepting the amount offered in the merger, have been denied the use of the fair value of their shares. Second, an award of interest recognizes that the corporation has received a benefit from the use of the fair value of petitioners’ shares during the pendency of the proceeding.”).

<sup>28</sup> *Kleinwort Benson Ltd. v. Silgan Corp.*, No. CIV. A. 11107, 1995 WL 376911, at \*10 (Del. Ch. June 15, 1995) (“In setting the fair rate of interest, the Court primarily considers two factors, the ‘prudent investor rate,’ and the surviving corporation’s cost of borrowing.”).

arrive at the final interest rate, the Court disclaimed any fixed way of combining them.<sup>29</sup> Sometimes they were weighed equally,<sup>30</sup> and other opinions laid more weight on the prudent investor rate.<sup>31</sup>

Determining the rate is only one aspect of fixing the amount of interest owed to the dissenting stockholder. The next issue is whether the interest is simple or compound and, if compound, what compounding interval to use. The pre-2007 version of the statute also allowed courts to award either simple or compound interest.<sup>32</sup> Simple interest delivers a constant set of interest payments from one period to another based on the original principal amount, but no interest is earned on interest from past periods. By contrast, when interest is compounded, the interest payment from one period is added to the principal amount such that in the following period interest accrues on a larger amount. The difference over time can be considerable. Imagine interest of 8% on a principal amount of \$100 over 7 years. If the interest award is simple, the value at the end of period will be \$156 (7 years x \$100 x 8%). By contrast, if the interest is compound, the value is \$171.38 ( $\$100 \times 1.08^7$ ), a difference of more than \$15, or nearly ten percent.

For many years, the customary award of interest in Delaware was simple interest.<sup>33</sup> The prevailing attitude, unaccompanied by much analysis, was that compound interest was a remedy “not generally favored in the law.”<sup>34</sup> The Court, in fact, ultimately concluded that it did not have the discretion under the existing appraisal statute to award compound interest.<sup>35</sup> In 1987, the Delaware legislature expressly conferred that discretion, providing that “[i]nterest may be simple or compound, as the Court may direct.”<sup>36</sup> Even with the newfound discretion, the Court in 1992 declined “to depart from this Court's standard practice of allowing only simple interest.”<sup>37</sup> It was

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<sup>29</sup> *Chang's Holdings, S.A. v. Universal Chemicals & Coatings*, No. CIV. A. 10856, 1994 WL 681091, at \*2 (Del. Ch. Nov. 22, 1994) (“Although no set formula exists, in most circumstances the Court looks primarily to the prudent investor rate, but also considers the corporation's cost of borrowing.”).

<sup>30</sup> *Chang's Holdings, S.A. v. Universal Chemicals & Coatings*, No. CIV. A. 10856, 1994 WL 681091, at \*3 (Del. Ch. Nov. 22, 1994) (“[B]oth parties sought a prompt resolution of this dispute, but their inability to agree despite good faith bargaining caused the long delay in determining the fair value of Chang's shares. Accordingly, I will give equal values to the prudent investor and cost of borrowing rates.”).

<sup>31</sup> *Kleinwort Benson Ltd. v. Silgan Corp.*, No. CIV. A. 11107, 1995 WL 376911, at \*12 (Del. Ch. June 15, 1995) (“Based on the evidence presented, I arrive at a prudent investor rate of 9.0% and a cost of borrowing rate of 10.51%. I do not give these factors equal weight. Under these circumstances, I believe the prudent investor rate is the most important factor. See *Cede*, supra, Mem. Op. at 83. Applying a 2/3 weight to the prudent investor rate and a 1/3 weight to the cost of borrowing rate, I award 9.5% simple interest from the date of the merger.”).

<sup>32</sup> *Rapid-American Corp. v. Harris*, Del. Super., 603 A.2d 796, 807 (1992) (“In its discretion, the Court can award simple or compound interest.”).

<sup>33</sup> *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 571, 123 A.2d 121, 127 (1956) (“I believe simple interest should be allowed here for the full period from the effective date of the merger to the date of payment.”).

<sup>34</sup> *Weinberger v. UOP, Inc.*, Del.Ch., 517 A.2d 653, 657 (1986).

<sup>35</sup> *Charlip v. Lear Siegler, Inc.*, No. 5178, 1985 WL 11565, at \*4 (Del. Ch. July 2, 1985) (“A dissenting shareholder's right to appraisal as well as his entitlement to interest on the appraisal award exists solely by virtue of statute. The ability to receive compounded interest, and this Court's ability to award compound interest, must also be statutorily based. Such authority is not found in § 262(h), which merely provides for ‘interest’ and does not expressly state that such interest may be compounded.”); *Gibbons v. Schenley*, No. C.A. 3746, 1975 WL 7477, at \*2 (Del. Ch. July 8, 1975) (“[T]he type of interest to be allowed a claimant in an appraisal proceeding is simple interest and not compound interest.”).

<sup>36</sup> Vol. 66, Ch. 136, Section 32; *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 927 (Del. Ch. 1999) (“Before the amendment of section 262(i) in 1987 (which gave this Court discretion to award simple or compound interest), this Court only had authority to award simple interest.”).

<sup>37</sup> *Harris v. Rapid-Am. Corp.*, No. CIV. A. 6462, 1990 WL 146488, at \*18 (Del. Ch. Oct. 2, 1990) aff'd in part, rev'd in part, 603 A.2d 796 (Del. 1992).



not until 1997 that the Court first awarded compound interest,<sup>38</sup> although the absence of any guiding standards for choosing the type of interest caused some frustration.<sup>39</sup> Throughout this period, the practice of awarding simple interest received sustained criticism in academic commentary for failing to accord with rudimentary principles of modern finance.<sup>40</sup> Nevertheless, as recently as 1999 the Delaware Supreme Court expressed “concern” over what it described as “a new pattern, one of awarding compound interest as a matter of course.”<sup>41</sup> The Supreme Court insisted that the Court of Chancery offer “an explanation by the court for its selection of compound interest.”<sup>42</sup>

The Court of Chancery had no problem justifying awards of compound interest, which became commonplace after 1999.<sup>43</sup> It observed that “[t]he rule or practice of awarding simple interest, in this day and age, has nothing to commend it—except that it has always been done that way in the past.”<sup>44</sup> Looking to all financial markets, the Court acknowledged that compound interest was standard practice.<sup>45</sup> To award simple, the Court reasoned, would fail to compensate the dissenter fully for the extent of the lost resource, while compound interest by contrast delivered complete relief.<sup>46</sup>

### C. *The 2007 Amendment to Simplify Interest in Appraisal*

By the early 2000s, dissenting stockholders could expect an award of interest that would compound. The statute, however, vested the Court with wide discretion while supplying no

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<sup>38</sup> *Grimes v. Vitalink Communications Corp.*, 1997 WL 538676 (Del. Ch. Sept. 17, 1997) (“[O]nly an award of compound interest may truly serve to compensate the petitioners for the loss of the use of their funds and to prevent the corporation from retaining unjust benefits from the use of petitioners' funds.”).

<sup>39</sup> *Grimes v. Vitalink Commc'ns Corp.*, No. 12334, 1997 WL 538676, at \*13 (Del. Ch. Aug. 28, 1997) opinion clarified sub nom. *In re Grimes v. Vitalink Commc'ns Corp.*, No. CIV. A. 12334, 1997 WL 589036 (Del. Ch. Sept. 17, 1997) and aff'd, 708 A.2d 630 (Del. 1998) (“To my knowledge, this Court has yet to formulate a list of factors to consider when determining whether an award of interest should be simple or compound. To be frank, I am not sure what factors might appear on such a list.”).

<sup>40</sup> Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 *Duke L.J.* 613, 713 (1998) (“The award of simple interest penalizes dissenting shareholders and does not accord with economic realities.”); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 *Geo. L.J.* 1, 42 (1995) (“Delaware still adheres to a standard practice of paying simple rather than compound interest, which can significantly reduce the minority shareholder's recovery.”); David S. Reid, Note, *Dissenters' Rights: An Analysis Exposing the Judicial Myth of Awarding Only Simple Interest*, 36 *Ariz. L. Rev.* 515, 515 (1994) (“[T]o fully compensate a shareholder for loss of use of money, it is essential, rather than discretionary, that courts begin to apply a more enlightened approach adequately accounting for the economic reality of the investment world. . . . [S]uch an approach necessarily involves awarding compound interest through application of future value concepts.”).

<sup>41</sup> *Gonsalves v. Straight Arrow Publishers, Inc.*, 725 A.2d 442 (Del. 1999).

<sup>42</sup> *Gonsalves v. Straight Arrow Publishers, Inc.*, 725 A.2d 442 (Del. 1999).

<sup>43</sup> E.g., *Le Beau v. M.G. Bancorporation, Inc.*, No. CIV.A.13414, 1998 WL 44993, at \*12-13 (Del. Ch. Jan. 29, 1998) (holding that an award of compound interest is appropriate because “in today's financial markets a prudent investor expects to receive a compound rate of interest on his investment”).

<sup>44</sup> *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 927 (Del. Ch. 1999).

<sup>45</sup> *Union Illinois 1995 Inv. Ltd. Partnership v. Union Financial Group, Ltd.*, 847 A.2d 340, 364 (Del. Ch. 2003) (noting that “the financial market standard is now based on compound, not simple, interest”).

<sup>46</sup> *Gonsalves v. Straight Arrow Publishers, Inc.*, 2002 WL 31057465 at \*10 (Del. Ch. Sept. 10, 2002) (noting that “a shareholder generally would not be fairly compensated for the loss of use of the fair value of her shares during the pendency of the appraisal process with an award of simple interest” and that “and “compound interest would generally be necessary to satisfy the purposes of that award”).

guidance as what interest rate to award or how to weigh competing alternatives.<sup>47</sup> As a result, litigating the interest rate became a significant part of trial as relevant issues multiplied: the return a prudent investor could expect, the corporation's cost of borrowing, and the appropriate compounding frequency. Litigants poured resources into disputing these issues,<sup>48</sup> to the frustration of the Court of Chancery. As Chancellor Chandler noted, "many pints of toner fluid (and typewriter ribbon ink before that) have been spilled as a result of attorneys arguing over the appropriate interest rate to be applied and judges analyzing the arguments and determining that rate."<sup>49</sup> Similarly, then-Vice Chancellor Strine called it "wasteful and dispiriting" to hold "an expensive debate (in terms of the use of judicial time and the payment of attorneys' and experts' fees) over the rate and frequency of pre- and post-judgment interest."<sup>50</sup>

As with other issues in an appraisal proceeding, the burden of proof on the "fair rate of interest" is formally on *both* parties.<sup>51</sup> Prior to 2007, when both parties failed to convince the court of their positions, the Court of Chancery sometimes relied on the legal rate on judgments in Delaware,<sup>52</sup> which mandates a rate equal to the prevailing federal funds rate plus five percent.<sup>53</sup> In appraisal proceedings, this rate came to become something of a default rate where each party had failed to carry its burden.<sup>54</sup>

Frustrated at the resources expended on determining the "fair rate" of interest, members of the Court of Chancery indicated that a sensible solution would be to fix the rate by statute.<sup>55</sup> In

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<sup>47</sup> Pinson v. Campbell-Taggart, Inc., 1989 WL 17438, at \*21 (Del. Ch. Feb. 28 1989) (noting that statute did not "provid[e] explicit guidance as to the precise method by which interest is to be determined after taking 'all relevant factors' into account").

<sup>48</sup> Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 709 (1998) ("Because the dissenting shareholder is entitled to payment as of the transaction date, and often does not receive full payment until much later, appraisal litigation often involves a skirmish over the amount of interest the corporation must pay the shareholder as a result of this delayed payment. In many cases, the litigants and courts have expended considerable energy resolving the interest rate that should be applied in this context.").

<sup>49</sup> ONTI, Inc. v. Integra Bank, 751 A.2d 904, 927 n. 85 (Del. Ch. 1999).

<sup>50</sup> Open MRI Radiology Assoc., PA v. Kessler, 898 A.2d 290, 343 (Del. Ch. 2006); Finkelstein v. Liberty Digital, Inc., 2005 WL 1074364, at \*26 (Del. Ch. Apr. 25, 2005) ("My last task is a familiar, but inefficient one: the calculation of prejudgment interest. The continued devotion of expert, attorney, and judicial time to this endeavor is of dubious social value."); Andaloro v. PFPC Worldwide, Inc., 2005 WL 2045640, at \*21 (Del. Ch. Aug. 19, 2005) ("[P]arties on both sides of cases of this kind ordinarily have little economic incentive to rationally address the complexities raised by the current statutory [interest] regime. . . .").

<sup>51</sup> Gholl v. Emachines, Inc., No. CIV.A. 19444-NC, 2004 WL 2847865, at \*18 (Del. Ch. Nov. 24, 2004) *aff'd*, 875 A.2d 632 (Del. 2005) ("[I]t is well established that '[e]ach party bears the burden of proving an appropriate rate under the circumstances.'").

<sup>52</sup> Neal v. Alabama By-Products Corp., No. CIV. A. 8282, 1990 WL 109243, at \*21 (Del. Ch. Aug. 1, 1990) *aff'd*, 588 A.2d 255 (Del. 1991) ("A more realistic and fair rate of interest, in my judgment, is the legal rate of interest in August 1985.").

<sup>53</sup> 6 Del. C. § 2301.

<sup>54</sup> Gholl v. eMachines, 2004 WL 2847865, Del. Ch. Nov. 24, 2004, at \*18 ("If each party fails to fulfill its burden of proof, the court may look to the legal rate of interest for guidance, but where the record is sufficiently developed, the legal interest rate generally is irrelevant."); Chang's Holdings, Del. Ch., C.A. No. 10856, at 6 ("The legal interest rate serves as a useful default rate when the parties have inadequately developed the record on the issue."); Gonsalves v. Straight Arrow Publishers, Inc., 2002 WL 31057465\*9 (Del. Ch. Sept. 10, 2002) ("In this case, the Court is not faced with an inadequately developed record warranting an award of interest at the legal rate as a fall back, or default, position.").

<sup>55</sup> E.g., Open MRI Radiology Assoc., PA v. Kessler, 898 A.2d 290, 343 (Del. Ch. 2006) (lamenting that "until there is a statutory solution" it was necessary to waste resources setting interest rates); Finkelstein v. Liberty Digital, Inc., 2005 WL 1074364, at \*26 (Del. Ch. Apr. 25, 2005) ("A simple statutory change setting the rate in equity to the legal rate, compounded monthly would seem a preferable approach.").

1999, Chancellor Chandler noted that a statutory interest rate had “strong intuitive appeal.”<sup>56</sup> In 2005, then-Vice Chancellor Strine observed that “the crafting of a specific legislative interest formula, which also addresses the frequency of compounding, for use in appraisal proceedings is both feasible and desirable for all affected constituencies.”<sup>57</sup> An interest rate set by legislation similarly had received endorsement in academic commentary as a desirable solution.<sup>58</sup> Law professor Barry Wertheimer proposed that the rate chosen should be able to respond to market conditions, rather than being fixed at a level that might become outdated. He suggested that “[a]n interest rate tied to the prime rate would be a workable solution.”<sup>59</sup>

In 2007, Delaware amended the appraisal statute in ways that built on the accumulated experience with individually-litigated disputes over the interest rate in appraisal claims.<sup>60</sup> The new amendment did precisely what judicial and academic commentary had proposed: the amendment established that petitioners are presumptively entitled to receive interest at a variable rate, and it borrowed the formula from the default legal rate of interest, equal to the federal funds rate plus 5%, compounded quarterly.<sup>61</sup> The statute, still in effect, also gives the chancellor overseeing the proceeding discretion to depart from either the rate or from the quarterly compounding. Exercising such discretion would be appropriate, according to Chancellor Chandler “where it is necessary to avoid an inequitable result, such as where there has been improper delay or a bad faith assertion of valuation claims.”<sup>62</sup>

Delaware’s legislative process leaves little trace of its reasoning in general,<sup>63</sup> and the scant legislative history on this 2007 amendment reveals almost nothing.<sup>64</sup> Nonetheless, the 2007 amendment to the appraisal statute reflected a number of important policy design choices. A major source of insight into the change comes from contemporaneous commentary, especially from law firms with significant advisory or litigation practices involving Delaware firms, which turn out short memoranda on changes to the DGCL. These sources shed light on two important features of the 2007 amendment. First, a default rate of interest made sense because it conserved on the costs of litigation, as the judicial dicta had suggested. According to a leading Delaware firm, the aspiration of the amendment was that “establishing a presumptive approach to awards of

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<sup>56</sup> *ONTI, Inc. v. Integra Bank*, 751 A.2d 904, 927 n. 85 (Del. Ch. 1999).

<sup>57</sup> *Andaloro v. PFPC Worldwide, Inc.*, 2005 WL 2045640, at \*21 (Del. Ch. Aug. 19, 2005).

<sup>58</sup> Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L.J. 613, 713 (1998) (“Rather than permitting ad hoc case-by-case determination, appraisal statutes should call for the payment of compound interest at a prescribed rate.”); *id.* at 709-10 (“A statutorily defined rate of interest would simplify matters and eliminate this counterproductive expenditure of resources.”).

<sup>59</sup> Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 Duke L.J. 613, 709-10 (1998).

<sup>60</sup> H. 160, 144th Gen. Assembly, 76 Del. Laws. c. 145, §§ 14, 15 (2007).

<sup>61</sup> 8 Del. C. § 262(h).

<sup>62</sup> *In re Appraisal of Metromedia Int'l Grp., Inc.*, 971 A.2d 893, 907 (Del. Ch. 2009).

<sup>63</sup> For an overview of the process of amending the Delaware General Corporation Law, see Lawrence Hamermesh, Columbia Law Review article.

<sup>64</sup> The only official legislative history is the synopsis included in the original house bill, which does little more than restate the text of the amendment. Synopsis to House Bill 160, available at <http://legis.delaware.gov/lis/lis144.nsf/vwLegislation/HB+160?Opendocument> (“These Sections amend the approach to awarding interest in appraisal proceedings, principally by establishing a presumption that interest is to be awarded for the period from the effective date of the merger until the date of payment of judgment, compounded quarterly and accruing at the rate of 5% over the Federal Reserve discount rate, giving effect to any variation in that rate during that period. The Court of Chancery may depart from this presumptive approach for good cause, in order, for example, to avoid an inequitable result such as rewarding, or insufficiently compensating for, improper delay of the proceeding or unreasonable or bad faith assertion of valuation claims.”).

interest may deter unproductive litigation on the interest issue and the accompanying counterproductive expenditure of resources.”<sup>65</sup>

A second central policy choice in the amendment was that the default rate should be equal to the legal rate of interest that Delaware law employs in other circumstances. Between 1997, when the Court first awarded compound interest, and 2007, when the statute was amended, the Court awarded interest in 24 cases, and in 6 of them—or 25% of them—the court awarded interest at the legal rate. As observers noted at the time, the legal rate in Delaware—federal funds rate plus 5% — “reflect[ed] what had become, as a practical matter, the default rate in the Court of Chancery.”<sup>66</sup> An esteemed professor of corporate law and a member of the Council noted at the time that the legal rate “has frequently been the basis for awards of interest in recent appraisal cases.”<sup>67</sup> With the 2007 amendment, Delaware adopted the same approach as the Model Business Corporation Act, which uses the prevailing legal rate as the applicable interest rate for dissenting stockholders.<sup>68</sup> The official commentary to the Model Act echoes Delaware’s reasoning: adopting the legal rate “eliminates a possible issue of contention and should facilitate voluntary settlements.”<sup>69</sup>

The 2007 Delaware amendment in fact did not change much in practice, beyond removing a contentious issue at trial. An examination of court interest awards shows that interest awards had already been tracking the legal rate since approximately 1990. We collected what we believe are all 35 cases awarding interest between 1985 and 2007. For each case, we collected the type of interest awarded: 12 awarded simple interest and 23 compound. For cases awarding compound interest, we calculated the compounding interval: 14 monthly, 7 quarterly, 1 semiannually, and 1 annually. For each case, we computed the effective interest rate assuming quarterly compounding, and then we combined these rates over time. From 1981, the earliest period covered by an interest award in our data, we averaged the interest awards covering each month. So if three opinions awarded interest for the period covering March 1987 of 3%, 8%, and 10%, the average rate awarded during that month would be 7%. Figure 1 below shows (in black) the average rate for each month from 1981 through 2007 and also shows (in gray) the prevailing rate under the legal rate (5% plus the federal funds rate).

**Figure 1**  
**Average Court of Chancery Interest Award, by month**  
(light gray line shows 5% above federal funds rate)

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<sup>65</sup> Michael B. Tumas, John F. Grossbauer, & Monique Z. Valbuena, *The 2007 Amendments to the Delaware General Corporation Law: Not a Sea-Change, But Worth Noting*, CSC Flash, at 2 (attorneys at Potter Anderson & Corroon). See also Lawrence Hamermesh, *Proposed Amendments to the Delaware General Corporation Law*, Harvard Law School Corporate Governance Blog, May 9, 2007 (“By making [the Delaware legal rate] the presumptive approach to awards of interest in such cases . . . it is hoped that unproductive litigation efforts on the interest issue can be avoided.”); McDermott Will & Emery, *Inside M&A*, October 2007 (noting that adoption of the 2007 amendment would “eliminate needless litigation concerning the rate of interest in these cases”).

<sup>66</sup> McDermott Will & Emery, *Inside M&A*, October 2007.

<sup>67</sup> Lawrence Hamermesh, *Proposed Amendments to the Delaware General Corporation Law*, Harvard Law School Corporate Governance Blog, May 9, 2007.

<sup>68</sup> MBCA sec. 13.01(5) (“Interest” means interest from the effective date of the corporate action until the date of payment, at the rate of interest on judgments in this state on the effective date of the corporate action.”).

<sup>69</sup> Model Business Corporation Act, Official Text with Official Comments and Statutory Cross-References Revised Through December 2010, 13-9 (2010).

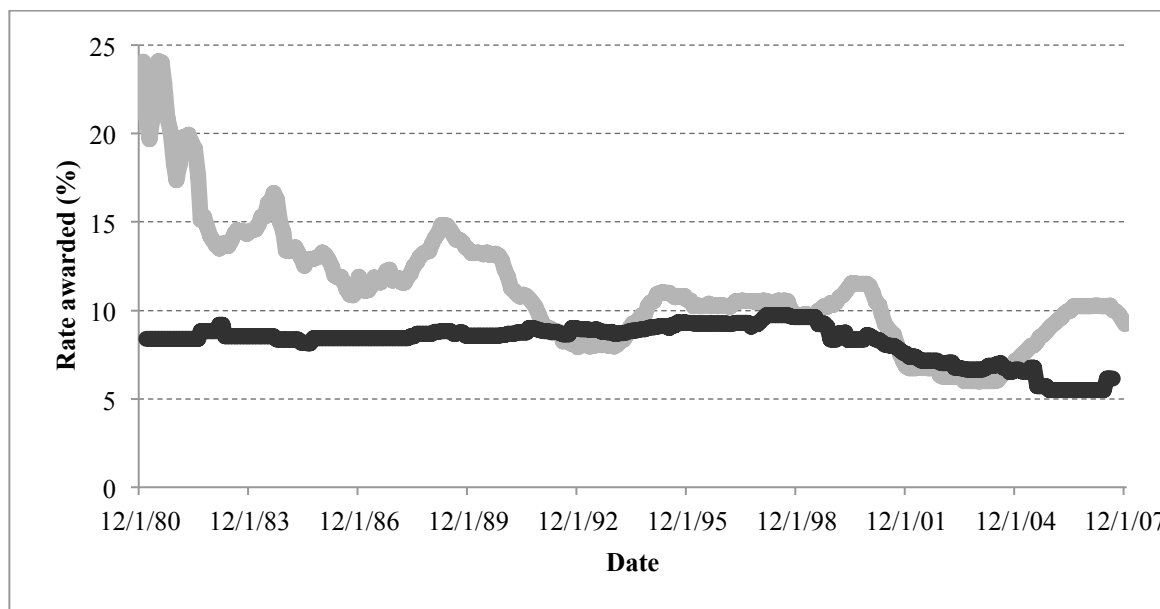


Figure 1 reveals that prior to 1990 the interest rate awarded in appraisal was often substantially below the legal rate. From approximately 1990 through 2004, however, the average interest rate awarded by the Court of Chancery largely tracked the legal rate. Indeed, the rate awarded by the Court was frequently *higher* than the legal rate.<sup>70</sup> The results between 2004 and 2007, where rates awarded again dipped below the legal rate, are not necessarily reflective of Court practice because the only appraisal cases during that period resolved the interest rate question by stipulation, not judicial resolution.<sup>71</sup> Thus, since 1990, the Court’s resolution of interest rate disputes was similar to the rate that would have been awarded under the 2007 amendment. In this sense, the 2007 amendment only codified already-prevailing practices.

The 2007 amendment attracted little note at the time outside of the law firm commentary, although Chancellor Chandler observed that the amendment “mercifully simplified” the question of interest in appraisal cases.<sup>72</sup>

#### D. The 2015 Proposed Amendment

For four years following the passage of the 2007 amendment, little changed in the world of Delaware appraisal. Beginning in 2011, however, appraisal activity—which historically had been trivially small—began to increase: more petitions, greater amounts of dissenting stock, and more sophisticated dissenters. The rise in appraisal activity was considerable relative to the prior dormancy of the remedy, but the rise was dwarfed by the increasing deluge of fiduciary class actions: Merger class actions currently outnumber appraisal petitions by a factor of 20. We have shown in other work that dissenting stockholders have disproportionately targeted transactions with

<sup>70</sup> Recall, too, that during this period the Court was still frequently awarding simple interest.

<sup>71</sup> *Highfields Capital, Ltd. v. AXA Fin., Inc.*, 939 A.2d 34, 42 (Del. Ch. 2007) judgment entered, (Del. Ch. Aug. 31, 2007) (“[T]he parties stipulated to, and the court entered, an order setting the pre-judgment interest rate in this action at 6.2%, compounded semi-annually, running from July 8, 2004.”); *Crescent/Mach I P’ship, L.P. v. Turner*, No. CIV.A 17455-VCN, 2007 WL 1342263, at \*15 (Del. Ch. May 2, 2007) (“The parties have stipulated to a pre-judgment interest rate of 4.8%.”).

<sup>72</sup> *In re Appraisal of Metromedia Int’l Grp., Inc.*, 971 A.2d 893, 907 (Del. Ch. 2009).

low merger prices and with insider transactions.<sup>73</sup> In other words, just as one would hope, dissenting stockholders have thus far focused their attention on deals that bearing markers of managerial or controlling stockholder opportunism.<sup>74</sup>

In the wake of the increase in appraisal activity, a worry developed in some quarters that that appraisal petitioners might be improperly motivated by a desire to capture the statutory interest rate.<sup>75</sup> The background rate conditions supply crucial context: The Federal Reserve has held interest rates at historic lows since late 2008, and 5.75% is a more attractive rate of return than 0.75%. On this account, appraisal petitioners acquire stock, dissent, and prosecute appraisal petitioners in order to capture the interest owed to dissenting stockholders, rather than because of the merits of the underlying claim.

An aggressive version of this claim—that appraisal petitioners are chiefly motivated by the statutory interest rate—does not withstand scrutiny, as we have shown before.<sup>76</sup> A threshold problem with the claim is that increase in appraisal activity does not line up in time with whatever interest rate conditions critics believe have incited that increase. Before the 2007 amendment, Delaware had been awarding interest on claims at least as generous as the legal rate for years before the 2007 amendment, as Figure 1 above shows. Even the arrival of historically low interest rates in 2008 does little explanatory work because the increase in appraisal filings did not occur until 2011 and dissenting equity value did not rise significantly until 2013. The timing of the rise in appraisal activity gives no indication that the statutory interest rate has anything to do with it.

More fundamentally, it is improbable that a sophisticated investor would assume the expense associated with prosecuting an appraisal claim, the respondent’s credit risk, the uncertain duration of the proceeding, and the investment risk associated with the outcome of the case in an effort to capture the legal rate of interest. As Stephen Davidoff Solomon observed, “at the end of the day, a 5.75 percent return is not going to cut it for a hedge fund, even in a zero-interest rate environment.”<sup>77</sup> As we elaborate further below, comparing an investment in an appraisal proceeding to an investment in a low-interest security like a Treasury bill is not even comparing apples to oranges—it is comparing apples to orangutans.

This is not to say that litigating parties will never engage in opportunistic behavior regarding the statutory interest rate. Two recent appraisal proceedings illustrate how the specter of interest rate opportunism can arise in ongoing litigation. In the summer of 2013, ISN Software found itself in a dispute over the trial schedule in an appraisal claim brought by former stockholders. ISN moved for entry of a scheduling order that would have had trial occur 14 months after the

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<sup>73</sup> See, e.g., Korsmo & Myers, *Structure of Stockholder Litigation*; Korsmo & Myers, *Appraisal Arbitrage*.

<sup>74</sup> This pattern of litigation stands in stark contrast to merger class actions, which appear to target large deals and deep pockets rather than problematic transactions. See Korsmo & Myers, *Structure of Stockholder Litigation*.

<sup>75</sup> 2015 Council White Paper on 262 Amendments, at 5 (“Some commentators and practitioners became concerned that the statutory interest rate, which for the last several years has provided an attractive rate relative to money market and government yields, encouraged interest rate arbitrage by appraisal claimants.”); *In re ISN Software Corp. Appraisal Litig.*, C.A. 8388-VCG, Scheduling Teleconference Transcript, Sept. 26, 2013 (expressing worry over whether “the interest rate that the Legislature has set encourages these types of appraisal cases and would also encourage or incentivize a slow walk toward the finish line”). See also Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 2 (“There has been a concern that a significant portion of appraisal petitions are motivated primarily or even exclusively by the interest factor itself (so-called ‘interest arbitrage’).”).

<sup>76</sup> See Korsmo & Myers, *Appraisal Arbitrage*, supra note 2.

<sup>77</sup> Steven Davidoff Solomon, *Delaware Courts Pause on the Deal Price Do-Over*, NY Times Dealbook, Feb. 19, 2015.

transaction closed. The petitioners had indicated a desire for a slightly longer litigation schedule of 15-18 months. ISN indicated that it sought such a hard-charging trial date in part because of its concern over the statutory interest rate.<sup>78</sup> Vice Chancellor Glasscock ultimately entered the longer trial schedule advocated by the dissenting stockholders,<sup>79</sup> but he also expressed apprehension about whether “the interest rate that the Legislature has set encourages these types of appraisal cases and would also encourage or incentivize a slow walk toward the finish line.”<sup>80</sup> Vice Chancellor Glasscock soon thereafter expanded on these sentiments in *Huff Fund v. CKx*, where the surviving company CKx sought an order forcing the dissenting stockholder to accept a cash payment in partial satisfaction of the ultimate judgment that would stop the running of interest.<sup>81</sup> Vice Chancellor Glasscock denied the motion,<sup>82</sup> concluding that the relief sought was “incompatible with the statute”<sup>83</sup> but at the same time expressing his sympathy with “the incentives driving this Motion.”<sup>84</sup> The issue, the Vice Chancellor suggested, was one that should attract the attention of the Council and the Legislature in Delaware: “[C]ompared with fault-based litigation, the opportunities for rent-seeking in appraisal actions are comparatively high; therefore, factors that tend to create perverse litigation incentives in these actions deserve close consideration by policy makers.”<sup>85</sup>

Responding to these concerns, policymakers in Delaware sought a way to eliminate the theoretical risk that interest might motivate stockholders to dissent and also to relieve respondent companies of being forced to pay rates they viewed as too high. In 2015, the body that proposes amendments to the DGCL—the Council of Delaware State Bar Association’s Section on Corporation Law—offered a new provision for the appraisal statute that would affect interest. The proposed language would be added to 262(h) as follows: “At any time before the entry of judgment in the proceedings, the surviving corporation may pay to each stockholder entitled to appraisal an amount in cash, in which case interest shall accrue thereafter as provided herein only upon the difference, if any, between the amount so paid and the fair value of the shares as determined by the Court.” Summarizing the intent of the provision, the Council explained that it “believe[d] corporations should have the option to cut off the accrual of interest by paying to the appraisal claimants a sum of money of the corporation’s choosing.”<sup>86</sup>

The concept behind the 2015 proposal has a distinguished provenance in the Court of Chancery and beyond. More than half a century ago, Chancellor Seitz floated a similar idea in *Felder v. Anderson, Clayton & Co.*,<sup>87</sup> suggesting that perhaps that “the statute should be amended to permit the corporation to pay immediately the minimum amount which the parties agree is involved” and that “interest should only be allowed upon the difference between the company’s

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<sup>78</sup> In re ISN Software Corporation Appraisal Litigation, C.A. 8388-VCG, Transcript of Scheduling Teleconference, Sept. 26, 2013, at 4 (arguing that court should be willing to entertain company’s trial schedule, “particularly given the type of case we’re dealing with, an appraisal action, and the current interest rate environment”).

<sup>79</sup> In re ISN Software Corp. Appraisal Litig., C.A. 8388-VCG, Scheduling Teleconference Transcript, Sept. 26, 2013.

<sup>80</sup> In re ISN Software Corp. Appraisal Litig., C.A. 8388-VCG, Scheduling Teleconference Transcript, Sept. 26, 2013.

<sup>81</sup> *Huff Fund v. CKx*, C.A. 6844-VCG, Respondent’s Reply Brief in Support of Motion to Stop the Accrual of Interest, filed Dec. 30, 2013, at 1.

<sup>82</sup> *Huff Fund v. CKx*, C.A. 6844-VCG, letter opinion, Feb. 12, 2014.

<sup>83</sup> *Huff Fund v. CKx*, C.A. 6844-VCG, letter opinion, Feb. 12, 2014, at 7.

<sup>84</sup> *Huff Fund v. CKx*, C.A. 6844-VCG, letter opinion, Feb. 12, 2014, at 7.

<sup>85</sup> *Id.*

<sup>86</sup> Council explanatory memo, at 5.

<sup>87</sup> 39 Del. Ch. 76, 90, 159 A.2d 278, 286 (1960).

offer and the appraised value.”<sup>88</sup> More recently, Vice Chancellor Glasscock remarked upon the “potential utility” of an approach similar to the 2015 amendment.<sup>89</sup> In addition, the Council’s proposal mirrors in basic design a feature of the Model Business Corporation Act, which depending on the circumstances either requires or permits the surviving company to pay over to dissenting stockholders “the amount the corporation estimates to be the fair value of their shares, plus interest.”<sup>90</sup> Under the Model Act, the payment is required for shares acquired prior to the announcement of the merger, but optional for shares acquired after the merger announcement.<sup>91</sup> The Delaware proposal would have made payment optional for all shares. Given, however, that a large proportion of dissenting shares in Delaware are acquired after the announcement of the merger terms,<sup>92</sup> this difference is less meaningful in practice than it appears on paper.

In contrast to the Model Act, which treats the cash payment as an “undisputed amount,” the 2015 proposed Delaware amendment made no such presumption. The synopsis prepared by the Council explicitly disclaimed any intent that the surviving corporation’s decision to exercise its option would create an inference that “the amount so paid by the surviving corporation is equal to, greater than, or less than the fair value of the shares to be appraised.”<sup>93</sup> The 2015 amendment proposal was silent on whether the company could recover amounts from the dissenter in the event that the court assigned a fair value that was below the initial payment that the company had made. Observers interpreted the statute’s silence as indicating that any over-payment could not be recovered under the statute.<sup>94</sup>

In most years, amendments proposed by the Council are enacted by the legislature almost as a matter of course. In a curious turn, however, the Council’s 2015 amendment proposals to the appraisal statute never became law. The interest rate proposal may have been collateral damage in a broader assault upon appraisal rights in Delaware from a coterie of defendants, together with M&A advisors. Seven influential law firms jointly sent a letter to the Council protesting that its 2015 reforms did not go far enough in curtailing the appraisal remedy.<sup>95</sup> While the firms expressed support for the Council’s proposal to limit the accrual of interest, they protested that the Council had not lowered the interest rate outright or otherwise done enough to stamp out appraisal activity in Delaware.<sup>96</sup> The Council’s proposed amendments were never introduced in the Delaware legislature, and by the close of the 2015 the appraisal statute stood unchanged.

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<sup>88</sup> *Felder v. Anderson, Clayton & Co.*, 39 Del. Ch. 76, 90, 159 A.2d 278, 286 (1960).

<sup>89</sup> *Huff Fund v. CKx*, C.A. 6844-VCG, letter opinion, Feb. 12, 2014, at 1.

<sup>90</sup> MBCA § 13.24.

<sup>91</sup> MBCA § 13.25.

<sup>92</sup> See Korsmo & Myers, *Appraisal Arbitrage*.

<sup>93</sup> Synopsis of 2015 proposal.

<sup>94</sup> Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 1 (“The Upfront Payment would presumably be non-refundable, as there is no claw-back mechanism provided in the proposed amendment for a company to recoup any amount paid out that turns out to have exceeded the ultimate appraisal award.”).

<sup>95</sup> Letter from Seven Law Firms to Council of the Corporate Law Section of the Delaware State Bar Association, April 1, 2015.

<sup>96</sup> Letter from Seven Law Firms to Council of the Corporate Law Section of the Delaware State Bar Association, April 1, 2015, at 2 (“We generally support the proposal to allow corporations the option of limiting the accrual of interest on appraisal awards by paying to appraisal petitioners such sum as the corporation chooses as to which amount interest would not accrue (although we continue to believe the statutory interest rate is too high). However, as the Council’s accompanying memorandum makes plain, the effect of the proposed legislation will only be that “the incentive for interest rate arbitrage will be dampened” – not that appraisal arbitrage will be eliminated.”).



## II. CRITICISMS OF THE EXISTING STATUTORY RATE

This Part considers the arguments of critics who believe the statutory rate of interest in appraisal proceedings should be reduced. We show that these arguments lack any firm foundation in an overall conception of what interest rates ought to achieve, and they provide no workable principles for selecting an appropriate interest rate.

In view of appraisal's critics, the statutory interest rate is self-evidently high.<sup>97</sup> Some have suggested that the statutory interest rate formula itself should be altered to reduce the resulting rate.<sup>98</sup> Critics were largely nonplussed by the Council's 2015 proposals, and naturally disappointed that the Council did not pursue the more direct expedient of simply lowering the statutory rate, a reform they continue to call for.<sup>99</sup>

### A. *The Failure to Provide Guiding Principles*

The puzzling thing about the claim that the interest rate is too high is that the basis for making such a determination is either incoherent or, more often, left entirely unstated. One facile comparison is to judge the default rate as too high simply because it exceeds prevailing rates on treasuries or retail banking products. It is not relevant, however, to look to what a consumer could earn on a passbook savings account or T-Bills or the rate on a certificate of deposit at the local bank branch. None of these would reflect either the opportunity costs for the petitioner or the cost of borrowing for the acquiring company, the traditional lodestars for Delaware courts prior to the 2007 amendment.

Much of the criticism of the statutory rate is likely rooted in a conviction that the amount of appraisal activity is simply too high, rather than any principled analysis of the interest rate itself. If appraisal activity is too high, the thinking appears to go, a lower interest rate would be desirable

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<sup>97</sup> E.g., Patrick Diaz & Anne Johnson Palmer, Proposed Amendments Address Appraisal Arbitrage, International Law Office, June 24, 2015 (Ropes & Gray authors) ("high statutory interest rate"); Brian M. Lutz & Jefferson E. Bell, Hurdles in Appraisal Actions for Companies Sold in 'Robust' Auction, Delaware Business Court Insider, Feb. 17, 2015 (the authors are litigators at Gibson Dunn & Crutcher) ("favorable statutory interest rate"); Trevor S. Norwitz, Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses CLS Blue Sky Blog, Feb. 10, 2015 ("above-market compound interest rate"); Edward M. McNally, Chancery Court Permits Appraisal Arbitrage, Delaware Court Business Insider, Jan. 14, 2015 ("very favorable"); Jessica Perry Corley & David W. Gouzoules, Developments in Appraisal Litigation, Alston & Bird Client Memo, at 3 (2014) ("In the current low interest rate environment, [the statutory rate] represents an attractive rate of interest, especially in light of the fact that the interest is paid regardless of the appraisal action outcome.").

<sup>98</sup> Trevor S. Norwitz, Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses CLS Blue Sky Blog, Feb. 10, 2015 ("To eliminate these perverse incentives, the statutory interest rate should be lowered to a market rate. Strong arguments can also be made for allowing the buyer to 'defease' any appraisal liability by depositing the merger consideration into a separate escrow-type account (without prejudice to its ability to contest fair value)."); Fried Frank M&A Briefing, June 18, 2014, at 6 ("In light of the significantly increased prevalence of appraisal petitions, it may be that the Delaware Legislature will consider legislative amendments to address some of the difficulties they present for buyers and sellers. Most obviously, the above market statutory interest rate could be reduced.").

<sup>99</sup> Patrick Diaz & Anne Johnson Palmer, Proposed Amendments Address Appraisal Arbitrage, International Law Office, June 24, 2015 (Ropes & Gray authors) ("The council's proposed amendments have been criticised as refraining from making more sweeping changes to render appraisal arbitration less attractive. Some advocate amendments to address the level of the statutory interest rate itself . . ."); Trevor S. Norwitz, Delaware Poised to Embrace Appraisal Arbitrage, CLS Blue Sky Blog, March 9, 2015 ("It is unfortunate that the Council is not also proposing to lower this above-market interest rate.").

simply because it would reduce incentives to pursue appraisal. Some critics are content to point out that the interest award is one possible factor influencing the decision to dissent,<sup>100</sup> which is so obviously true as to hardly need pointing out. Many critics, however cling to the belief that the “high” interest rate is itself sufficient to attract petitioners,<sup>101</sup> while at the same time believing that appraisal activity is destructive and that there is already too much of it. In light of these ideological commitments, the critics’ urge to reduce the interest rate is at least understandable. If the interest rate were just lower, fewer stockholders would dissent. The critics’ focus on the interest rate as an urgent priority for reform is thus not so much the product of any independent examination of what the interest rate should do so much as a skirmish in a broader campaign against the appraisal remedy.<sup>102</sup>

The available empirical evidence, however, shows that appraisal plays a small but beneficial role in public company M&A, focusing private enforcement resources on transactions that are most likely to merit scrutiny.<sup>103</sup> As distinguished commentators have recently observed, the structural features of appraisal are such that it suffers from a problem, if anything, of pervasive under-enforcement.<sup>104</sup> If the interest rate were to be used as a crude lever for either increasing or decreasing the amount of appraisal litigation as a whole, the only empirically justified conclusion is that the interest rate should be considerably higher in order to offset the under-enforcement problem and generate more of the social benefits that would flow from an increase in appraisal activity.

This overall approach, however, is wholly misguided. Using the interest rate as a makeshift sluice for controlling the volume of appraisal litigation would be a mistake for two main reasons. First, anything less than radical adjustments would likely be ineffective for this purpose. There is little reason to suspect that modest tinkering with the interest rate would be an effective way to penalize or subsidize appraisal activity. As a policy lever, it is likely a weak one in that any

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<sup>100</sup> E.g., Patrick Diaz & Anne Johnson Palmer, Proposed Amendments Address Appraisal Arbitrage, International Law Office, June 24, 2015 (Ropes & Gray authors) (“One factor contributing to the popularity of appraisal arbitration is that the Delaware General Corporation Law has a high statutory interest rate – the Federal Reserve discount rate plus 5% – that accrues with quarterly compounding from the effective date of the merger through a judgment on the appraisal claim at the conclusion of the litigation years later.”); Fried Frank M&A Briefing, June 18, 2014, at 2 (“Factors that appear to be contributing to the increased popularity of Delaware appraisal claims in recent years include the well above market statutory interest payable on appraisal awards (5% above the Fed discount rate, compounded quarterly and accruing from the closing date of the transaction to the date the appraisal award is actually paid) . . .”).

<sup>101</sup> See, e.g., Brian M. Lutz & Jefferson E. Bell, Hurdles in Appraisal Actions for Companies Sold in ‘Robust’ Auction, Delaware Business Court Insider, Feb. 17, 2015 (the authors are litigators at Gibson Dunn & Crutcher) (“[T]he favorable statutory interest rate that applies in these cases continues to present arbitration opportunities.”); Jessica Perry Corley & David W. Gouzoules, Developments in Appraisal Litigation, Alston & Bird Client Memo, at 3 (2014) (“To an individual or casual shareholder with limited resources, [the statutory interest rate] is not much of an enticement. But to institutional investors and hedge funds with potentially millions of dollars’ worth of shares, this return on investment is one of the reasons why the appraisal remedy is so appealing, especially given today’s interest rates.”).

<sup>102</sup> See Peter E. Kazanoff & Paul Gluckow, Appraisal Arbitrageur’s Standing Reaffirmed by Chancery Court, Feb. 3, 2015 (noting “merger participants [are] waging an escalating battle with so-called ‘appraisal arbitrageurs’—hedge funds that purchase shares after the announcement of a merger (and often on the eve of the stockholder vote) intending to seek appraisal as an investment strategy”).

<sup>103</sup> See Korsmo & Myers, *Structure of Stockholder Litigation*; Korsmo & Myers, *Appraisal Arbitrage*.

<sup>104</sup> See James D. Cox & Randall S. Thomas, *Addressing Agency Costs Through Private Litigation in the U.S.: Tensions, Disappointments, and Substitutes*, SSRN draft dated Sept. 2, 2015, at 39-40 (describing limitations of appraisal remedy).

reasonable change in the interest rate is likely to be small in relation to the risks and costs of pursuing appraisal. As we explain below, the statutory interest rate is already below the opportunity cost of any sophisticated investor. This is not to say the interest rate has no impact at the margins on the amount of appraisal activity. It surely does. An increase in the interest rate would lead to an increase, at the margin, in appraisal activity; a decrease in the rate would lead, at the margin, to a decrease in activity. But these marginal effects are likely small.

Second, and perhaps more importantly, attempting to fine tune the amount of appraisal litigation by fiddling with the interest rate would deform the incentives facing petitioners and respondents alike, creating opportunities for strategic behavior in litigation. As is explained in the next Part, if the interest rate were to loom large in the mind of stockholders—either as an inducement or deterrent to dissent in the first place, or as an incentive to truncate or drag out the litigation—the focus of appraisal activity would be shifted in unwelcome ways. Such a development would threaten to weaken the existing empirical association between appraisal activity and proxies for legal merit: in particular, unusually low merger prices and insider participation. Any such weakening would undermine the utility of the appraisal remedy as a deterrent to opportunism in the merger market.

Criticism of the existing statutory interest rate as “too high” is puzzling enough, but criticism of the Council’s 2015 proposed amendment is even more baffling. The gravamen of the criticism of the current interest rate regime is that the “high” statutory interest rate is driving the increase in appraisal activity, including meritless petitions.<sup>105</sup> Yet criticism of the Council’s proposal centers on the assertion that “prepaying part of the fair value at the beginning of an appraisal proceeding might further *encourage* appraisal arbitrage.”<sup>106</sup> The original argument was that being able to force the company to keep their money and pay the interest rate serves as an inducement to appraisal arbitrageurs. The new argument is that *not* being able to force the company to keep their money and pay the interest rate would serve as an inducement to appraisal arbitrageurs. This puzzling about-face suggests that many of those complaining about the interest rate care less about optimizing the interest regime and more about curtailing the viability of appraisal as a remedy for minority shareholders.

## *B. The Misleading Comparison of Appraisal Claims to Bonds*

One exception to the general failure of critics to provide any real benchmark for an appropriate interest rate are recent arguments that the rate should mirror rates on corporate bonds.<sup>107</sup> This approach is misguided. It is rooted in the mistaken notion that the dissenting stockholder is in a position akin to that of a willing lender. This flawed premise afflicts a recent paper by Jetley and Ji, who offer a detailed treatment of the interest rate question.<sup>108</sup> In their

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<sup>105</sup> E.g., Trevor S. Norwitz, Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses, CLS Blue Sky Blog, Feb. 10, 2015 (“The appraisal arbitrage problem is further exacerbated by the generous statutory interest rate in Delaware for appraisal proceeds - prime plus 5% compounded - which means that even an entirely meritless appraisal claim will often still be an extremely attractive investment.”).

<sup>106</sup> Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, \_\_ Bus. Law. \_\_ (forthcoming 2016) (SSRN draft at 53-54) (emphasis added).

<sup>107</sup> See Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, \_\_ Bus. Law. \_\_ (forthcoming 2016)..

<sup>108</sup> Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, \_\_ Bus. Law. \_\_ (forthcoming 2016).

analysis, they attempt to “[b]enchmark[] the statutory rate against market rates.”<sup>109</sup> They rightly dismiss the facile comparison to the risk-free rate, noting that “the statutory rate is designed to compensate petitioners for more than the time value of money only.”<sup>110</sup> Instead, they look to corporate bonds issued by financial firms with a three-year maturity rated **BB** or higher, reasoning that these bonds mirror the risks faced by the petitioner.<sup>111</sup> They conclude that the statutory interest rate exceeded that benchmark rate in most of the years from 2010 to 2014.<sup>112</sup> Jetley and Ji do not directly argue for reducing the statutory rate, but the clear implication of their presentation is that the rate is too high relative to the bond benchmark they selected.

Even if it were appropriate to measure the statutory interest rate against corporate bond rates, a problem with the Jetley and Ji analysis on its own terms is that it looks to the wrong population of bonds. Three-year bonds do not capture the durational risk associated with appraisal claims, and in its pre-2007 jurisprudence Delaware paid careful attention to this factor.<sup>113</sup> More importantly, the more appropriate benchmark bond rate would be yields on bonds issued in conjunction with acquisitions by financial sponsors and management groups. Indeed, it’s not clear why this analysis should be limited to bond yields in the first place when other types of acquisition financing better capture the predicament of the dissenting stockholder. When the Dole Food Company was taken-private by its CEO in 2013, generating one of the more closely-watched appraisal cases, the company issued \$300 million of notes bearing an interest rate of 7.25%—well above the statutory rate. Moreover, these notes were senior secured notes, protections unavailable to the dissenting stockholder and which place the notes higher in the payment stream than the claim of a dissenting stockholder.<sup>114</sup> Solely on the terms of the dissenter-as-bondholder view, the statutory interest rate would falter precisely in situations where appraisal is best poised to deliver social benefits, such as in highly leveraged management buyouts. As Vice Chancellor Laster observed in the Dole case itself, “I have yet to see an appraisal where the company’s cost of debt, as shown by its bonds, is not higher than the statutory rate.”<sup>115</sup>

The effort to select the right type of bond return for a dissenting stockholder, however, suffers from a more fundamental error: The dissenting stockholder is not a bondholder. Jetley and Ji find that the statutory rate would sometimes “compensate[] appraisal petitioners for more than the time value of money and for more than a bond-like claim.”<sup>116</sup> But it is entirely appropriate that the statutory rate would do so. The dissenting stockholder did not invest in three-year corporate bonds and is not any type of lender to the surviving company. To be sure, in the event that the

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<sup>109</sup> Jetley & Ji, SSRN draft at 48.

<sup>110</sup> Jetley & Ji, SSRN draft at 48.

<sup>111</sup> Jetley & Ji, SSRN draft at 48.

<sup>112</sup> Jetley & Ji, SSRN draft at 53 (“[T]he Delaware statutory rate . . . was higher than the rate commensurate with the risk of a bond-like claim on an entity with a credit rating of ‘BB’ or higher.”).

<sup>113</sup> *Neal v. Alabama By-Products Corp.*, No. CIV. A. 8282, 1990 WL 109243, at \*21 (Del. Ch. Aug. 1, 1990) *aff’d*, 588 A.2d 255 (Del. 1991) (noting that looking to short-term borrowing rates was inappropriate because doing so “flawed because it ignores the protracted nature of appraisal litigation” where “the dissenting shareholder [is] forced to wait years for a return on his litigation investment”).

<sup>114</sup> The surviving company has no limitations on how it uses its assets during the pendency of an appraisal proceeding and has no duty to escrow or otherwise set aside assets to satisfy the appraisal judgment. *Sporborg v. City Specialty Stores, Inc.*, 35 Del. Ch. 560, 571, 123 A.2d 121, 127 (1956) (“[T]he defendant Corporation had the use of plaintiffs’ money during this period without any ownership obligation toward plaintiffs.”).

<sup>115</sup> *In re Appraisal of Dole Food Co.*, C.A. 9079-VCL, Transcript of Telephonic Rulings of the Court on Defendants’ and Respondent’s Motions for Certification of Interlocutory Appeal and for a Stay Pending Appeal, Feb. 13, 2015, at 25.

<sup>116</sup> Jetley & Ji, SSRN draft at 53.

surviving company declares bankruptcy, the dissenter would be *creditor* of the estate. But the dissenter is perhaps more analogous to a party bringing a claim for the common law tort of conversion. There is plainly some liability on the part of the surviving company, but that liability is not negotiated or voluntary. This supplies yet another reason to look to the legal rate of interest, which prevails where parties have some debt but no agreement on an interest rate.<sup>117</sup>

It is, indeed, a mistake to treat the decision to exercise appraisal rights as a truly voluntary one, akin to buying a corporate bond. The decision to exercise appraisal rights is of course a conscious one, but a stockholder's choice to dissent from an abusive transaction is no more "voluntary" than a driver's "choice" to jump out of a vehicle that is being carjacked. The impending merger will cancel the dissenter's stock in any case, and the only way to vindicate the dissenter's conflicting valuation is to seek appraisal. That decision merely alters the manner in which the stockholder is coercively cashed out of its equity stake in the company. It is certainly true that dissenting stockholders are often specialists who establish a position principally for the purpose of seeking appraisal. Such specialists could be said to "voluntarily" pursue appraisal, but such a conclusion does no analytical work. As we have shown elsewhere, the appraisal arbitrage phenomenon is a beneficial one, promising to lead to better deterrence of abusive transactions and greater compensation for legacy minority stockholders.<sup>118</sup> If these benefits are to be preserved, the specialists who generate them must be able to proceed in appraisal on the same terms as the original stockholders. At a minimum, there are no grounds for singling out the socially valuable role of appraisal specialists for special penalty.

Ultimately, it is a *non sequitur* to assume that the appropriate rate is one negotiated at arm's length by a willing lender and a willing borrower. Indeed, looking to the cost of borrowing may be entirely inapt because the only voluntary association minority stockholders made with the firm was in expectation of an equity rate of return. The impulse to treat the dissenter as a type of lender generated some incoherence in Delaware's pre-2007 jurisprudence. The Court would typically seek to select a rate equal to the "return [the dissenters] might have expected to receive on a prudent investor basis had they received the fair value of their shares of capital stock of [the respondent] on [the merger's effective date] and thereupon invested such moneys prudently."<sup>119</sup> Without justification, this approach presumes a fundamental change in the character of the dissenter's investment—from a concentrated equity investment to a diffuse portfolio of debt instruments—and one accomplished by forces outside of the dissenter's control. Moreover, this approach in practice often yielded results that were positively bizarre. For example, one court declined to consider yields on A and AA rated corporate bonds because those represented a riskier investment than a prudent investor would choose,<sup>120</sup> even though the very same investor had just been forcibly cashed out of its (much riskier) equity stake.

In sum, critics of the existing statutory interest rate have identified no appropriate benchmarks or coherent set of principles for choosing an appropriate interest rate, let alone shown that such benchmarks or principles would warrant a lower rate. As the preceding analysis reveals, most criticism of the interest rate constitutes more of a rhetorical move than a reasoned argument grounded in a careful examination of the role of the interest rate.

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<sup>117</sup> See 6 Del. § 2301 (providing that legal rate of interest applies "[w]here there is no expressed contract rate" of interest).

<sup>118</sup> See Korsmo & Myers, *Appraisal Arbitrage*.

<sup>119</sup> *Lebman v. Nat'l Union Elec. Corp.*, 414 A.2d 824, 829 (Del. Ch. 1980).

<sup>120</sup> *Robbins & Co. v. A.C. Israel Enter.*, C.A. No. 7019, slip op. at 30-31 (Del. Ch. Oct. 2, 1985), cited in Folk on Corporate Law section 262.10 (2d ed. 1988).

### III. PRINCIPLES FOR INTEREST RATE REFORM

In this part, we attempt to supply what critics of the appraisal remedy and of the statutory interest rate have not: a coherent set of principles for setting an appropriate rate of interest. The procedure for setting the interest rate should observe two primary principles, and two secondary principles. The primary principles are that the interest rate (1) should not overly distort the decision to pursue an appraisal claim in the first place; and (2) should make the parties indifferent to the passage of time in litigation. From these primary principles, it follows that the interest rate regime would function ideally if the rate charged to the company were equal to its marginal cost of capital and a conceivably different rate delivered to the dissenter were equal to its opportunity cost of capital. This ideal solution is tempered, however, by the secondary principles that the procedure for setting the interest rate (1) should not consume undue litigation resources; and (2) should err on the side of encouraging the resolution of disputes.

#### A. *The Policy Goals of Interest in Appraisal*

Fashioning the appropriate interest rate is a deceptively complex policy question. The first point to recognize, though, is that the award of interest should serve to further the broader policy goals of the appraisal remedy. The primary policy goals of the appraisal remedy are to compensate minority shareholders who have been injured by opportunistic or otherwise abusive transactions in order to deter such transactions in the first place.<sup>121</sup> These policy goals can best be met if appraisal petitioners bring meritorious claims, and if these claims are resolved accurately. Selecting an appropriate interest rate is a second-order question that should serve these first-order concerns.

#### B. *Primary Principles*

Two primary principles follow from these policy goals. The first primary principle is that the interest rate should not distort minority stockholders' decision to dissent in the first place. The decision to dissent should be focused on the key merits issue—whether the merger price is below fair value—and should not be unnecessarily distorted by the interest rate. Distortions can happen in at least two ways. First, an interest rate that is too high or too low can directly alter petitioners' decisions to bring a claim. A sufficiently high interest rate can make a claim positive net present value even where fair value is below the merger price, while a sufficiently low interest rate can make a claim negative net present value even where fair value is above the merger price. Second, rather than focusing exclusively on the merits, petitioners are forced to take the creditworthiness of the respondent into account if the interest rate fails to do so. That is, when a uniform interest rate is applied, a weak claim against a financially healthy respondent could, all else equal, be more attractive than a strong claim against a financially weak respondent, an unwelcome result.

The second primary principle—which follows from the goal of encouraging accurate resolution of claims—is that the award of interest should serve to make the parties indifferent to the passage of time. Litigation is a form of dispute resolution that necessarily takes time: exchanging information, resolving questions of law by motion, presenting evidence to the trier of fact, the preparation of decisions, and the execution of judgments. In a typical appraisal proceeding, a trial

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<sup>121</sup> See Korsmo & Myers, *Appraisal Arbitrage*, supra note 1.

may take perhaps two years to complete, but post-judgment appeals can sometimes extend that timeline significantly. The infamous case of *Cede & Co. v. Technicolor* lasted for more than 22 years.<sup>122</sup> While *Technicolor* is an obvious outlier, the example illustrates the potential for extraordinary lags between the closing of a transaction and the resolution of the appraisal dispute.

If the parties to litigation are not indifferent to the passage of time, their behavior will be affected in ways that threaten either to increase litigation costs or to imperil the accuracy of the resolution, or both. An interest rate that is too low will give the company an incentive to drag out the proceeding, wasting litigation resources. A too-low rate will also give the dissenter an incentive to settle quickly for less than fair value, imperiling the deterrence and compensation functions of appraisal. An interest rate that is too high will create the opposite situation—a dissenter tempted to engage in dilatory tactics, and a company eager to settle even for more than fair value. It is impossible to say with any confidence how these dynamics will play out in any given case. It seems most likely to us, however, that where interest rates are set improperly, disputes will tend to be resolved in one of two ways: either 1) via a trial judgment after substantial delay occasioned by dilatory tactics; or 2) by the time-disadvantaged party giving up substantial value in order to reach settlement with the time-advantaged party. Both options are undesirable, as the first entails unnecessary litigation costs and the second entails a loss of accuracy.

From these considerations flows the principle that the interest rate should make the parties time-indifferent. Under conditions where parties are time-indifferent, each party's has optimal incentives: Party A cannot profit by rushing or delaying, not only because the timing of the resolution of the dispute will not affect Party A's payoff from the case, but also—and crucially—if Party A also knows that its adversary is time-indifferent, Party A has no second-order incentive to engage in strategic rushing or delay to pressure its adversary to settle on terms divorced from the underlying merits.

Indeed, though the implementation often left much to be desired,<sup>123</sup> this time-indifference principle appears to underlie Delaware's pre-2007 judicial procedures for setting the interest rate. As detailed in Part I, prior to the creating of the statutory interest rate, Delaware Courts looked to both compensate the petitioner for the loss of use of their funds during the pendency of the proceeding, and at the same time to avoid unjustly enriching the respondent.<sup>124</sup> Indeed, in Delaware's pre-2007 jurisprudence, there were occasionally explicit references to removing time from the parties' incentives. Chancellor Chandler's observation in *Gonsalves v. Straight Arrow*

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<sup>122</sup> The merger was accomplished on January 24, 1983, *Cede & Co. v. Technicolor, Inc.*, 884 A.2d 26, 31 (Del. 2005), and the final judgment was satisfied in July of 2005. See Satisfaction of Judgment, *Cede & Co. v. Technicolor*, C.A. 07129, filed July 13, 2005.

<sup>123</sup> To give one example of the shortcomings of pre-2007 jurisprudence, consider the practice of charging interest at a blended average of the petitioner's opportunity cost of capital and the respondent's weighted average cost of capital. Where the respondent's cost of capital was greater than the petitioner's opportunity cost, this meant awarding an interest rate that was *greater* than the petitioner's opportunity cost, but *less than* the respondent's cost of capital. Such a result would give *both* parties an incentive to drag out the proceedings for as long as possible, perhaps helping to explain some of the extremely drawn out appraisal cases of yesteryear. See, e.g., *Cede v. Technicolor*; *Neal v. Alabama By-Products Corp.*, No. CIV. A. 8282, 1990 WL 109243, at \*21 (Del. Ch. Aug. 1, 1990) aff'd, 588 A.2d 255 (Del. 1991) ("Appraisal cases are akin to wars of attrition, with the dissenting shareholder forced to wait years for a return on his litigation investment.").

<sup>124</sup> *Grimes v. Vitalink Communications Corp.*, 1997 WL 538676 (Del. Ch. Sept. 17, 1997) ("An award of interest serves two purposes. First, an award of interest recognizes that petitioners, by electing to pursue appraisal rather than accepting the amount offered in the merger, have been denied the use of the fair value of their shares. Second, an award of interest recognizes that the corporation has received a benefit from the use of the fair value of petitioners' shares during the pendency of the proceeding.").

*Publishers* captures this insight: “In essence, an interest award is the Court's attempt to put both parties in the position most closely approximating their respective positions had the fair value of the dissenting shareholder's stock been paid on the date of the merger.”<sup>125</sup> Delaware law recognized this fundamental connection in other ways too. The Court had the power to treat dilatory behavior by a party as a tacit admission that the interest rate was too favorable and exercise its discretion to alter the interest rate against that party.<sup>126</sup>

With these two primary principles in mind, it follows that the optimal rate for the dissenter is one that is equal to its opportunity cost of capital, while the appropriate rate for the respondent is one that equal to its marginal cost of capital. An interest rate that diverges from a party's marginal cost of capital can cause mischief and interfere with the effectiveness of the underlying remedy. Policy problems mount whether the rate is too high or too low. If the rate is below the petitioner's opportunity cost of capital, the petitioner will be dissuaded at the margin from bringing worthwhile appraisal claims and will be inclined to settle too cheaply to avoid the undercompensated passage of time. If the rate paid to the petitioner is above its opportunity cost of capital, the incentive at the margin is to bring claims to capture the interest premium and to drag out the claims to maximize exposure to that rate. On the respondent side, the problems are the converse. When the rate charged to the surviving company is below its marginal cost of capital, it would welcome the appraisal claim and also seek to prolong the proceeding to take advantage of the cheap financing. By contrast, if the rate is above the respondent's marginal cost of capital, the respondent will experience undue pain with the passage of time and be inclined to settle richly to avoid the accrual of interest.

### C. *Secondary Principles*

To these primary principles, we add two secondary principles rooted in practical considerations. Identifying the appropriate interest rate is itself a fact and analysis-intensive process that consumes private and judicial resources and is subject to uncertainty. Any dispute resolution system faces tradeoffs between costs (including time and resources) and accuracy. A lengthy and expensive proceeding that results in only a marginally more “accurate” interest rate is not necessarily superior to a more truncated procedure that trades off a little accuracy for reduced costs. What should be sought is not perfect accuracy, but an optimal tradeoff that produces a result accurate enough to generate the desired incentive effects at an acceptable level of cost. Thus, the first secondary principle guiding our proposed reform of the interest rate is that determining the appropriate rate should not itself be a complex and expensive undertaking. All else being equal, simplicity should be favored and procedures requiring extraordinary judicial efforts should be eschewed.

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<sup>125</sup> *Gonsalves v. Straight Arrow Publishers, Inc.*, 2002 WL 31057465\*9 (Del. Ch. Sept. 10, 2002). This principle also arises in other areas of law that deal with prejudgment interest. *General Motors Corp. v. Devex Corp.*, 461 U.S. 648, 655 (1983) (“In the typical case [of patent infringement] an award of prejudgment interest is necessary to ensure that the patent owner is in as good a position as he would have been in had the infringer entered into a reasonable royalty agreement.”).

<sup>126</sup> See *Union Illinois 1995 Inv. Ltd. Partnership v. Union Financial Group, Ltd.*, 847 A.2d 340, 364 (Del. Ch. 2003) (noting that “inexcusable torpor . . . would justify the imposition of simple interest”). This principle is also evident in patent disputes. See *General Motors Corp. v. Devex Corp.*, 461 U.S. 648, 655 (1983) (“[I]t may be appropriate to limit prejudgment interest, or perhaps deny it altogether, where the patent owner has been responsible for undue delay in prosecuting the lawsuit.”).



The final secondary principle for interest rate grows out of the unavoidable inaccuracy of any point estimates for appropriate interest rates. All else being equal, incentives to delay are likely to be more destructive than incentives to resolve quickly, as litigation delay generally entails a waste of both private and public resources. In the presence of uncertainty, then, the rules should err on the side of giving parties an incentive to resolve their dispute promptly. For example, suppose the plausible range for the petitioner's opportunity cost is between 8% and 9%; in the presence of that uncertainty, it would be appropriate for the court to select an interest rate of 8%, or even slightly lower, which would ensure the petitioner has the appropriate incentives to move the case to resolution. This approach helps to ensure that the petitioner and respondent will have no incentive to be dilatory in resolving their dispute.

#### IV. A SUPERIOR INTEREST RATE REGIME IN DELAWARE APPRAISAL

It is a tall task to design a uniform interest rate—as the 2007 reform did—that applies across all cases. While such an approach has undoubtedly reduced the resources devoted to resolving interest rate questions, error costs are bound to be higher with a one-size-fits-all formula. The silver lining of these errors is that they are likely to be in the right direction: the legal rate is likely lower than the opportunity cost of capital for the sophisticated appraisal petitioners who hold the bulk of dissenting stock, and also higher than the marginal costs of capital for at least a handful of surviving companies. This is not to say that the 2007 amendment is necessarily a bad approach, however. For what it is—a single interest rate that is set by formula and applies to both parties in all cases—the legal rate does a serviceable job. If nothing else, it has helped to create an environment where appraisal litigation appears to be largely meritorious, even if under-enforcement of appraisal rights is still a problem. But given the pressure on Delaware to alter its interest rate regime, it likely must abandon the regime for something else, and there is room for improvement.

In this Part, we present a proposal to reform the interest rate regime in Delaware appraisal. As an initial matter, we reject the feasibility of an “optimal” interest rate regime that attempts to determine the parties' opportunity costs in favor of a second-best regime that is more easily administrable. Our proposed regime has five salient features designed to further the principles enunciated in Part III. First, as in the Council's 2015 proposal, the company has a unilateral option to prepay an amount of its choosing to the dissenter. Second, also like the Council's proposal, the amount of the initial payment does not constitute an undisputed amount or a floor on fair value. Third, the petitioner can, at any time, abandon the litigation and retain the amount prepaid. Fourth, prepayment can be made only at the outset of the proceeding. Fifth, *either* party will be liable to the other for interest on the difference between the amount prepaid and the fair value adjudged at trial, with the interest rate set at the weighted average cost of capital (WACC) of the target company.

##### A. *An “Optimal” Interest Rate Regime is Impractical*

Assigning interest rates to make parties perfectly indifferent to time is, unfortunately, unrealistic. Most obviously, time-indifference for both parties could not be achieved by a single interest rate unless by some extraordinary serendipity the petitioner's opportunity cost of capital were equal to the respondent's. In virtually every case, optimal incentives could only be achieved by charging one interest rate to the respondent and awarding a different interest rate to the petitioner. If, for example, the respondent had a cost of capital of 13%, while the petitioner had an

opportunity cost of capital of only 8%, joint time-indifference could only be achieved by charging the respondent 13% while only awarding the petitioner 8%. While such a system could, in theory, be implemented—with the surplus perhaps escheating to the state or flowing to a worthy entity like the Delaware Bar Foundation—it would be, to our knowledge, *sui generis*. Even more problematic would be the situation when the roles are reversed, with the petitioner having an opportunity cost of 13% and the respondent 8%. In this situation, joint time-indifference could only be achieved by awarding the petitioner more interest than is charged against the respondent, a problem with no realistic solution.

Moreover, employing two different interest rates would fail the test of conserving litigation resources by expanding the issues before the court. In particular, the opportunity cost of capital for the petitioner is likely to defy easy calculation, particularly given the parties' incentives to be strategic about their actual opportunity costs. In addition, unlike the respondent's cost of capital, which would have to be calculated anyway in most appraisal proceeding as part of performing a discounted cash flow valuation, determining the petitioner's cost of capital would represent an entirely new issue for judicial resolution.

## *B. A Second-Best Interest Rate Regime*

In light of these practical difficulties, an “optimal” solution with two separate interest rates is untenable. As the Council sagely recognized, though, the parties' incentives could be improved substantially by focusing not on the rate itself, but rather by reducing the amount of money to which a rate must be applied in the first place. In this section, we build on the Council's proposal to allow the respondent to make an initial payment that stops the running of interest on that amount, and we offer several improvements designed to avoid strategic behavior and better promote time-indifference.

### *1. An Option to Prepay to Stop the Running of Interest*

We propose that Delaware amend its statute to give surviving companies the option to make an initial payment to dissenting stockholders, in any amount the company chooses, thereby stopping the accrual of interest on amounts so paid. Dissenting stockholders would be required to accept the payment, with no discretion to reject it. At the end of the proceeding, any difference between amounts so paid and the amount the court ultimately determines to constitute fair value would still be subject to interest, as further described below. This proposal captures the same basic idea at the heart of the Council's 2015 proposal, and serves both of the primary principles introduced in Part III: it promotes time-indifference without distorting the incentives of minority stockholders to bring meritorious claims.

In several recent appraisal proceedings, companies have complained that the current regime does not allow them such an option. For example, ISN Software recently protested that “the incentives created by the default interest rate, in the current interest rate environment, are significantly out of balance in favor of appraisal petitioners,” noting that the “default statutory rate is more than seven times the federal discount rate.”<sup>127</sup> CKx, another respondent company in a recent appraisal proceeding, similarly bemoaned “the harsh effects of the continuing accrual of above-

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<sup>127</sup> In re ISN Software Corporation Appraisal Litigation, C.A. 8388-VCG, Respondent ISN Software Corporation's Motion for Entry of a Scheduling Order, Sept. 9, 2013, at 5 n. 3.

market interest rates.”<sup>128</sup> Companies may have access to cheap sources of capital like a revolving credit line that they would use to pay off the dissenter.<sup>129</sup>

By giving the company the option to prepay, the importance of the interest rate is vastly diminished. If the surviving company’s management believes the interest rate exceeds their marginal cost of capital, or is otherwise too high, this option gives them the opportunity to put their money where their mouth is. Indeed, the danger of setting the interest rate too high largely dissipates in the presence of an option to prepay. If the interest rate is excessive, it will simply give the surviving company—the party with the best information as to fair value—a more powerful incentive to put its best estimate of fair value on the table at the outset of the proceeding. In the presence of a prepayment option, it is only the risk of setting the interest rate too low that remains acute. If the interest rate is lower than the surviving company’s cost of capital, the company would simply refuse to prepay and would face an incentive to prolong the litigation for as long as possible. This problem is partially addressed below.

In any event, the surviving company would subsequently only be exposed to the interest rates on adjudged amounts exceeding the prepayment, reducing any incentive to rush or prolong the proceeding. Amounts paid over would similarly lessen the time-sensitivity of dissenting stockholders by reducing their exposure to the interest rate. To achieve this, the payment need not be cash; it could also be in the form of any publicly-listed asset that formed a portion of the merger consideration, including contingent value rights. For purposes of valuing the amount paid to determine how much interest accrual was stopped by the payment, any consideration paid over should be valued as of the date when it was delivered to the dissenter by reference to public prices, as this best measures the cash equivalent of what was provided to the dissenter.

## 2. *The Prepayment Does not Constitute an Undisputed Amount*

The amount of the initial payment should not constitute a concession by the company of the minimum fair value of the company. Furthermore, the dissenting stockholders should be required to pay back, with interest, any amounts by which the initial payment exceeds the fair value determined at trial. This aspect of our proposal differs from the Council’s 2015 proposal, at least as the Council’s proposal has been interpreted.<sup>130</sup> In this regard, the Council’s proposal functionally tracked the Model Act, which contemplates the surviving company making a payment of an

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<sup>128</sup> Huff Fund v. CKx, C.A. 6844-VCG, Respondent’s Reply Brief in Support of Motion to Stop the Accrual of Interest, filed Dec. 30, 2013, at 1.

<sup>129</sup> In evaluating the benefits the company obtained by delaying the payment of fair value to the dissenter, pre-2007 cases rejected looking to whatever source of capital the company claimed it would draw upon to satisfy the appraisal judgment. *Kleinwort Benson Ltd. v. Silgan Corp.*, No. CIV. A. 11107, 1995 WL 376911, at \*11 (Del. Ch. June 15, 1995) (“The combined average rate for these borrowings is 10.51%. Respondent contends that the rate for its revolving credit line, which is 9.08%, represents its actual costs of borrowing for the purposes of this appraisal action. According to Respondent, Silgan would have used this source of credit to increase its borrowings had it not had use of Petitioners’ funds. Petitioners argue that the Court should ignore secured debt like the revolving credit line in determining Respondent’s cost of bargaining. Petitioners portray Silgan’s retention of their money as an unsecured loan, thus Silgan’s rate for unsecured borrowing is the relevant rate. In determining Silgan’s borrowing rate, I will not exclude any of Silgan’s sources of credit. Silgan’s aggregate borrowing rate best reflects the benefit it received from having use of Petitioners’ funds during the pendency of this proceeding.”).

<sup>130</sup> As explained in Part I, the Council’s 2015 proposal would not have formally limited the respondent’s ability to argue a fair value at trial that was less than the amount of the prepayment. The proposal, however, contained no mechanism for the return of overpayments. As a result, the respondent would technically be free to argue a lower value, but doing so not do them any good. *See supra*, Part I.

amount “not in dispute,” meaning that the payment sets a floor for the rest of the litigation. Under the Council’s proposal, the company was free to argue that the fair value was below the amount of the initial payment, but it did not provide for any right to recover such overpayment. Not treating the initial payment as an undisputed amount serves two purposes. First, it preserves downside risk for dissenting stockholders, and with it the incentive to pursue only meritorious claims, furthering our first primary principle. Second, it allows respondents to put their best estimate of fair value on the table without fear of prejudicing their litigation position, thus maximizing the time-indifference of the parties, furthering our second primary principle.

One of the virtues of appraisal claims is that they present downside risk: a stockholder faces a real risk that she will receive less than the merger consideration, which stands as an independent deterrent to nuisance claims without any need for policing by judges. Of course, we would expect sophisticated appraisal specialists to select claims for litigation that present a larger chance of gain than a risk of loss, but that is simply evidence that they face the right incentives and that the system is working well.

The importance of downside risk in appraisal can most easily be grasped by comparison to the situation in merger class actions. In a typical merger class action, a plaintiffs’ attorney can file a claim almost costlessly, representing a lead plaintiff lacking a meaningful economic stake. Furthermore, the plaintiff stockholders have already received the merger consideration and are litigating for pure upside, with no risk of loss. With a low cost of bringing a claim and no risk of loss, there exists no natural economic deterrent against bringing low-value nuisance suits in an effort to extract a quick settlement for litigation costs. And, in fact, in recent years virtually every significant merger has attracted a fiduciary duty class action, with the vast majority settling quickly for little more than a few supplementary disclosures for stockholders and a cash fee for the plaintiffs’ attorneys.<sup>131</sup> The judges of the Court of Chancery have recently begun to more aggressively police these settlements, but they face an uphill battle in the face of the parties’ economic incentives. We posit that the existence of downside risk is one of the primary reasons the pattern of appraisal litigation is so different, with petitioners narrowly focusing on meritorious claims.<sup>132</sup>

The interest rate regime should not undermine the risk of loss that faces petitioners and risk making the dynamics in appraisal more like those in merger class actions. Both parties should still face litigation risk even after the initial payment. Treating an initial payment as an undisputed amount, or otherwise treating it as a floor at trial, would reduce the two-sided litigation risk in appraisal, perhaps sharply. Turning appraisal into a free (or low-cost) option for petitioners would diminish the incentive for petitioners to avoid low-merit claims, and threaten to transform appraisal litigation into something more resembling the swamp of nuisance suits that characterizes merger class actions. Two-sided litigation risk can be preserved by requiring petitioners to return, with interest, any prepaid amounts in excess of fair value determined at trial.

This procedure would also serve to prevent giving the surviving company an incentive to underpay. The primary goal of mutual time-indifference can best be achieved if the respondent prepays an amount approximating the fair value ultimately determined at trial.<sup>133</sup> The respondent is well-placed to do so, given that it is the party with the best information as to fair value, but it must confront the proper incentives. Unless the company is free to argue at trial that the fair value is less

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<sup>131</sup> See Cain & Davidoff.

<sup>132</sup> See Korsmo & Myers, *Structure of Stockholder Litigation*.

<sup>133</sup> Ideally, if fair value is determined to be equal to the prepayment, the interest rate becomes entirely irrelevant.

than the amount of the initial payment, and unless the petitioner must repay excessive prepayments, the company will have an incentive to be stingy in its initial payment for fear of overpaying.<sup>134</sup> Indeed, in analyzing the Council’s proposal, M&A lawyers emphasized the importance of avoiding overpayment.<sup>135</sup> As one M&A advisor noted, treating prepayments as a floor would discourage companies from making an initial payment that “exceeds the amount it is arguing represents fair value (*even if the company believes that the appraisal award will significantly exceed that amount*).”<sup>136</sup> Our proposal reduces the incentives of respondents to skew the amount of the initial payment away from the company’s actual estimate of its fair value, inhibiting what would otherwise be a useful mechanism of dispute resolution.

### 3. *The Dissenter Can Walk Away with the Prepayment*

Under our proposal, the surviving company’s option to provide a prepayment is unilateral. The dissenting stockholder has no discretion to refuse the prepayment. Moreover, the dissenter will ultimately be required to pay interest on any overpayment. As a result, the surviving company would often have an incentive to engage in strategic behavior, paying *more* than their best estimate of fair value. In particular, if the interest rate is above the company’s cost of capital, overpaying dissenting stockholders would offer an attractive return. Similarly, if the interest rate is above the dissenting stockholder’s cost of capital, the surviving company could purposely overpay in an effort to make the dissenter time-sensitive and thereby increase settlement pressure. In either situation, overpayment will erode the time-indifference of the parties, and the second scenario would also impede the accuracy of the proceeding by giving dissenters an incentive to settle quickly even for less than fair value.

To counteract any incentive for the surviving company to overpay, our proposal makes clear that the dissenting stockholder retains the unilateral right to walk away with the prepayment in full satisfaction of their claims. This feature of our proposal balances the surviving company’s incentives. If it prepays less than its best estimate of fair value, it faces the prospect of owing additional interest. If it prepays more than its true estimate of fair value, it faces the prospect that the dissenters will simply pocket the payment and walk away. As a result, the company’s incentive is to offer its best estimate of fair value, neither more nor less. In such a scenario, the initial payment may function as the only payment. This result would both avoid the unnecessary consumption of resources in litigation and resolve the dispute at a price set by the best-informed party.

Given the stark informational disadvantage that the dissenting stockholder faces in evaluating the fair value of the company without any fact discovery, the decision to walk away from

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<sup>134</sup> Mary Siegel, *An Appraisal of the Model Business Corporation Act’s Appraisal Rights Provisions*, 74 *LAW & CONTEMP. PROBS.* 231, 236 (2011) (“[K]nowing that its payment of fair value will be a sunk cost will cause a corporation to be judicious about the amount it declares to be the fair value of the stock.”).

<sup>135</sup> E.g., Fried Frank M&A Briefing, *Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder*, March 23, 2015, at 4 (“A company would need to take into account the degree of confidence it has, and at what stage of the proceeding it has it, as to what the likely range of the ultimate appraisal award will be—so that the company does not pay more in the Upfront Payment than the amount ultimately awarded (since, as noted, any excess amount presumably would be forfeited).”).

<sup>136</sup> Fried Frank M&A Briefing, *Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder*, March 23, 2015, at 5 (emphasis added).

the appraisal claim after receiving the upfront payment would often be challenging. As Delaware courts recognized in pre-2007 case law, “[a] dissenting stockholder cannot easily evaluate the corporation’s [settlement] offer in an appraisal action because the corporation is usually in the best position to determine the value of the stock.”<sup>137</sup> If the interest regime induces the company to play games with the upfront payment, the dissenter is unlikely to seriously consider accepting the claim and walking away. The design of the interest regime proposed thus far, however, should make it credible that the informationally-advantaged respondent has, at the very least, not *over*-paid in its prepayment. Thus, the dissenter could more confidently decline to pursue additional litigation following receipt of an initial payment that exceeds her estimate of fair value.

#### 4. *The Prepayment Option is Time-Limited*

The company’s unilateral prepayment option is designed to promote time-indifference by relieving it from paying interest on the appraisal claim at a rate that exceeds its cost at which it could raise enough money to satisfy the dissenter. Because the company will know whether this situation holds at the time the transaction closes, our proposal requires it to make an election about the initial payment in a reasonable amount of time following the close of the transaction: 30 days from the effective date of the merger. No interest would be charged during this 30 days.

Limiting the pre-payment option to 30 days preserves an important option for the company without opening the door to tactical gamesmanship—by either side—that could undermine litigation and settlement incentives. In the wake of the Council’s 2015 proposal—which would have allowed the company to make a payment any time before entry of judgment—deal lawyers advised firms to consider such tactical maneuvers. One prominent M&A law firm issued a memo advising clients that the “decision whether, when, and in what amount to make an Upfront Payment will be complicated.”<sup>138</sup> One consideration was the “strategic disadvantage” of making a payment to the dissenters because doing so would reduce their at-risk capital, decrease their credit risk, and allow them to fund their litigation expenses.<sup>139</sup>

An examination of the recent disputes involving ISN and CKx—two companies that complained about the interest rate in court papers—reveals the extent to which parties in appraisal could use timing as a tactical gambit to apply pressure to their adversaries. In ISN, for example, the company was negotiating the scheduling order at the same time it was trying to induce the petitioners to accept a cash payment that would partially satisfy an ultimate judgment and stop the running of interest on that portion.<sup>140</sup> The harder it pressed on the scheduling order in court, the more attractive its cash payment would appear to the dissenters. The attempt to prepay by CKx

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<sup>137</sup> Chang’s Holdings, S.A. v. Universal Chemicals & Coatings, No. CIV. A. 10856, 1994 WL 681091, at \*2 (Del. Ch. Nov. 22, 1994).

<sup>138</sup> Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 4.

<sup>139</sup> Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 4 (“A company would have to consider the strategic disadvantage to the company of providing a significant cash payment to the dissenting stockholders before the end of the appraisal proceeding that would reduce their capital at stake and credit risk and that could be used to fund their expenses.”).

<sup>140</sup> In re ISN Software Corporation Appraisal Litigation, C.A. 8388-VCG, Respondent ISN Software Corporation’s Motion for Entry of a Scheduling Order, Sept. 9, 2013, at 4 (“ISN suggested the possibility of making a prepayment of a portion of any potential judgment in this action in order to stop the running of interest on such portion. ISN indicated that the resolution of that issue would likely impact its view on scheduling.”).

was especially peculiar in light of its timing: its motion to force the petitioners to accept prepayment did not come until *after* trial, more than two years after the closing of the merger. If the interest rate had actually been excessive, surely CKx would have found it nettlesome far sooner. In fact, it seems highly unlikely the interest rate was excessive. CKx was grumbling about paying a 5.75% interest rate just months after it had vigorously argued at trial that its cost of capital was 13%.<sup>141</sup> Even at the time of the merger, the fairness opinion supplied by CKx’s financial advisor had estimated 13% to 15% as the appropriate range for the company’s cost of capital.<sup>142</sup> In this light, the statutory rate of interest in Delaware could only be considered extraordinarily favorable to CKx, and their desire to prepay can be presumed to stem from tactical motivations. On the dissenting stockholder side, it is hard to understand why the dissenters would refuse to accept any proffer of payment except to maintain settlement leverage on the company.

Limiting the window in which the company can elect to make the initial payment would constrain the ability of the company to act strategically. The purpose of our proposal is to push the parties towards time-indifference, not to allow parties new avenues for exploiting the time-sensitivity of adversaries with tactical maneuvers.<sup>143</sup>

### 5. *The Appropriate Interest Rate is the WACC of the Surviving Company*

Under our proposal, either party must pay interest on any differential between the amount prepaid and the amount adjudicated as fair value. As noted above, the optimal interest rate would actually be two interest rates, charging and awarding each party interest at a rate equal to their respective opportunity costs of capital. If, however, the surviving company has good incentives to prepay their best estimate of fair value, the “accuracy” of the interest rate is dramatically reduced in importance. At this point, what is at stake in choosing an appropriate interest rate is best revealed by examining the incentives for the surviving company and the remaining opportunities for strategic behavior.

No matter the interest rate, the surviving company is effectively deterred from prepaying more than its estimate of fair value by the risk that the dissenting stockholder will simply choose to pocket it and walk away. If the interest rate is excessive from the surviving company’s perspective, it can simply avoid it by prepaying its best estimate of fair value. The dissenting stockholder will then have the asset in hand and can take advantage of whatever opportunities it would otherwise miss out on, satisfying the goal of time indifference. It is only if the interest rate is too low that the company may behave strategically by deliberately underpaying (or not paying at all) and taking

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<sup>141</sup> Huff Fund v. CKx, C.A. 6844-VCG, Redacted Version of Respondent’s Opening Post-Trial Brief, May 17, 2013, at 45 (“Mr. Cohen drew upon a variety of sources for a WACC that led him to find a range of between 9% and 18%, from which Mr. Cohen selected a 13% WACC as reasonable.”).

<sup>142</sup> Schedule 14D-9, CKx, Inc., filed with the SEC on May 18, 2011, at 33 (noting “a range of discount rates from 13% to 15%, which were chosen by Gleacher & Company based upon an analysis of the weighted average cost of capital of CKx”).

<sup>143</sup> Under our proposal, the company would be forced to elect to make an initial payment before the time runs for filing a petition. If a stockholder is ultimately found not to be eligible for appraisal, he would not be owed interest on amounts not prepaid, but would be required to pay back, with interest, any amount prepaid in excess of the merger consideration. If the company truly believes that a stockholder is not eligible for appraisal, it should be entirely willing to decline to make an initial payment, confident in the knowledge that it will prevail in its motion to dismiss. But doing so would expose it to the need to pay interest in the event the stockholder is ultimately found to be appraisal-eligible. In this way, the proposal again has the virtue of forcing the company to put its money where its mouth is.

advantage of the cheap “borrowing.”<sup>144</sup> This directly undermines the time-indifference principle and will frustrate rather than further the underlying aims of the remedy. In a predictable set of cases—where the company’s cost of capital is higher than the statutory rate—the company will have an incentive to drag out the litigation and the dissenter will have an incentive to rush. This time factor will bias the parties’ reservation prices (and their settlement positions) such that the settlement dynamic will be driven by factors other than the fair value of the stock.

The immediate conclusion is that, where the surviving company has a unilateral option to prepay and the dissenter has the option to walk away from the claims, the interest rate should err on the side of being set too high. A high interest rate has the additional virtue of somewhat increasing the risk to both parties from dilatory tactics, thus furthering our secondary goal of encouraging expeditious resolution of the dispute. Adjusting the interest regime in service of the expeditious resolution of disputes would not be novel. It is the logic behind the Model Business Corporation Act’s analogous provisions: As Professor Mary Siegel noted, “the [MBCA’s] prepayment feature identifies the amount that is actually in dispute, and such identification encourages settlement: both sides can tangibly recognize that the amount in dispute is, perhaps, fairly small.”<sup>145</sup> Beyond corporate law, a number of other areas of law alter the entitlement to prejudgment interest or the applicable rate depending on preliminary settlement behavior. California, for example, has adopted a provision that applies a penalty rate of interest to personal injury claims. In the event that a plaintiff makes a settlement offer, the defendant rejects it, and the plaintiff obtains a more favorable judgment, interest accrues at 10% annually from the date of the settlement offer.<sup>146</sup> Similarly, although prejudgment interest is generally not available in tort claims, Ohio law allows for it when a prevailing party made a good-faith effort to settle a case and the opposing party failed to make a good faith effort to settle.<sup>147</sup> Like these statutes, the design of the proposal here uses the interest rate as an instrument to induce the parties to be reasonable.

One simple solution would be to alter the default rate to a significantly higher rate—something like the federal funds rate plus 10 percent, or even higher. Doing so, however, would significantly increase the risk of inaccuracy distorting the parties’ incentives. A more complex but still eminently workable solution—the one we propose—would look to the WACC of the target company as the rate at which to charge the company. This rate has a number of key advantages. Chief among them is that using the WACC takes into account the characteristics of the particular company without increasing the cost of litigation.<sup>148</sup> First, the parties will be computing this figure anyway as part of their valuation cases because it is an essential term in calculating a discounted cash flow valuation of the company, which is a common valuation method both in Delaware

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<sup>144</sup> E.g., Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost—Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 3 (noting that in determining whether to make an initial payment “[a] company would need to determine the economic benefit of reducing the amount on which the statutory interest will have to be made, as compared to the economic benefit of holding all of the funds for the full period of the appraisal proceeding (based on the company’s cost of capital, access to capital, need for cash, and other factors)”).

<sup>145</sup> Mary Siegel, An Appraisal of the Model Business Corporation Act’s Appraisal Rights Provisions, 74 LAW & CONTEMP. PROBS. 231, 237 (2011).

<sup>146</sup> California Code sec. 3291.

<sup>147</sup> Ohio Rev. Code Ann. § 1343.03(C) (Banks-Baldwin 1994) (requiring payment of interest where “the party required to pay the money failed to make a good faith effort to settle the case and that the party to whom the money is to be paid did not fail to make a good faith effort to settle the case.”).

<sup>148</sup> Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage—Is There a Delaware Advantage?*, \_\_ Bus. Law. \_\_ (forthcoming 2016) (SSRN draft at 53) (“[I]t may not be possible to set an interest rate based on the characteristics of a target or an acquirer without increasing the scope of issues that are likely to be litigated in an appraisal proceeding.”).



appraisal proceedings and in banker fairness opinions. Second, the court itself will already be choosing a WACC in performing its own valuations. The number chosen will simply do double duty, satisfying our secondary objective of avoiding undue litigation costs.

The other major advantage of this approach is that it turns WACC into a double-edged sword. The appropriate WACC is already a hotly contested issue in most proceedings, as a high WACC leads to a lower valuation, and a low WACC leads to a higher valuation.<sup>149</sup> Given this dynamic, the petitioner's incentive is to argue for as low a WACC as is plausible, while the company's incentive is to use the highest WACC that passes the straight-face test. Using the WACC as the interest rate would temper these incentives, at least for the petitioner. A lower WACC would lead to a higher fair value for the petitioner, but less interest on that fair value. If the surviving company has prepaid, however, it will still retain some incentive to exaggerate the WACC, as doing so will both reduce the calculated fair value and potentially require the petitioner to repay overpayments at a higher interest rate.

Using WACC is not perfect. In virtually every case, it will not equal the ideal rate—the marginal cost of capital—for either party. For a management buyout where the management group exhausted its credit—an archetypical appraisal case—marginal capital for the surviving company would likely be equity with a very high expected rate of return. For a large creditworthy conglomerate that has swallowed up a smaller company, the rate may be lower. The difficulty with attempting to use marginal cost of capital, however, is that it requires a separate inquiry, is not susceptible of ready proof, and invites massive gamesmanship. No doubt every company would insist that its marginal capital would come from its revolving credit line. The risk would be high of systematically erring in a way that gave the company a strong incentive to underpay, leading to both parties retaining a time-preference. An additional difficulty is that the cost of capital for the surviving company may differ from the one being calculated and used—that of the target company—because, for example, the surviving company may have the guarantee of a new parent company or some affiliate. In many cases, though, the surviving company is simply the same company shifted into a newly formed shell entity. In any event, the respondent is always protected against an inaccurate interest rate by its unilateral option to prepay or not prepay.

The most pressing difficulty with using the target company's WACC is that it generally will not be equal to the dissenter's cost of capital. Nevertheless, this unavoidable inaccuracy from using the WACC will be minimized or eliminated if the company chooses to prepay an amount equal to its best estimate of fair value. The residual risk, then, is that when the WACC is lower than the surviving company's opportunity cost, the company will underpay (or not pay at all). In this event, neither party will be perfectly time-indifferent, and the petitioner will typically be disadvantaged. Given the impracticality of using multiple different interest rates, however, we regard this problem as unavoidable, and certainly no worse than under the current interest rate regime.

### *C. The Policy Merits of This Interest Rate Regime*

The great virtue of the interest rate regime proposed here is that it forces the company and the dissenting stockholder to be reasonable. Facing a rate equal to its weighted cost of capital, the company must decide whether to exercise the option to make an initial payment to the dissenters and, if so, how much. The company's incentive is to offer its best estimate of the fair value of the cashed-out stock. The dissenting stockholder similarly must decide whether to walk away from the

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<sup>149</sup> A low WACC implies that future cash flows do not need to be as steeply discounted, thus increasing their present value. See Brealey & Myers.

appraisal claim with only the initial payment. In view of the incentives facing the company to be reasonable in selecting the payment amount and the risks of having to repay with interest, the dissenter will have every incentive to very seriously consider accepting the offer in full satisfaction of the claims.

The interest rate proposal here also would promote settlement, which would be a welcome development for an area of law that has been regularly characterized by the Court of Chancery as pitched battle.<sup>150</sup> In *Chang's Holdings v. Universal Chemicals & Coatings*, then-Vice Chancellor Chandler observed that “appraisal actions often resemble wars of attrition in which the plaintiff’s mounting legal expenses hinder her efforts to pursue a just valuation.”<sup>151</sup> By correcting the incentives associated with the passage of time, the interest rate regime developed here can lead to efficiency-enhancing settlements.

This proposal also addresses precisely the problem that critics say is generated by the current interest rate regime: that the interest rate is an independently attractive feature of participating in an appraisal claim.<sup>152</sup> It would no longer be even theoretically attractive for a stockholder to dissent in hopes of capturing the statutory interest rate.<sup>153</sup> If the company were confident that the merger price equaled the fair value of the stock, it could immediately pay the dissenters the merger price, and never pay a cent in interest. The threat of this outcome would prevent stockholders from pursuing such a path in the first place. Thus, the supposed policy crisis—that the statutory interest rate is deforming the appraisal remedy—would be solved completely.

Equally important, strong appraisal claims would be unharmed by this regime. If anything, the focus of the litigation in such cases would be more squarely on the merits of the claim—the fair value of the cashed-out stock—without any distractions engendered by the interest rate. The amount of equity dissenting in the most problematic transactions may increase.<sup>154</sup> Given the salutary effects of appraisal activity we have adduced in other work, this would be a welcome development.

## CONCLUSION

We propose a new interest rate regime for Delaware appraisal actions: The surviving company would have a unilateral option to prepay an amount of its choosing to the dissenting

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<sup>150</sup> *Neal v. Alabama By-Products Corp.*, No. CIV. A. 8282, 1990 WL 109243, at \*21 (Del. Ch. Aug. 1, 1990) aff’d, 588 A.2d 255 (Del. 1991) (“Appraisal cases are akin to wars of attrition, with the dissenting shareholder forced to wait years for a return on his litigation investment.”).

<sup>151</sup> No. CIV. A. 10856, 1994 WL 681091, at \*2 (Del. Ch. Nov. 22, 1994)).

<sup>152</sup> Trevor S. Norwitz, Delaware Legislature Should Act to Curb Appraisal Arbitrage Abuses CLS Blue Sky Blog, Feb. 10, 2015 (“The appraisal arbitrage problem is further exacerbated by the generous statutory interest rate in Delaware for appraisal proceeds - prime plus 5% compounded - which means that even an entirely meritless appraisal claim will often still be an extremely attractive investment.”). Daniel E. Wolf et al., *Appraisal Rights--The Next Frontier in Deal Litigation?*, KIRKLAND M&A UPDATE, KIRKLAND & ELLIS, 2 (May 1, 2013), [http://www.kirkland.com/siteFiles/Publications/MAUpdate\\_050113.pdf](http://www.kirkland.com/siteFiles/Publications/MAUpdate_050113.pdf). (“[T]he mere threat of the mounting interest cost can coerce companies into considering unfavorable settlements with stockholders bent on pursuing an appraisal action.”).

<sup>153</sup> Gaurav Jetley & Xinyu Ji, *Appraisal Arbitrage--Is There a Delaware Advantage?*, \_\_ Bus. Law. \_\_ (forthcoming 2016) (SSRN draft at 53) (“[T]he Council’s proposal appears to be a practical way to limit the extent to which the statutory interest rate may serve to improve the economics for appraisal arbitrageurs.”).

<sup>154</sup> Fried Frank M&A Briefing, Proposed Appraisal Statute Amendments would Permit Companies to Reduce Their Interest Cost--Likely to Discourage “Weaker” Appraisal Claims and Make Settlement of “Stronger” Claims Harder, March 23, 2015, at 3.

stockholder within 30 days of the completion of the relevant transaction. The dissenting stockholder would thereafter possess a unilateral option to walk away from the litigation for the amount prepaid. The amount so paid would not prevent the surviving company from arguing a lower fair value at trial. Finally, following trial, *either* party would be liable to the other for interest on the difference between the amount prepaid and the adjudged fair value, with the interest rate set at the weighted average cost of capital of the target company.

This regime would ensure that issues related to the passage of time fade into the background. In this way, this approach to the interest rate—a second-order aspect of the appraisal remedy—would promote the first-order goals of the appraisal remedy itself, delivering fair value to stockholders in mergers and deterring opportunistic transactions.