From *Corwin* to *Dell*: The Cost of Turning a Blind Eye

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I. INTRODUCTION

This essay considers the ramifications of the Delaware Supreme Court's December 2017 *Dell* appraisal decision within the context of Delaware's more sweeping clampdown on shareholder litigation protections in recent years, beginning with *Corwin* in 2015.

While the Delaware Supreme Court rejected the "judicial gloss" of a formalized deal price rule in *Dell*, the gloss has, for all intents and purposes, been applied. The appraisal remedy had already been enfeebled in recent years by a slew of at-or-below deal price rulings, but *Dell*'s promulgation of a de facto procedural safe harbor marks a more systematic curtailment.

The efficacy, as well as the public policy coherency, of *Dell* is tied to the notion that procedural "best practices" lead to, or are reflective of, fair dealing. Unfortunately, this is often not the case because the actors who are most likely to be conflicted are also the ones most likely to be in control the narrative presented in public-facing materials, particularly amid a broader boardroom shift—the "lone-insider" effect—which has undermined the monitoring capabilities of independent directors.

In addition to lower deal premia and higher agency costs, the primary effects of Delaware's post-2015 effort to dull shareholder defenses, culminating in *Dell*, will likely be: 1) faster CEO pay growth, and 2) more M&A and higher industry-specific measures of concentration, which research has shown to contribute to declining competition, lower levels of labor market mobility, wage stagnation, and increasing inequality in the

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United States.

II. DELAWARE'S BROADER CLAMPDOWN ON SHAREHOLDER LITIGATION

A. Corwin*,* Trulia*, and the 'Death' of Fiduciary Duty*

The path to *Dell* begins with *Corwin*,[1] a 2015 decision that limited the number of transactions subject to enhanced scrutiny under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[2] The principles of the decision have since been reiterated in cases such as *Singh v. Attenborough*[3] (May 2016), *In re Volcano Corp. Stockholders Litig.*[4] (June 2016), and *In re OM Group, Inc. Stockholders Litig.*[5] (October 2016).

Corwin degraded shareholders' ability to get discovery on the back-end by empowering defendants to stonewall requests for transparency on the basis of a shareholder vote,[6] essentially rendering fiduciary duty litigation toothless as a means of exposing bad actors after the fact. The decision's deference to shareholders' savvy marked a convenient about-face from prior Delaware efforts to shield shareholders from their own naiveté—notably, *Airgas,* a 2011 Chancery ruling which upheld the poison pill based on the Delaware Supreme Court's doctrine of substantive coercion, or "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value."[7]

Corwin's pinioning of ex-post shareholder discovery was then coupled with an effective narrowing of shareholders' ex-ante defenses, with *Trulia*, a January 2016 decision which held that the Delaware courts would no longer countenance merger litigation settlements that did not achieve meaningful benefits for shareholders.[8] If plaintiffs do not know in

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[1] *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015).
[2] 506 A.2d 173 (Del. 1986).
[3] 137 A.3d 151 (Del. 2016).
[4] 143 A.3d 727 (Del. Ch. 2016).
[5] 2016 Del. Ch. LEXIS 155 (Ch. Oct. 12, 2016).
[6] *See* Steven M. Haas, *The* Corwin *Effect: Stockholder Approval of M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (Feb. 21, 2017), https://corpgov.law.harvard.edu/2017/02/21/the-corwin-effectstockholder-approval-of-ma-transactions/.
[7] Steven Davidoff Solomon, *Winners and Losers in the Airgas Poison Pill Case*, Dealbook (Feb. 16, 2011), at https://dealbook.nytimes.com/2011/02/16/who-won-in-the-airgas-poison-pill-case/.
[8] Matthew D. Cain, Jill E. Fisch, Steven Davidoff Solomon, & Randall S. Thomas, *The Shifting Tides of Merger Litigation* (December 4, 2017), Vanderbilt Law Review, 2018 Forthcoming; U. of Penn, Inst for Law & Econ Research Paper No. 17-6; UC Berkeley Public Law Research Paper No. 2922121; Vanderbilt Law Research Paper No. 17-19; European Corporate Governance Institute (ECGI) - Law Working Paper No. 375/2017. Available at SSRN: https://ssrn.com/abstract=2922121.

advance whether discovery will yield information that can generate a settlement with meaningful benefits, and (say) 80% of the time it does not yield such information, Trulia substantially decreases the expected value of brining a claim, and the likelihood that inculpating information will come to light. Not surprisingly the result of Trulia is that filings in Delaware fell by nearly 50% in 2016,[9] while the dismissal rate for deal-related litigation, which averaged 24% from 2010-2014, rose to 89% in 2017.[10]

The two-pronged dilution of fiduciary duty litigation delivered by *Corwin* and *Trulia* was, in large part, a reaction to the avalanche of deal litigation "beyond the realm of reason"[11] subsuming Delaware at the time. Specifically, from 2003-2008, about 40% of deals resulted in litigation, and about 30% of that litigation was filed in Delaware; by 2015, those figures were roughly 90% and 60%, respectively, resulting in more than 75 deal-related Delaware suits in 2015 compared to an average of about 20 per year from 2003-2008.[12]

Corwin and *Trulia* did help trim the volume of deal-related litigation, at least in Delaware,[13] but they did so with blunt instruments and only accomplished their putative objective by, for all intents and purposes, gutting fiduciary duty litigation as an efficacious shareholder defense.

The "death"[14] of fiduciary duty made remaining shareholder defenses dearer—in particular, the appraisal remedy, which became petitioners' last line of defense for exposing conflicted actors via access to a fulsome discovery process.

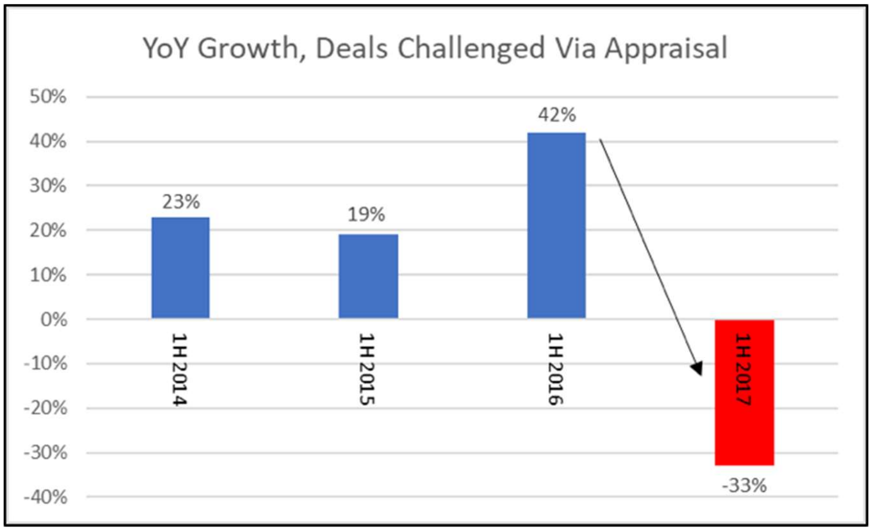
B. *Delaware's Weakening of the Appraisal Remedy: Preliminary Results*

Despite the appraisal remedy's newly enhanced importance for shareholders in the wake of *Corwin* and *Trulia*, an effort to discourage appraisal litigation gained substantial momentum in the latter-half of 2016. In August of that year, reforms to the Delaware appraisal statute—

[9] *Id.* at 23.
[10] *Id.* at 25.
[11] William Chandler and Anthony A. Rickey, *The Trouble with Trulia: Re-Evaluating the Case for Fee-Shifting Bylaws as a Solution to the Overlitigation of Corporate Claims* (April 4, 2017). Available at SSRN: https://ssrn.com/abstract=2946477.
[12] *See id.* at 23.
[13] *Id.*
[14] Guhan Subramanian, *Appraisal After Dell* (January 2, 2018). The Corporate Contract in Changing Times: Is the Law Keeping Up? (U. Chicago Press) (2018 Forthcoming). Available at SSRN: https://ssrn.com/abstract=3095164

intended to make appraisal less economically attractive[15]—took effect, followed shortly thereafter by a slew of at-or-below merger price appraisal opinions, beginning with *Lender Processing*, and subsequently *PetSmart*,[16] *SWS*,[17] and *Clearwire*.[18]

The result—as one would expect when costs are raised and benefits are reduced—has been that fewer deals are being challenged via appraisal. During the first half of 2017, eighteen deals were challenged, one-third fewer than the twenty-seven challenged during the same period in 2016.[19]

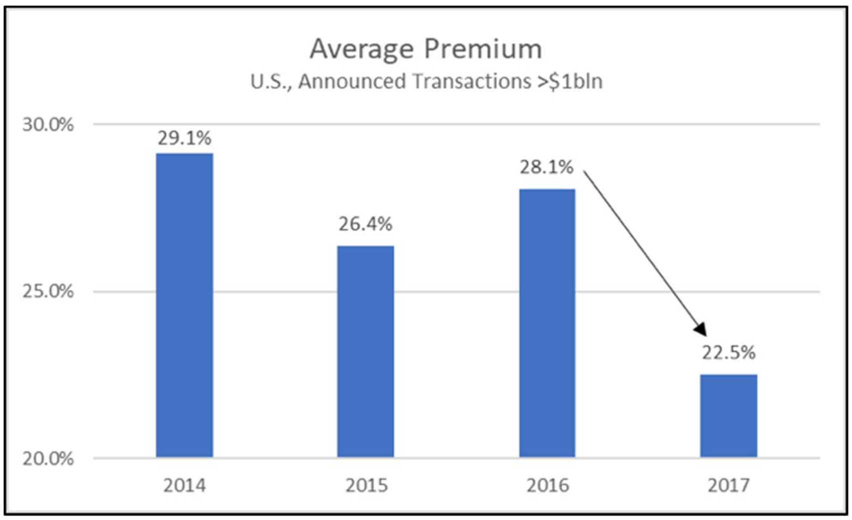


Those seeking curtailment of the appraisal remedy in Delaware had argued that the presence of appraisal-seeking holdouts induces buyers to withhold top dollar, thereby harming non-appraising shareholders. That is, acquirers would maintain dry powder ex ante for payments to purported rent-seekers in the form of appraisal arbitrageurs ex post. In the words of one highly respected deal lawyer: "This [appraisal] risk is one that troubles

[15] Guhan Subramanian, *Using the Deal Price for Determining "Fair Value" in Appraisal Proceedings* (February
6, 2017 draft), *in* THE CORPORATE CONTRACT IN CHANGING TIMES: IS THE LAW KEEPING UP? (U. Chi. Press 2017).
[16] *In re PetSmart, Inc.*, No. 10782-VCS, 2017 Del. Ch. LEXIS 89 (Ch. May 26, 2017).
[17] *See* Audra L. Boone, and Brian J. Broughman, and Antonio J. Macias at 34, *Merger Negotiations in the Shadow of Judicial Appraisal* (September 27, 2017). Indiana Legal Studies Research Paper No. 381. Available at SSRN: https://ssrn.com/abstract=3039040.
[18] *ACP Master, Ltd. v. Sprint Corp.*, Nos. 8508-VCL, 9042-VCL, 2017 Del. Ch. LEXIS 125 (Ch. July 21, 2017).
[19] Matthew Schoenfeld, *The High Cost of Fewer Appraisal Claims in 2017: Premia Down, Agency Costs Up* (January 2018). Harvard Business Law Review Online, Volume 8 (2017-2018).

buyers of Delaware companies (especially private equity firms), preventing them from paying the highest prices they can pay."[20] On their view, curtailment of appraisal should have sent premia upwards as buyers used more of their powder for bids.

But for 2017, after statutory and judicial efforts to make appraisal less effective, the average U.S. target premium of 22.5% was the lowest of any year since at least 2005.[21] In fact, the target premium in 2Q 2017 of 19.3% was the single lowest of the fifty quarterly observations dating to 1Q 2005.[22]



But beyond falling premiums, another related impact of the fall in appraisal filings was an uptick in managerial agency costs. In 1H 2017, the average named executive officer's (NEO) CIC, or "golden parachute," in deals substantial enough to warrant an Institutional Shareholder Services (ISS) recommendation, was 2.1% of transaction equity value, up 52% from its 2012-2016 average of 1.36%.[23] And it does not appear that a handful of outlier transactions were responsible for the surge—the median 1H 2017 parachute was 1.83% of transaction value, nearly triple the 2012 to 2016 median of 0.69%.[24]

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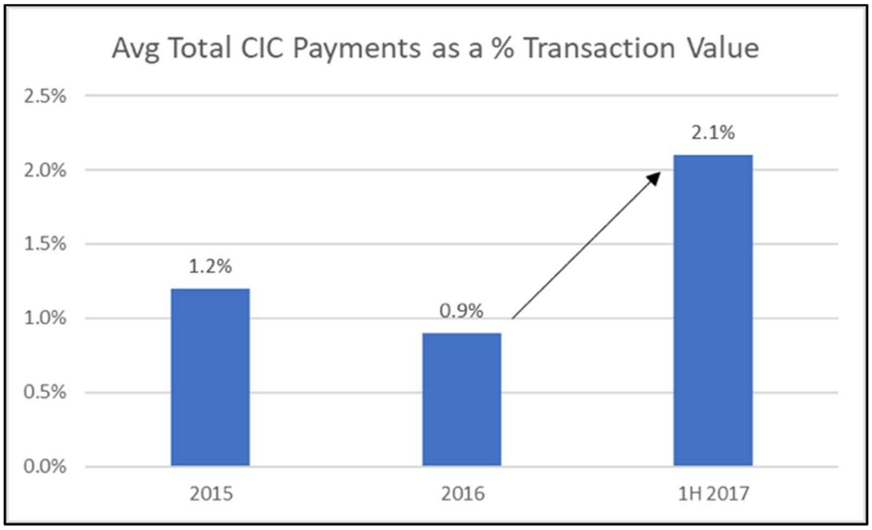
[20] Trevor Norwitz, *A Debate: Is the Appraisal Rights Remedy in Need of Repair?*, Remarks at the Delaware Business Law Forum (Nov. 2016).
[21] Market Data, BLOOMBERG (Bloomberg Terminal, 'MA' Function, select 12-Year Trailing U.S. M&A Transaction Data, narrow by Transactions >$1 billion USD) (last searched Jan. 31, 2018).
[22] *Id.*
[23] ISS, Advisory Votes on Golden Parachutes (Aug. 9, 2017) (on file with author).
[24] *Id.*

These two effects—falling premia and rising parachutes—are likely related. The prospect of appraisal, because it includes discovery that can unearth bad behavior, makes target managers more reluctant to push for low-price sales to favored acquirers in exchange for a plum post-sale position or a sweetened exit package. As the prospect of appraisal evaporates, so will this reluctance.



III. *DELL*: FINISHING WHAT CORWIN STARTED

The appraisal remedy, already weakened, suffered a more permanent blow on December 14, 2017, when the Delaware Supreme Court reversed and remanded the Chancery's May 2016 *Dell* appraisal ruling,[25] which had awarded dissenting shareholders a 28% premium to deal price.[26] The *Dell* reversal followed August's *DFC Global* opinion, in which the Supreme Court reversed another premium-to-deal-price Chancery ruling.[27]

The Dell appraisal challenged a $25 billion private-equity financed management buyout (MBO), led by its founder and 15% shareholder Michael Dell, and completed in November 2013.[28] Despite the implicit biases which tend to imbue MBOs and disadvantage minority shareholders, the Dell deal incorporated a number of procedural

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[25] *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd., et al., (Dell Reverse & Remand)*, No. 565, 2016 (Del. December 14, 2017).
[26] *In re Appraisal of Dell (Dell Trial Fair Value)*, C.A. No. 9322-VCL, (Del. Ch. May 31, 2016).
[27] *DFC Global Corp. v. Muirfield Value Partners*—A.3d—, 2017 WL 3261190 (Del. Aug. 1, 2017).
[28] *See Dell Trial Fair Value*, *supra* note 30.

protections to mitigate prospective conflicts,[29] including the formation of a special committee of independent directors and a majority-of-the-minority voting standard for approval.

In this vein, while the Supreme Court's *Dell* ruling addressed other, narrower, considerations—ranging from the "winner's curse" in MBO transactions[30] to the evidentiary value of private-equity internal rate of return (IRR) calculations[31]— its guiding principle and broader public policy objective was to promulgate the primacy of process in deals which adopt "best practices" at the front-end: "If the reward for adopting many mechanisms designed to minimize conflict and ensure stockholders obtain the highest possible value is to risk the court adding a premium to the deal price based on a DCF analysis, then the incentives to adopt best practices will be greatly reduced."[32]

At the fore of the "best practices" lauded in *Dell* was a purportedly "robust sales process"[33] on the back of which the Court mandated a "strong reliance upon the deal price and far less weight, if any, on the DCF analyses."[34] In doing so, the Court, for all intents and purposes, established a procedural safe harbor for third-party transactions with "robust sale processes," permanently increasing the costs and reducing the benefits of the appraisal remedy.

Namely, since 2013 there have been ten Chancery appraisal rulings in third-party transactions with arguably "robust" sales processes, eight of which have yielded at-or-below deal price fair value rulings.[35] The only two exceptions, which yielded petitioner-friendly rulings, were *DFC Global* and *Dell*.[36] The first of these 'exceptional' rulings to be overturned, *DFC Global*, was struck down by the Delaware Supreme Court in August 2017: "…the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and that second-guessing the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous."[37] Following Dell's reversal, there are no exceptions remaining, and by expunging the final indicia of authentic case-by-case Chancery discretion to conduct *de novo* valuation analyses, the Court has made it unlikely that deals which even resemble "disinterested" transactions will be challenged via appraisal moving forward.

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[29] *See id.* at 5.
[30] *Dell Reverse & Remand*, at 26.
[31] *See id.* at 45.
[32] *Id.* at 64-65.
[33] *Id.* at 61.
[34] *Id.* at 64
[35] *See Merger Negotiations in the Shadow of Judicial Appraisal*, *supra* note 16.
[36] *See id.* at 34.
[37] See *DFC Global Corp. v. Muirfield Value Partners*, *supra* note 31.

The net impact is that deals which appear procedurally "clean," as sketched out by the transacting companies in their proxy materials, will escape closer scrutiny moving forward because shareholders are now boxed in by the one-two punch of *Corwin*'s ratifying shareholder vote and *Dell*'s de facto procedural safe harbor.

IV. WISHING IT DOESN'T MAKE IT SO: 'BEST PRACTICES' DOESN'T MEAN FAIR DEALING

The efficacy, as well as the public policy coherency, of *Dell* is tied to the notion that procedural "best practices" lead to, or are reflective of, fair dealing. But, oftentimes, that link doesn't hold.

Prima facie procedural "best practice" is a subpar gauge of propriety because the actors most likely to be conflicted are also the ones most likely to be in control the narrative presented in public-facing materials. In turn, if that narrative is insincere, incomprehensive, or otherwise deficient, deference to a ratifying shareholder vote per *Corwin* or to a proxy which delineates a purportedly "robust sales process" per *Dell* (conferring de facto deference because such deals will simply not face appraisal challenges moving forward) actually rewards bad behavior by extending an unearned imprimatur.

For a lens into the details often omitted from public-facing materials, consider a recent appraisal case challenging the 2016 sale of Towers Watson to Willis Group.

In that case, a Motion to Compel hearing—in the wake of petitioner accusations that Towers Watson had destroyed, withheld, or failed to produce relevant evidence[38]—led to the public disclosure of internal documents of a large Willis Group investor alleged to have had undisclosed contact with Towers Watson's CEO.[39] The publicly released documents appear to show that the Willis Group investor offered Towers Watson's CEO a three-year pay package worth up to $140 million[40] during an undisclosed meeting just two months before a contested shareholder vote[41] and a subsequent renegotiation of merger terms which he

[38] *See* Jeff Montgomery, *Discovery Claims Roil $18B Towers Watson Appraisal Fight*, Law360 (Oct. 26, 2016).
[39] *See* Jeff Montgomery, *Towers Watson Settles $18B Willis Merger Appraisal Suit*, Law360 (Sept. 18, 2017).
[40] *See EXHIBITS 1-12 TO PETITIONERS' REPLY BRIEF IN FURTHER SUPPORT OF THEIR MOTION TO COMPEL.,* Transaction ID 60653938, Case No. 12064-CB, PUBLIC VERSION FILED MAY 26, 2017
[41] *Id.*

spearheaded.[42] Allegations of conflict and disloyalty during this renegotiation period is the subject of a pending class action suit[43] filed after the public disclosure of the aforementioned documents.

Or, consider last year's *Clearwire* appraisal opinion, which revealed a previously undisclosed quid pro quo between Softbank's founder, chairman and CEO, Masayoshi Son, and Paul Otellini, then-CEO of Intel.[44] Intel was a strategic investor in Clearwire, holding 12.9% of non-controlled shares, and Son wanted Sprint to acquire Clearwire before the then-pending Softbank-Sprint transaction closed.[45] Per Vice Chancellor Laster:

> SoftBank bought Intel's vote in support of the Clearwire-Sprint Merger. The record establishes that Son secured Intel's support for the merger by promising Intel a broader commercial relationship, including a partnership on a new cellular handset. Intel's CEO wrote bluntly that Intel "agreed to sell [its Clearwire] shares contingent on a broader business deal." Vote buying ordinarily is analyzed as an independent wrong. In this instance, it was part of Sprint and Softbank's unfair dealing.[46]

Proponents of deference to "best practices" might counter that part and parcel to such deference is the blessing and oversight of independent directors who offer a reliable check on flimsy or misleading disclosure practices.

But independent directors are increasingly ill-equipped to check bad actors because of a transformational (perhaps *the* transformational), but oft overlooked, shift within the boardroom: The ascendance of the "lone-insider" CEO.

The seed for this shift was planted in the push for better governance in the aftermath of Sarbanes-Oxley. One of the tenets of the post-Sarbanes effort was pressuring companies to jettison insiders from the boardroom and replace them with independent directors,[47] an effort which resurfaced

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[42] *Id.*
[43] *See* Bernard Goyder, *Willis faces lawsuit over Towers Watson deal*, The Insurance Insider (Nov. 23, 2017)
[44] *See ACP Master, Ltd. et al. v. Sprint Corp., et al. at 14*, C.A. No. 8508-VCL (Del. Ch. July 21, 2017)
[45] *Id.*
[46] *Id.* at 59.
[47] *See* Michelle L. Zorn, Christine Shropshire, John A. Martin, James G. Combs, & David J. Ketchen, Jr., *Home Alone: The Effects of Lone-Insider Boards on CEO Pay, Financial Misconduct, and Firm Performance*, Strategic Mgmt. J. (2017).

with renewed vigor following the financial crisis. As a result, more than 70% of companies in the S&P 1500 are now overseen by "lone-insider" boards, in which the CEO is the only executive director.[48]

Research has shown that lone-insider boards hamper the monitoring capabilities of independent board members by restricting their access to critical information and by limiting their ability to find viable internal CEO succession options. With respect to the latter, prior to the movement to jettison insiders, CFOs and other executives commonly served on the board and established relationships with independent board members,[49] providing well-vetted succession options and implicitly checking CEOs' leverage over fellow board members.

The result of the diminished capability of independent directors to oversee lone-insider CEOs appears to be rent-seeking and underperformance: Per a study published in 2017, lone-insider CEOs are paid 81% more than their non-lone-insider peers[50] while "firms with lone-insider boards have net incomes approximately $54 million less, on average, than non-lone-insider firms, given the mean net income of $544 million in [the] sample."[51] With some back of the envelope math—more than 70% of S&P 1500 companies have adopted this structure, rounding down to 1,000 companies, each losing out on $54 million per year in net income—the value destruction, at over $50 billion per year, becomes apparent.

Nearly three-quarters of the companies that sold themselves in 1H 2017 were overseen by "lone-insider" CEOs.[52] It's difficult to believe that the same self-interest and value destruction doesn't extend itself to M&A when these CEOs put their companies up for sale.

In fact, a prospective sale may be more challenging from an oversight perspective because independent directors' ability to assess reservation price necessarily relies upon the forward-looking financial forecasts prepared by the "lone-insider," whereas less-speculative, more concrete, quarterly filings, hold greater sway in the normal course of business.

Both Jeffrey A. Weiss, CEO of DFC Global, and Michael S. Dell, CEO of Dell, were lone insiders when they spearheaded the take-privates of DFC Global and Dell, respectively.[53]

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[48] *See* Jim Combs and Dave Ketchen, *The Downside of Independent Boards*, Wall Street Journal (May 16, 2017).
[49] *See Home Alone: The Effects of Lone-Insider Boards on CEO Pay, Financial Misconduct, and Firm Performance, supra* note 43.
[50] *Id.*
[51] *Id.*
[52] *See* BLOOMBERG, *supra* note 12 & SEC Filings.
[53] *Id.*

V. UNINTENDED CONSEQUENCES: MAKING 'CLEAN MERGERS' DIRTIER

An obvious risk of codifying standards for deference ex-ante is that it will allow bad actors, who would have otherwise been exposed, to slip between the cracks by concealing more, not less, information. Specifically, with the guidelines for effectively eliminating appraisal risk neatly sketched out, it may prove beneficial for conflicted actors to disguise "dirty" deals as clean in proxy materials because while such subterfuge wouldn't withstand a robust discovery process, a façade of propriety will discourage appraisal petitioners weary of deference, thus rendering discovery moot.

Reflecting on this point, an article published last summer by Hon. Sam Glasscock III comes to mind.[54] The Vice Chancellor contends that utilizing valuation techniques, as opposed to deferring to deal price, in the appraisal of "clean mergers"[55] does little to encourage more efficient capital markets: "I find little to recommend extending an appraisal right to dissenters in the case of a "clean" merger."[56]

But, respectfully, the problem with restricting the extension of the appraisal right in "clean mergers," as the Vice Chancellor suggests, is that it's impossible to know if a merger is "clean" before discovery. Shareholders must rely on the proxy materials provided to them by the company when deciding whether to petition for appraisal and per the examples above, these materials can leave out details which might be germane for determining cleanliness. This tendency toward omission by bad actors goes a long way in explaining why valuation dislocation—between deal price and standalone value—is a more reliable gauge of self-dealing than is the presence or absence of formulaic procedural protections: Valuation is harder to massage or put lipstick on.

Encouraging deference to mergers which appear "clean"—under the assumption that conflicted actors won't twist the narrative into superficially "clean" territory to eliminate the prospect of appraisal and the discovery which accompanies it—overlooks the immense control which conflicted actors have over the narrative presented, particularly when most are sovereign, lone-insider, CEOs.

In the Post-*Dell* era, the dirtier the reality, the greater the incentive to present a "clean" appearance to minimize the probability of that dirt ever being exposed.

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[54] The Honorable Sam Glasscock III, *Ruminations on Appraisal*, Delaware Lawyer, Volume 35 (Summer 2017).
[55] *Id.* at 8.
[56] *Id.* at 10.

V. FROM *CORWIN* TO *DELL*: HIGHER CEO PAY, MORE DEALS, BUT AT WHAT COST?

In addition to lower deal premia and higher agency costs, the primary effects of Delaware's post-2015 effort to dull shareholder defenses, culminating in *Dell*, will likely be: 1) faster CEO pay growth, 2) more M&A and higher industry-specific measures of concentration, which research has shown to contribute to declining competition, lower levels of labor market mobility, wage stagnation, and increasing inequality in the United States.

A. Higher CEO Pay & More Deals

Burgeoning golden parachutes, a result of pinioned shareholder deterrents, not only enrich departing executives but, logically, they also pressure going-concern CEO compensation upwards. Negotiating leverage for incumbent CEOs is enhanced because the alternative of a sale is commensurately more attractive than it was previously due to the increased rents able to be extracted thereby, thus challenging boards to meet or exceed the net present value of these newly-available rents when structuring go-forward compensation.

This dynamic is not unlike that in which the prospective sale value of a company sometimes sets a pseudo-floor in equity markets[57]—the difference here, however, is that considering the "lone-insider" phenomenon, most CEOs have substantially greater leverage to enforce that de facto reservation price on their boards than do shareholders upon public markets.

CEO pay growth has already accelerated in the post-*Corwin* era,[58] and the trend will likely gain additional steam following *Dell*.

'More deals,' the second first-order effect, refers specifically to those deals which would not otherwise occur without the rent-seeking opportunities afforded by dulled shareholder deterrents and weakened oversight. The symptoms of these relaxed conditions—undisclosed quid pro quos, CEOs' dominion over independent directors, sandbagging and market manipulation—are disparate, but the common thread is that they all tend to spur, or result from, M&A.

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[57] See Benjamin Bennett and Robert A. Dam, *Merger Activity, Stock Prices, and Measuring Gains from M&A* (January 3, 2018). Available at SSRN: https://ssrn.com/abstract=3000574.

[58] *See Equilar | Associated Press CEO Pay Study 2017* (May 23, 2017) http://www.equilar.com/reports/48-associated-press-ceo-pay-study-2017

Indeed, as a result of a decade-long shift in the composition of CEOs' long-term incentive pay—away from stock option-based compensation and towards "performance-based" stock awards[59]—CEOs of underperforming companies are uniquely incented to initiate self-interested, value-destructive, sales processes, in the wake of weakened shareholder defenses.

Like the "lone-insider" phenomenon, the decline of stock option-based compensation and the ascent of performance-based stock awards, respectively, are rooted in the wake of Sarbanes-Oxley, in this case a standard introduced by the Financial Accounting Standards Board (FASB) in 2004 that required companies to expense stock options based on fair value on the grant date.[60] The standard decreased the attractiveness of compensating top executives with stock options; performance-based share awards were the next-best alternative.

Performance-based share awards only vest if certain performance metric 'thresholds' are met over a predefined time period. The most common of these performance metrics is "Relative Total Shareholder Return" (rTSR), which is a measure of a company's long-term stock appreciation relative to a list of comparable companies.[61] With respect to the predefined time period for measuring rTSR, about 71% of companies set the performance period at three years.[62] In 2015, 57% of companies in the S&P 500 used rTSR in the calculation of performance-based long-term incentive awards, up from 42% in 2011.[63]

Performance-based share grants can engender perverse incentives among underperforming CEOs in the M&A context because change in control provisions typically trigger their vesting, regardless of performance since grant date. As a result, those CEOs who are deepest "underwater" on performance-based share grant metrics—say, a CEO at the tail-end of a three-year performance during which shares have lagged peers—are those who are most incented to press the "reset button" by initiating self-interested sales processes.

An example may help clarify this perverse "reset button" incentive among underperforming executives, as well as its cost to shareholders. Consider John Doe, hired as CEO of WidgetCo on January 1, 2016:

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59 *See* Matthew Goforth, *The Long Game: Incentive Pay Aims at Generating Lasting Return*, HARV. L. SCH. F. ON CORP. GOVERNANCE AND FIN. REG. (June 6, 2017), https://corpgov.law.harvard.edu/2017/06/06/the-long-game-incentive-pay-aims-at-generating-lasting-return/

60 *SUMMARY OF STATEMENT NO. 123 (REVISED 2004)*, Financial Accounting Standards Board. Available at: FASB.Org.

61 *See The Long Game: Incentive Pay Aims at Generating Lasting Return*, *supra* note 68.

62 *Executive Incentive Plans: How Leading Companies Pay for Performance*, Equilar (Apr. 6, 2016), http://www.equilar.com/reports/35-executive-incentive-plans.html

63 *The Long Game: Incentive Pay Aims at Generating Lasting Return, supra* note 68.

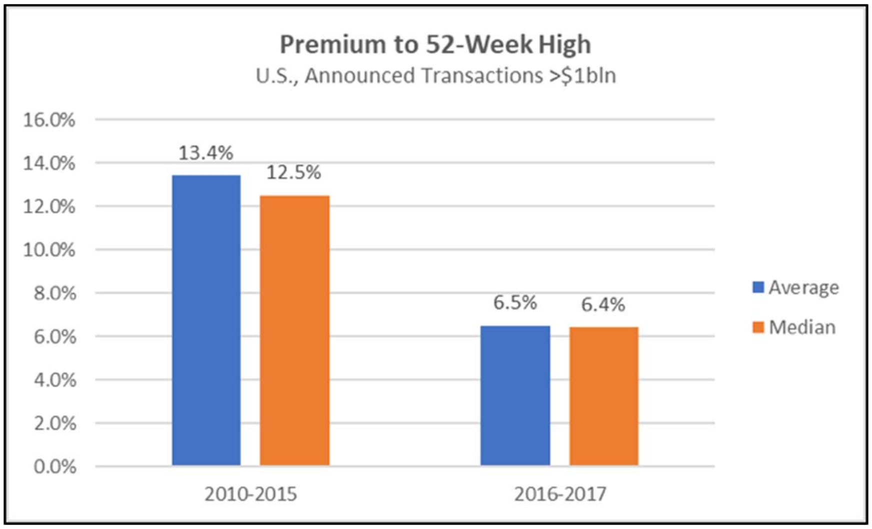
- Mr. Doe receives a performance-based share grant upon his hiring. The terms are as follows: If the company's shares outperform peers' over the three-year period ending January 1, 2019, Mr. Doe will receive 1 million shares of WidgetCo stock. Shares trade at $10.00 per share on the day Mr. Doe is hired.
- Fast-forward two years—it's now January 1, 2018, and the company's shares have remained flat at $10.00 per share, while peers' shares have risen by 40%. Thus, with one year remaining in the performance period, Mr. Doe is "underwater" by 40% on his stock grant; namely, for Mr. Doe to receive his 1 million shares on January 1, 2019, WidgetCo will have to outperform peers by more than 40% over the coming year.
- Considering his plans for the company in 2018, Mr. Doe can choose one of two paths: He can either pursue an expansion of the Widget factory, which he believes would add $3.00 per share in value, yielding a year-end WidgetCo share price of $13.00 per share (representing a 30% return for shareholders), or he can initiate a sales process, which he believes would result in a sale of the company by year-end for $11.00 per share (representing a 10% return for shareholders). Mr. Doe knows, however, that even if WidgetCo shares rise by 30% in 2018 as a result of the factory expansion, he's still unlikely to receive his share grant the following year: Peers' shares would have to decline by more than 10% to fully close the 40% performance gap, which Mr. Doe sees as a low probability occurrence.
- So, instead of expanding the factory, Mr. Doe opts to initiate a sales process, because if the company is sold his shares will vest automatically, regardless of how far underwater he is.
- The company is ultimately sold for $11.00 per share at year-end 2018 and despite WidgetCo underperforming peers during the performance period, Mr. Doe is paid $11 million for his 1 million newly-vested shares upon the sale's completion.

Unfortunately, the kind of self-interest displayed by Mr. Doe isn't confined to the hypothetical: There's already real-world evidence of an acceleration in such behavior amid a weakened appraisal remedy. One way to gauge the impact and prevalence of this form of rent-seeking, from shareholders' perspective, is via target M&A premium to trailing 52-week high. This measure is better suited to gauge the frequency with which "underwater" CEOs are pressing the "reset button"—versus simple pre-announcement, T-1, premium—because it tends to eliminate noise engendered by CEOs "talking-down" share prices, or "sandbagging," ahead of deal announcement to "create space" for an acceptable T-1 premium, and thus avail themselves of CIC payouts.[64]

Lower premia to 52-week high would be consistent with more "underwater" CEOs putting their companies up for sale. Namely, if "unaffected" share price has slumped from its 52-week peak, a company's CEO is relatively more likely to be "underwater" given shares' downward trend. By the same token, a depressed "unaffected" share price relative to 52-week high will also lend itself to a smaller sale premium relative to 52-week high.

Per the chart below, from 2010 to 2015, the average and median premium to 52-week high were 13.4% and 12.5%, respectively[65]—but since 2016, as shareholders' ability and appetite to challenge transactions waned, those figures have dropped to 6.5% and 6.4%, respectively.[66] The data are particularly striking because for a lion's share of the 2016-2017 period, markets remained near all-time highs—the S&P 500 did not register a single 3% correction from its previous high for all of 2017[67]—which should push premium to 52-week high data upward relative to the more volatile 2010-2015 period. For example, even at 2017's historically low 22.5% average merger premium (on a T-1 basis), a company which sold itself at 3% below its 52-week high would still log a 19.5% premium to 52-week high.

[64] *See The High Cost of Fewer Appraisal Claims in 2017: Premia Down, Agency Costs Up*, supra note 18.
[65] *See* BLOOMBERG, *supra* note 21.
[66] *Id.*
[67] Ryan Vlastelica, *The unsinkable U.S. stock market just tied a historic record for not falling*, MarketWatch (Jan. 18, 2018).



B. *Unintended Social Consequences: Less Competition, Increased Inequality*

The winners from this inorganic uptick in deal activity are the usual suspects—CEOs and their advisors—but the losers potentially extend well beyond minority shareholders.

Research published by Jason Furman and Peter Orszag, the chair of the Council of Economic Advisors and the Director of the Office of Management and Budget, respectively, under President Obama, suggests that by bolstering already high industry-specific measures of concentration and market share, M&A can contribute to declining competition, lower levels of labor market mobility and business dynamism, wage stagnation, and increasing inequality in the United States.[68] Nearly a third of U.S. industries are now considered highly concentrated from the standpoint of federal antitrust standards, compared to about a quarter of industries two decades ago.[69]

While guarding against these adverse, anticompetitive, impacts, can and should be the province of federal antitrust authorities, they are inherently limited by the statutory scope of antitrust merger reviews. Such

[68] Jason Furman and Peter Orszag, *A Firm-Level Perspective on the Role of Rents in the Rise in Inequality*, Presentation at "A Just Society" Centennial Event in Honor of Joseph Stiglitz, Columbia University (Oct 16, 2015). Available at: https://obamawhitehouse.archives.gov

[69] Theo Francis and Ryan Knutson, *Wave of Megadeals Tests Antitrust Limits in U.S.*, Wall Street Journal (Oct. 18, 2015)

reviews typically focus on horizontal, rather than vertical, integration,[70] and many of the adverse social consequences of mergers, such as "the negative effects of mergers on communities losing corporate headquarters, including a loss of civic leadership, philanthropy, jobs, and investment,"[71] are not relevant to antitrust analyses.

Furman and Orszag touch on the concentration-related impacts of M&A more broadly, which is why it's important to point out that the incremental subset of M&A driven by enhanced rent-seeking opportunities post-*Dell* is likely to be particularly damaging with respect to its impact on industry-specific measures of concentration.

Namely, and as touched upon earlier, underperforming CEOs—those "underwater" with respect to their performance-based stock grant thresholds—are particularly likely to initiate self-serving sales processes due to the automatic vesting provisions which typically accompany change in control transactions. Because the selling parties are disproportionately "underperformers," sales to strategic parties tend to result in the strong, "outperformers," becoming stronger.

This augmentation of stronger, outperforming, peers, touches upon another aspect of Furman and Orszag's research which shows that the most profitable firms, as measured by return on invested capital (ROIC),[72] have grown substantially more profitable on a relative basis in recent decades in concert with increased industry-specific concentration. The increased relative profitability of outperformers has allowed them to erect ever-stronger competitive moats, discouraging new entrants[73] and pushing the rate of small business formation to its lowest level in a generation.[74] In turn, it's also increasingly allowed these high-ROIC outperformers to shift from "price takers" to "price makers"—with fewer market participants, there's not only less competition to bid up workers' salaries, but there's also less competition to compete on price for the products and services sold by small businesses up and down the supply chain.[75]

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[70] *NON-HORIZONTAL MERGER GUIDELINES*, The United States Department of Justice. Available at: https://www.justice.gov/atr/non-horizontal-merger-guidelines

[71] Richard Brunell, *The Social Costs of Mergers: Restoring Local Control as a Factor in Merger Policy*, North Carolina Law Review, Vol. 85, No. 1, 2006. Available at SSRN: https://ssrn.com/abstract=992272

[72] *See Benefits of Competition and Indicators of Market Power,* Council of Economic Advisers Issue Brief (April 2016). Available at: https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160414_cea_competition_issue_brief.pdf

[73] *Id.*

[74] See *Kerrigan Testimony Before the House Small Business Committee: Reversing the Entrepreneurship Decline*, Small Business & Entrepreneurship Council (July 19, 2017) http://sbecouncil.org/2017/07/19/kerrigan-testimony-before-the-house-small-business-committee-reversing-the-entrepreneurship-decline/

[75] *See Benefits of Competition and Indicators of Market Power, supra* note 80.

To be clear, none of this is to say that M&A is 'bad' for society. Without a viable exit option and the prospect of a rich reward, fewer innovators would risk their time and capital starting new companies or improving old ones. M&A is, on net, 'good' for society, because it's integral to the U.S.'s chief competitive advantage: It's robust capital markets, which generally allow money to flow to where it creates the most value.[76] The innovation fostered by this rules-based liberation of capital has brought billions around the world out of poverty and continues to improve Americans' quality of life[77] by making the things we buy and the services we consume better and cheaper.

But M&A also has real social costs—both more immediate ones like the layoffs announced after most deals in the name of "synergies,"[78] as well as longer-lasting ones like the problems of increased market concentration and heightened income inequality. Unfortunately, the additional, 'inorganic,' rent-seeking transactions enabled post-*Dell* will still carry these material social costs, but will lack the redeeming qualities of 'organic' M&A aimed at creating, rather than reallocating, value.

[76] *See Financing America's Growth: How Robust Capital Markets Can Help Revitalize Our Economy*, U.S. Chamber of Commerce (June 22, 2016) https://www.uschamber.com/speech/financing-america-s-growth-how-robust-capital-markets-can-help-revitalize-our-economy
[77] *See* Matthew Schoenfeld, *Air Jordan and the 1%*, Wall Street Journal (July 10, 2012)
[78] *See* Danny Friedman, Axel Reinaud, Patrick Staudacher, Chris Barrett, and Niamh Dawson, *Six Essentials for Achieving Postmerger Synergies*, Boston Consulting Group (March 2017) http://image-src.bcg.com/Images/BCG-Six-Essentials-Achieving-Postmerger-Synergies-Mar-2017_tcm9-148629.pdf