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Valuing the Firm and the Development of Delaware Corporate Law

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VALUING THE FIRM AND THE DEVELOPMENT OF DELAWARE CORPORATE LAW

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I. INTRODUCTION

The merger and acquisition boom has created considerable ferment in the development of corporate law. A major acquisition rarely passes without major litigation. The active market for corporate control is, in part, fueled through a burst of creativity in acquisition techniques of investment bankers and lawyers. Litigation challenges to many of these new techniques have come from shareholders and target managers. The challenges place immense pressure on the legal system to respond. Accordingly, Delaware courts recently decided landmark cases in the areas of parent-subsidiary mergers,[1] obligations of directors in arms-length control transactions,[2] and legality of structural and financial defensive tactics such as selective use of self-tenders, agreeing to lock-up options, and issuing poison pill preferred stock.[3] Although the issues involved have been novel, these

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1. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
2. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
3. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (selective self-tenders approved); Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985), *aff'g* 490 A.2d 1059 (Del. Ch. 1985) (issuing "poison pill" preferred stock in the anticipation of a partial or two-tiered tender offer approved). However, in McAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 506 A.2d 173 (Del. 1985) the Delaware Supreme Court preliminarily enjoined enforcement of a lock-up option and no-shop feature agreed to by the Revlon board which would have had the effect of ending the bidding for Revlon in a

cases have been decided within the doctrinal structure of traditional corporate law: first determining whether the case should be decided under a duty of care or duty of loyalty standard and then analyzing the metes and bounds of whatever duty is invoked.

This Article explores a consistent theme present in the Delaware cases: that managers are obligated in discharging their duties of care and loyalty to make a non-market based judgment of the intrinsic value of their publicly traded corporations. One variation on this theme is the notion that courts are competent to second guess managers' valuation judgments.

The ramifications of these related approaches are profound. In the parent-subsidiary merger context, the Delaware Supreme Court held that even where there was no use of material inside information the parent corporation violated its fiduciary duty of loyalty to the independent shareholders of its subsidiary, regardless of the fact that shareholders of the subsidiary were offered a substantial premium over the pre-transaction market price of the subsidiary.[4] In the arms-length merger context, the court held that directors violated their duty of care to the corporation by accepting a proposed transaction at a substantial premium over market because they failed to independently value the firm and negotiate for the presumably higher independent value.[5] Finally, in the face of potential or actual tender offers, Delaware courts held that anticipatory structural and specifically targeted defensive tactics were justified so that supposed inadequate offers could be hindered or defeated.[6]

The non-market based intrinsic value model has lead Delaware courts in the wrong direction. As a consequence, the courts have asked the wrong questions, and for the most part, they have reached the wrong results. As an alternative to the current approach, the Delaware courts should use a market based notion of value. This suggestion is derived from the law and economics perspective on corporate law problems. Writers from this school use the efficient market model for stock prices as a starting point. Within this school of thought there is a consensus that the stock market is relatively efficient in the semi-strong sense.[7] Available public information is im-

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situation where all bidders had proposed some form of liquidation of Revlon.

4. Weinberger v. UOP, 457 A.2d 701. *See infra* text accompanying notes 43-83 for an analysis of *Weinberger* and its views of valuation.

5. Smith v. Van Gorkom, 488 A.2d 858. *See infra* text accompanying notes 84-112 for an analysis of the effect of valuation questions on *Van Gorkom*.

6. "Inadequate" was defined not with reliance on the current market price but with some belief that there was a non-market based intrinsic value for the firm in question that could be derived from external data. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946; Moran v. Household International, Inc., 500 A.2d 1346.

7. Studies of the price movements of securities measure the relative strength of stock

pacted (albeit potentially with some noise) promptly and in an unbiased manner into stock prices. There is some ambiguity in the law and economics literature as to whether current market prices are a sufficient proxy for the intrinsic value of firms.

Part II of the article reviews the case for market value as reflective of fundamental value under current control structures and argues that even if this position is rejected, the better legal rule would be to act as if market value did reflect fundamental value. Under this approach a court would explore first whether the current market value was incorrect. Claims of distorted market value would be skeptically viewed. To find distortion, the court would be required to make a finding akin to that needed in an inside trading case. Assuming an undistorted market value and no side payments, managers would be protected when they approved transactions at a price above the market price. Conversely, managers would be forbidden to significantly hinder shareholders from accepting above market price offers for their shares. Part III explores the holdings of several recent Delaware landmark cases and the impact of valuation models on these cases and examines how these cases would have been decided under the suggested approach.

II. Models of Valuation

How do investors purchasing for passive investment value shares? Do investors seeking control value businesses differently? Is the stock market an accurate measure of either the investment or control value of a publicly traded corporation? None of these questions is analyzed in any detail in the recent Delaware corporate cases. The Delaware courts assume, without much discussion, that there is an intrinsic value for a corporation apart from market price and that courts are competent to determine intrinsic value more accurately than the market. In order to explore these notions, an examination of how purchasers in both the purchase for control and purchase for passive investment circumstances describe their valuation techniques and and a discussion of academicians' views about how firms are and should be valued follows.

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markets as processors of information. The weak form of the efficient market model suggests past price information cannot be used to predict future price movements. The semi-strong form holds that publicly available data is so promptly impacted into the price of a security that supranormal profits cannot be derived from the production and analysis of new information. The strong form states that nonpublic information is processed in no materially different way than public information. Empirical data supports the weak and semi-strong forms but not the strong form of the model.

A. *Securities Analysts and the Valuation Problem*

The stock market today is driven by professionally managed trading.[8] Institutional investors dominate the market.[9] Most professional traders use some form of fundamental analysis.[10] The most commonly cited theoretical model used by securities analysts of the valuation of a single share for the passive investor is the present value of the income stream accruing to the owner of the share.[11] Income may be derived from the payment of dividends and appreciation on sale. The required rate of return to induce the investment combines a calculation of the projected income and the amount of risk that the projected income will be materially different. Investors will demand a risk premium over the rate of return for risk-free investments.

Fundamental research encompasses an analysis of what future income is likely to be for a particular firm, an evaluation of the risk that predicted income will be materially different, and a determination whether the stock in question is over or undervalued as compared to other investments. Fundamental research is thus premised on the notion that through examination of firm specific data, meaningful[12] predictions concerning future returns (prices) might be made. Tremendous resources

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8. Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess. (1977).

9. Institutional investors own approximately one-half of the shares of New York Stock Exchange companies and account for perhaps 70% of the trades on the exchange. *See* Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COL. L. REV. 249, 297-99 (1983).

10. The leading description of fundamental analysis is GRAHAM, DODD & COTTLE, SECURITIES ANALYSIS: PRINCIPLES AND TECHNIQUES (4th ed. 1962). Fundamental analysis usually attempts to predict future firm worth based on predicted future firm earnings. Buy, sell or hold decisions are made by comparing the current market price to an expected future worth. For a recent description of the activities of securities analysts see Kleinfield, *The Many Faces of the Wall Street Analyst*, N.Y. Times, Oct. 27, 1985, s 3, at 1.

11. HAWKINS & CAMPBELL, EQUITY VALUATION: MODELS, ANALYSIS AND IMPLICATIONS, 15-16 (1978). In connection with assumed dividend payout ratios, earnings-per-share growth rates lead to a projection of dividend payments and these dividend payments create stock values. *Id.* By combining this analysis with the required rate of return and the growth rate of dividends, projected price-earnings ratios may be derived.

12. Fundamental research is strongly premised on the belief that firms do have intrinsic worth and that it is a profitable enterprise to attempt to outguess the consensus judgement of the market on value as reflected in the current market price. Returns to users of fundamental research can be measured absolutely or against a predicted market rate of return for investments of that risk. Whether fundamental research results in an excess rate of return when measured against a predicted rate of return is doubtful. The evidence is stronger that fundamental research provides at least a normal return for the investment in the activity. *See infra* notes 13-14 and accompanying text.

are devoted to this process.[13] Investors study specific companies in detail and examine the prospects for the industry and the economy as a whole. Publicly available data is studied, a small part of which is SEC mandated disclosure documents, and managers are directly queried. Sophisticated mathematical models are used in evaluating the information received and subjective judgments are made about the quality of reported earnings and other information.

The variety of techniques used is impressively diverse.[14] Professional traders utilize a variety of different present value models. Central to these models is an evaluation of the potential for earnings and dividend growth and a judgment on the risk premium associated with the particular investment. Other investors use relative value models, arguing that individual stocks have value only in relation to other stocks. These models typically measure past and forecasted relative price-earnings ratios, relative dividend yields, relative earnings per share, and relative return on equity. A share could be over or under valued if the current relative price-earnings ratio and return on equity considering projected earnings departs substantially from the past relationship. Investors also track the asset value of corporations measuring, for instance, the break-up or liquidation value of the firm. In addition, elaborate models of firm performance based on balance sheet ratios may be used. Investors assess the quality of earnings reported, as well as the holdings of other institutions in the same stock. The markets in which the firm operates are evaluated and an independent judgment as to the quality of management is made. Frequently an investor utilizes a variety of these techniques in an eclectic mix to determine whether to buy, sell or hold.

B. *Valuation of Firms by Purchasers of Control*

The valuation techniques used by purchasers of control are remarkably similar to the valuation techniques used by passive investors. Purchasers of control gather preliminary data from publicly available sources, analyze financial data, review sales and cost data, value underlying assets, and collect information concerning the strengths and weaknesses of the

13. More than 15,000 analysts cover corporations, 4000 of whom are employed by brokerage firms, earning on average over $100,000 per year. Klienfield, *supra* note 10.

14. Hawkins and Campbell, *supra* note 11, surveyed 75 major institutional investors to determine what valuation models they used to evaluate common stocks and how they made use of financial statement data in valuation models. The description of fundamental analysis used in this section of the Article summarizes the Hawkins and Campbell study. This study shows that institutional investors act consistently with the models of fundamental analysis used in such leading texts as Graham, Dodd & Cottle, *supra* note 10.

firm's management team. They examine the firm's competitive position in its product markets, assess overall industry growth potential and attempt to measure the effect of likely macroeconomic trends on the firm. Control purchasers create the same type of mathematical models of the long-run capitalized value of the firm as used by passive investors. The results of these investigations are matched against the current market price of the firm.[15]

Some differences exist in the valuation process used by control purchasers as compared with the techniques used by passive investors because an integration of separate businesses occurs.[16] In discounting to present value, a passive investor who sees potential gain as a consequence of changed management strategies must factor into the analysis the likelihood that management will adopt the strategy. A purchaser of control obtains the power to change business strategies.[17] The buyer may be able to

15. The following summarizes the rich literature on the techniques of valuation used by participants in control transactions. *See, e.g.*, HELFERT, VALUATION: CONCEPTS AND PRACTICE (1966); PRATT, VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY-HELD COMPANIES (1981); Gooch & Grabowski, *Advanced Valuation Methods in Mergers and Acquistions*, 11 MERGERS & ACQUISITIONS 15 (1979); Heath, *Valuation Factors and Techniques in Mergers and Acquistions*, 40 FINANCIAL EXECUTIVES 34 (1972); Saffer, *Touching All the Bases in Setting Merger Prices*, 19 MERGERS & ACQUISITIONS 42 (Fall 1984). The assumption underlying much of this literature is that there are differences between the valuation given to a firm by passive investors as compared with the valuation given firms by purchasers of control. Bradley & Korn, *Bargains in Valuation Disparities: Corporate Acquirer versus Passive Investor*, 20 SLOAN MGMT. REV. 51, 56-61 (1979). The search for such disparities drives the market for corporate control in the same way the search for undervalued firms creates market efficiency for trades on the exchange.

16. A purchaser of control does not have the liquidity of a passive investor, but has the advantage of the ability to change the management practices of the acquired firm. For example, a control purchaser could adopt the strategy of liquidation and value the acquired business accordingly. A passive investor, would only add a small increment to value to reflect the discounted present value of the possibility of enhanced value on liquidation because management is not likely to undertake a liquidation strategy. Saffer, *supra* note 15, at 43-45.

17. This raises the issue of why the urge to merge? Several theories have been advanced. For a summary of these theories see Weston & Chung, *Do Mergers Make Money? A Research Summary*, 18 MERGERS & ACQUISITIONS 40 (Fall 1983). Mergers may be prompted by various factors including: tax factors; differential efficiency (e.g. purchaser management is particularly good); inefficient target management (almost anyone could do better); operational efficiency; financial synergy; undervaluation (desired assets purchased more cheaply through buying company rather than replicating assets); agency problems; managerialism; and, the urge to create market power.

Under the tax code, a merger may be used to substitute capital gains for ordinary income, to capitalize future earnings at a lower tax rate, or to transfer accumulated tax losses to a firm that can benefit from the losses. Some authors ascribe the urge to merge as resultant from the creation of a new firm having a lower cost of capital than each individual party. Economies of scale in raising capital or the possibility of increased leverage without change management structures or strategies which enhance the value of the purchased firm. Moreover, purchasers of control look to potential synergies[18] arising from the control transaction. In addition, the buyer may realize that other potential buyers view the firm to be purchased as being more valuable than passive investors do. Faced with potential competition, a purchase price may be selected to forestall actual competition. Proposed transaction prices are thus compared against typical premiums offered by purchasers. In sum, deals for control are accomplished at a premium because the purchaser perceives a variance between the current market value of a firm and its value as measured in the hands of the purchaser. The perceived variance can be either the product of factors unique to control transactions or the product of traditional fundamental analysis where the purchaser believes the market has miscalculated intrinsic worth.

C. The Link Between the Stock Market and the Market for Corporate Control

Abundant academic research focuses on the efforts of securities analysts and the operation of the stock market within the context of the

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increased bankruptcy risk can create financial synergy. Control transactions may be used to replace managers who are inefficient on an absolute scale. In some cases, target management may be efficient but the acquiror's management is simply more efficient. Thus, takeovers play a role in monitoring the efficiency of management and reduce the consequences of the separation of ownership and management in the modern American corporation. *See infra* notes 124-125 and accompanying text. It has been argued that some mergers are driven by the opposite motive. That is that managers seek growth for its benefits to managers, not shareholders.

The literature suggests that purchasers also believe that they may be purchasing assets that are undervalued in the absolute sense. That is, that no control transaction is needed to increase value. This belief is the same sort of notion that drives passive investors to search for undervalued stocks. Even if the acquired firm's assets were undervalued in this sense, the transaction itself creates the opportunity to extract that value.

Finally, the effect of capital structure on firm value can be considered in the merger and acquisition context. There is an abundance of financial economics literature on the effect of financial structure on firm value. Firms may have underutilized leverage capacity the use of this debt capacity is subsidized by the tax deduction on interest payments. However, the tax benefit must be weighed against increased agency costs and bankruptcy risks of increased risk. *See, e.g.*, Brennan & Schwartz, *Optimal Financial Policy and Firm Valuation*, 39 J. FIN. 593, 597-600 (1984); Franks & Pringle, *Debt Financing, Corporate Financial Intermediaries and Firm Valuation*, 37 J. FIN. 751 (1982); Heinkel, *A Theory of Capital Structure Relevance Under Imperfect Information*, 37 J. FIN. 1141, 1149 (1982); Masulis, *The Impact of Capital Structure on Firm Value: Some Estimates*, 38 J. FIN. 107, 112-115 (1983); Modigliani, *Debt, Dividend Policy, Taxes, Inflation and Market Valuation*, 37 J. FIN. 255, 255-56 (1982); Talmor, *The Determination of Corporate Optimal Capital Structure change Under Value Maximization and Informational Asymmetry*, 36 J. ECO. & BUS. 65 (1984).

18. For example, synergy may arise from economics of scale or scope.

efficient market model.[19] For the most part, this research shows that the prices of actively traded securities are informationally efficient.[20] New information moves the price of a stock in the correct direction very promptly. The opportunities for supranormal profits from fundamental research are small as a consequence of the highly competitive nature of the securities markets. Informational monopolies by traders, in the absence of inside trading,[21] are extremely difficult to create and exploit because so many highly skilled and well financed competitors are searching the same data sources for new information affecting the value of a firm. Due to the costs associated with the collection and analysis of many types of information concerning firms, some small amount of noise exists in the price signalling mechanism. This noise enables professional traders to recover the costs of the investment in information gathering at a normal rate of return.[22] There is considerable controversy as to the utility of the efficient market model when applied to control transactions. The controversy has two elements. First, it is argued that the enterprise value of the firm is not accurately measured by the stock market, even under current control structures. That is firms have an intrinsic current value in the hands of present managers which is not measured by the stock market.[23] Second,

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19. *See* Dennis, *Materiality and the Efficient Capital Market Model: A Recipe For the Total Mix*, 25 WM. & MARY L. REV. 373 (1984); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

20. For a good description of the challenges to the efficient market model see Wang, *Some Anomalies Which Suggest That Stock Market Is Not Efficient*, 19 U.C.D. L. REV. 341 (1985). Professor Wang properly noted that the law and economics literature has not carefully distinguished between two different senses of market efficiency—informational efficiency and intrinsic (fundamental) value efficiency. He noted that some studies raise questions as to whether the market is informationally efficient. These studies show that expert traders do make some return from their informational search efforts. Such studies are not inconsistent with the efficient market model as described by Gilson & Kraakman, *supra* note 19. Gilson and Kraakman observe that some noise is injected into the price signalling mechanism as a consequence of the costs of collecting certain types of firm specific data. Efficiency of the market is a product of both the distribution of information and the cost of collecting that information.

Professor Wang also argued that even if the stock market is informationally efficient it does not follow that it is fundamentally efficient and collects data raising questions concerning the linkage between trading efficiency and fundamental efficiency. For a response to this criticism, see *infra* notes 25-34 and accompanying text.

21. Insiders trading on material, non-public information have been able to make supranormal profits despite the signaling effect of their trading. *See* Dennis, *supra* note 19, at 380 (collecting studies). Price and trade decoding is less efficient than direct communication in giving the market information. Gilson & Kraakman, *supra* note 19, at 565-69, 573-76.

22. Gilson & Kraakman, *supra* note 20, at 578.

23. Wang, *supra* note 20; Lowenstein, *supra* note 9, at 276-80 *See also* Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision-*

even if the stock market accurately measures value under current management, legislatures and courts should intervene to ensure that the gains created by a control transaction are shared with the existing shareholders of the acquired firm.[24]

The corporate law literature based on the efficient market model has been somewhat ambiguous on whether stock market prices are both informationally efficient and reflect intrinsic value.[25] The premise of this Article is that the stock market is efficient in both senses, absent hard proof of material information not publicly known. As described above, models of valuation used by passive investors and by purchasers of control are so similar that there can be no convincing explanation as to why the highly competitive passive investor market would come to different results than purchasers of control in assessing current firm value when both operate in competitively structured markets. There would have to be an exploitable market failure in the structure of the capital markets for differences to exist in the current value of the same firm in the two markets. Empirical evidence of such a market failure has not been produced. Instead, purchasers of control are willing to pay more than the current market price of a firm not because of the existence of a separate present intrinsic value unmeasured by the market, but rather because they are changing control structures of the acquired firm in the hope of capturing the gains created by the deal.[26]

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making, 57 CALIF. L. REV. 1 (1969). Professor Eisenberg observed that the volatility of the stock market shows that the market does not measure the value of the enterprise. This view is reflected in Reporter's Study No. 1, *Transactions in Control*, 9 (A. L. I., 1985). Professor Eisenberg is the chief reporter for the Corporate Governance Project of the American Law Institute.

24. As an empirical matter, irrespective of whether such gain sharing is wise public policy, the dynamics of the market for corporate control result in the majority of the gain going to the acquired firm's shareholders. *See infra* note 26.

25. For example, this ambiguity is reflected in the leading article on the appropriate role for managers when a tender offer for their company occurs. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981). Easterbrook and Fischel stated that "[a] share is 'underpriced' or 'overpriced' in relation to some future price. We do not imply that a share has any intrinsic value." *Id.* at 1165 n.13. The remainder of the article proceeds on the notion that "any statement that a given stock is really worth more than its price is not believable." *Id.* at 1166-67. As a consequence, Easterbrook and Fischel argue premiums paid by offerors reflect real gains in value from increased productivity in the use of the target's assets. *Id.* at 1167-68. *See also* Easterbrook & Jarrell, *Do Targets Gain From Defeating Tender Offers*, 59 N.Y.U. L. REV. 277, 287 (1984) (often stock is over or under priced in relation to its "true" [future] value, but studying gains and losses from tender offers only depends on the degree of pricing accuracy not changing rapidly).

26. In recent years, the motivation for and the effect of control transactions have been the subject of considerable inquiry by financial economists. The questions have been studied

Several arguments have been made which suggest that systematic market failures exist that prevent stocks from reflecting current intrinsic value. The foremost of these arguments[27] begins by observing that the market reflects the trading instincts of professional money managers. These money managers are only concerned with the short-run performance of investments, and not with long-run firm prospects. The claim is thus made that professional investors primarily make their investment decisions based only on short-run earning prospects and beliefs as to what other professional investors will do.[28] As a consequence, underlying firm asset values and long-run operating prospects are virtually ignored by professional money managers.[29] For example, the argument is routinely made that large discrepancies exist between the stock price of a firm and the liquidation value of its underlying assets. Hence there can be arbitrage between the passive investor market which is overly focused on the short-run and those investors evaluating the long-run value of firms.

This argument is dependent upon a badly distorted picture of professionally managed trading.[30] While the opinions of other professional

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using stock market price movement studies. These studies show whether there are abnormal gains or losses in the value of the securities of the participating firms in a control transaction. The studies filter out market-wide price movements and match the actual returns of investors against the returns that would be predicted from only market-wide phenomenon. These studies are collected and analyzed in Jensen & Ruback, *The Market For Corporate Control:The Scientific Evidence,* 11 J. FIN. ECON. 5 (1983); Weston & Chung, *supra* note 17. *See also* Easterbrook & Jarrell, *Do Targets Gain from Defeating Tender Offers, supra* note 25. The results of the studies strongly show that shareholders of the acquired firm gain significantly from the control transaction and that defeating a tender offer leaves the target shareholders in a worse position. It is not as clear, however, that the shareholders of the acquiring firm have statistically significant gains, on net the shareholders of the acquired firms do not lose. There is also evidence that buyer abnormal gains are significantly correlated with seller returns. On net then, control transactions create net gains in shareholder wealth. The studies collectively indicate that: (1) control transactions are rational business activity; (2) such activity is inconsistent with the managerialism or the market power theories; and (3) such activity is consistent with synergy (including differential efficiency and strategic planning rationales) or efficiency theories.

27. These arguments are best expressed by Lowenstein, *supra* note 9; Lowenstein, *Management Buyouts,* 85 Colum. L. Rev. 730 (1985). *See also* Eisenberg, *supra* note 23.

28. J.M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST, AND MONEY 153-57 (1936). *See also* BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY (1965). An empirical observation cited in support of the short-term focus of passive investors is the growth from 1960 in the turnover rate of New York Stock Exchange companies, resulting in transaction costs of between 1% and 2% for a matched purchase and sale. Lowenstein, *supra* note 27, at 752-53. Deregulation of securities commission rates and a consequent dramatic drop for institutional investors in transaction costs (which makes the effort to exploit noise in the price signalling mechanism easier) provides a plausible explanation for the growth in turnover without regard to differing investing time horizons.

29. *See supra* note 28.

30. Hawkins & Campbell, *supra* note 11.

traders are factored into the investment decision, analysis of fundamental factors appears to be the principal tool used in professionally directed investment decision-making. Moreover, the argument depends on some misperception of short-run versus long-run investment strategies. The assessment of long-run firm prospects should be part of any rational investment strategy, but long-run earning prospects should play a relatively smaller role in investment decision-making in comparison to short-run earning projections because of discounting both for the time value of money and the uncertain ability to predict returns over the long-run.[31] In addition, there should be no different collective discount rate for the earnings that assets owned by a firm will return over time versus the discount rate for the firm as a whole. This means that the break-up value of a firm should not depart routinely from the stock market value absent suboptimal managerial behavior.[32]

A second argument is made that the market price of a firm masks variant views of the value of a firm subject to a control transaction.[33] This non-market value assertedly arises as a consequence of firm specific factors which create exit barriers. These barriers may result in particular investors considering their current ownership of a specific firm's shares superior to other similar investments or a premium offer for that investment. For example, founding families or other large block holders, employees, or holders of firm specific information might have idiosyncratic non-market based valuations of a firm. As an empirical matter, the firm specific information argument (absent the presence of material inside informa-

31. For a further explanation of this point see Dennis, *Two-Tiered Tender Offers and Greenmail: Is New Legislation Needed*, 19 GA. L. REV. 281, 316 (1985)

32. What then explains the concentration of takeovers or buyouts in particular industries such as the oil and retailing industries? It is not surprising that takeovers in recent years have focused on firms with large cash flows in areas of the economy with low growth prospects. In such instances, managers might very well wish to retain cash to fund marginal investment opportunities, cash that can be spent without the direct monitoring power of the capital markets in raising new capital. These marginal investment opportunities return to managers the potential for increased compensation through firm growth since firm size is positively correlated with managerial compensation. F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 35-37 (2d ed. 1980) (collecting studies). If instead the cash flow of a firm is committed as interest payments through increasing leverage, firm managers make a promise to pay out cash flow, rather than waste it on empire building.

33. *E.g.*, Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RESEARCH J. 341.

tion) lacks support.[34] If informational advantage is not the basis of an idiosyncratic valuation, then the most likely basis of such a valuation is the capitalization of managerial perquisites.[35] Protection of this interest raises directly an agency cost problem. If protected, the unique managerial valuation exacerbates the monitoring difficulties of non-managerial shareholders.

Even if a significant number of control transactions were driven by a belief that there was a disparity between the current market price of the firm (unchanged by a control transaction) and the enterprise value of the firm rather than a desire to create some synergy or efficiency gain, the question nevertheless arises as to whether legislatures and courts should mandate that managers ascertain enterprise value and act with regard to those values. The question as to whether a search for enterprise value should be mandated arises in two contexts: when managers wish to promote a control transaction as well as when they are opposed to such a transaction. If there is a duty to ascertain the enterprise value of a firm, irrespective of the current market price, then managers in consensual control transactions may be held liable if they encourage a transaction at a premium, but below the later determined current enterprise value of the firm. If managers of firms faced with a control transaction oppose the transaction, they may be protected when adopting defensive tactics by a claim that the transaction is not in the best interests of shareholders because, while at a premium, it is still below enterprise value.

In both contexts, mandating the search for enterprise value creates the wrong type of incentives and invites substantial risk of error in *post hoc* reviews by courts. Reviewers must first determine whether a particular firm has a separate enterprise value. The data used to make such a decision will be of the same type as considered by passive investors and potential purchasers of control. Litigation can only attempt to replicate the processes that investors have already undertaken. In some instances the enterprise value and the market value will be relatively consistent. Moreover, experience with the appraisal process indicates that courts are not particularly institutionally competent to make valuation decisions.[36] Nor is there any evidence that courts are *better* than the market in making valuation judgments. The risk of over or under inclusive judicial error in separating out cases where there is actually a non-market based enterprise

34. Grossman, *On the Efficiency of Competitive Stock Markets Where Traders Have Diverse Information*, 31 J. FIN. 383 (1976).

35. *See* Dennis, *supra* note 31 at, 327-28.

36. For a description of the difficulties with judicial appraisal valuations see *infra* notes 38 & 39 and accompanying text.

value is high; so too is the risk of error in measuring this value once identified.

Related to the institutional difficulties of judicial valuation proceedings is the problem of attempting to ascertain what maximizes shareholder wealth for the long run. The control transaction provides an immediate gain to shareholders. If shareholders are to benefit from either the possible[37] or actual use of judicial intervention, those benefits must produce gains in excess of the currently offered premium, including compensation for the time value of money. In the context of management approved control transactions which occurred at too low a price, this would require a finding, in the absence of the challenged transaction, that the stock market at some future time would reflect higher enterprise value (which compensated for the time value of the lost premium) or that another control transaction at the higher price would reasonably occur. Similarly, in the situation where management opposes the control transaction, target shareholders only benefit if traders on the stock market come to their senses or if target managers organize a successful subsequent control transaction at a higher premium.

Incentives created by a requirement to search for enterprise value are backwards. Managers who wish to promote a control transaction face some risk because of the threat of litigation. By requiring an analysis of enterprise value the Delaware courts may cause managers to disapprove of a control transaction that would result in a gain to shareholders. Conversely, managers opposing a control transaction are given a powerful justificatory tool. They can claim their defensive efforts were intended to protect enterprise value. Yet, in the typical consensual transaction there would be no reason to believe that managers were not acting in the interest of all shareholders;[38] in the hostile situation, there is considerable reason to believe a conflict exists between managers and shareholders.[39]

III. Valuation Theory and the Delaware Courts

The question of how to protect enterprise value has been a central

37. *Ex ante* shareholders also must consider whether a rule requiring the search for enterprise value reduces firm value by diminishing the monitoring power of the market for corporate control. *See infra* notes 124 & 125 and accompanying text.

38. A reviewing court would have to be concerned about the possibility of a side payment to the acquired firm's insiders where the transaction appears to have been made at arm's length. If a side payment was made, then all the informational risks of an interested transaction are present. In addition, a side payment would be inconsistent with the auctioning model for control transactions. Without the problem of side payments, managers' decisions then should be given deference under the business judgment rule.

39. *See infra* notes 117-125 and accompanying text.

concern of the Delaware courts in developing corporate law doctrine in a variety of different contexts affecting control transactions. This section of the Article examines how notions of value have affected both the choice of doctrinal category and the application of a legal rule to a particular factual context.

A. Valuation in Parent-Subsidiary Mergers—UOP v. Weinberger

A vexing problem for the Delaware courts has been the treatment of parent-subsidiary mergers.[40] Several issues have been raised with respect to such mergers including: (1) the type of business justification, if any, needed for the parent to undertake the transaction; (2) the type of disclosures to be made; (3) the amount of consideration to be paid the shareholders of the subsidiary; and (4) the type of remedies which may be available to the shareholders of the subsidiary. The Delaware courts have consistently held that, as an interested transaction, a parent-subsidiary merger makes a heightened duty of loyalty analysis appropriate.[41] At one point, the Delaware courts required the parent to justify the transaction with reasons other than the desire to freeze out minority shareholders.[42] In *Weinberger v. UOP, Inc.*[43] the Delaware Supreme Court abandoned this requirement and made appraisal the primary remedy[44] for shareholders harmed by the merger. In addition, *Weinberger* abandoned the Delaware block approach for appraisal valuation. In dealing with appraisal cases, Delaware courts are now open to all generally accepted valuation techniques used in the financial community, including elements of future value

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40. For an historical survey of the shifts in the Delaware law regarding controlled mergers see, Weiss, *The Law of Take Out Mergers: Weinberger, Inc. v. UOP, Inc. Ushers in Phase Six*, 4 CARDOZO L. REV. 245 (1983); Weiss, *The Law of Takeout Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981). For an insightful discussion of the related concept of valuation theories as they affect regulation of management buyouts see Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U.L. REV. 630 (1985).

41. Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952).

42. Singer v. Magnavox Co. 380 A.2d 969, 978-79 (Del. 1977).

43. 457 A.2d 701 (Del. 1983).

44. The court indicated that "in certain cases, particularly where fraud, misrepresentation, self-dealing, deliberate waste of corporate assets, or gross and palpable overreaching are involved," it may be inappropriate to make appraisal the exclusive remedy. *Id.* at 714. Where appraisal is not exclusive, the chancellor was empowered to fashion any appropriate injunctive or monetary relief. *Id.* at 715. As will be shown below, the scope of both the reconstructed appraisal remedy as well as any substitute, therefore, remain quite unclear after *Weinberger*. Delaware courts have, however, continued to grant relief other than appraisal for breaches of fiduciary duty in the context of parent-subsidiary mergers. *See* Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099 (Del. 1985) (overreaching in timing of transaction invokes remedy beyond appraisal).

not of unduly speculative nature.[45] *Weinberger* also took a broad approach to the types of disclosure needed when seeking shareholder approval of the transaction.[46]

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45. 457 A.2d at 712. The Delaware block method consists of weighing a combination of market, earnings, and asset values. Market value does not necessarily have to be the current market price, but may be the market value averaged over some time period prior to the merger. Earnings value might also be averaged over a number of prior accounting periods, possibly adjusted for non-recurring items. Asset valuation requires an appraisal of the firm's assets, usually at a going concern value. *See* Note, *"Fair Value" Determination in Corporate "Freeze-Outs," and in Security and Exchange Act Suits: Weinberger, Other, and Better Methods,* 19 VAL. U. L. REV. 521 (1985); Note, *Dissenting Shareholder's Appraisal Remedy,* 30 OKLA. L. REV. 629 (1979) (collecting cases using block approach).

The court in *Weinberger,* in abandoning the block method as a mandatory method of appraisal, allowed for proof of gains not of a speculative nature arising out of the transaction such as "elements of future value, including the nature of the enterprise" as part of the appraisal process. 457 A.2d at 713. This is despite statutory language which states that on appraisal, value shall be determined "exclusive of any element of value arising from the accomplishment or expectation of the merger. . . ." DEL. CODE ANN, tit. 8, § 262(h) (1982). The court read § 262(h) as applying only to use of pro forma data and projections of a speculative nature.

Professors Kanda and Levmore have argued that the Delaware appraisal statute is intended to protect shareholder inframarginal value and that the right to appraisal creates gross rules of thumb protecting inframarginality. They constructed *Weinberger* as allowing consideration of the qualities of the target as a partner in other mergers (not just the one dissented from). This creates an appraisal premium which is authority to protect inframarginality. Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law,* 32 UCLA L. REV. 429, 437-41 (1985). Under this model, the average value of a share (and hence the value of the firm) would be higher than the market value of a single share multiplied by the number of shares outstanding. It is hard to imagine that shareholders in widely traded firms have differing average values for the shares they hold. *See* Dennis, *supra* note 31 at 324-29. Professors Kanda and Levmore recognized that an appraiser could not be asked to measure idiosyncratic estimations of a corporation's worth. They instead suggested the protection discovery value, a concept similar to my approach—reliance on market value except where inside information is a driving force for the transaction. *See* Kanda & Levmore, *supra* at 443-44.

Within *Weinberger's* stated framework, separating speculative gains from non-speculative gains where neither has occurred at the time of the transaction makes appraisal very complex. It is possible to calculate gains arising from the transaction using stock market studies of the price movement of the acquiring firm's shares. *See* Fischel, *The Appraisal Remedy in Corporate Law,* 1983 A.B.FOUND. RESEARCH J. 875, 895-96. Such studies would have to factor out any other abnormal gains to the parent occurring at the same time. Moreover, even if some (or most) of the gain went to the parent, the question would still remain: if the parent was forced to pay a higher price thus changing the risk-return calculus, would the transaction occur in the form of a merger or would the parent attempt to extract the gain from other perquisites of control? The very duty to share might discourage the transaction from occurring.

46. The court stated the disclosure duty as one of "complete candor." The court held that "[c]ompleteness, not adequacy, is both the norm and the mandate under the present circumstances. . . ." 457 A.2d at 710 (quoting Lynch v. Vickers Energy Corp., 383 A.2d 278, 281 (Del. 1977)). This test of disclosure could be read to expand beyond the federal test of materiality which ties disclosure to concepts of economic significance. *See* TSC

The theory of intrinsic corporate value played an important role in each aspect of the court's holdings, from the explicit consideration of valuation theory in the appraisal test portion of the opinion to the portion of the opinion dealing with disclosure theory. To understand the role of valuation theory in the case, some discussion of the factual background of the opinion is necessary. Before the challenged merger, The Signal Companies (Signal) owned 50.5% of UOP.[47] Signal elected seven of the thirteen UOP directors, one of whom was the president and chief executive officer of UOP.[48] Both Signal and UOP were publicly traded New York Stock Exchange companies.

Before the transaction, UOP was trading for some $14 per share.[49] Signal had spun off a significant subsidiary and wished to invest considerable excess cash. One possible use of this excess cash was to buyout the remaining public shareholders of UOP. Two senior executives who were members of both boards studied the possibility and produced a report of their findings.[50] The report was given to Signal but not to the outside directors of UOP or disclosed to UOP shareholders. The Delaware Supreme Court considered the report to be the crucial evidence in the case.[51] Although the court stated that the report used UOP data, the report did not appear to use any information that would be deemed inside information under federal law.[52] Rather, the executives promoted the

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Industries Inc. v. Northway, Inc., 426 U.S. 438 (1976). There is an interaction between a court's view of value and its view of the adequacy of disclosure. Internal judgments of the purchaser become relevant only when the court believes these judgments are better statements of value than the value established by the market price. Thus, in cases such as *Weinberger*, the disclosure violation really does not add to plaintiffs' substantive rights. Where the Delaware court has found no substantial fairness issue, it has cited with approval the federal test of materiality. Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985).

47. 457 A.2d at 704.

48. *Id.* at 704-05.

49. *Id.* at 704.

50. *Id.* at 705.

51. *Id.* at 708-09. The court was also concerned that the proxy materials did not disclose the nature of the negotiations between Signal and UOP and that the haste with which the investment banking firm reached its fairness judgment as well as the speed of the approval of the transaction by UOP's board. *Id.* at 708. These concerns were all subsidiary to the question of disclosure of value.

52. *Id.* at 711. To prove use of inside information under federal law, plaintiff must show that the report used material data (data affecting the value of UOP) unknown to the investing public. *See, e.g.*, Dirks v. SEC, 463 U.S. 646 (1983). In *Weinberger* the report contained no discussion of the hidden future earnings capacity of UOP as a controlled subsidiary, but rather discussed the benefits of complete versus partial ownership of the subsidiary from the perspective of Signal. The analysis was standard MBA fare about reduced agency costs from the elimination of fiduciary obligations to minority shareholders and the potential risks of the transaction as measured against potential returns.

transaction primarily for its benefits to Signal.[53] The transaction would have increased Signal's earnings and measured well on a risk-return analysis as compared with Signal's other acquisitions.

On those bases, a spreadsheet was prepared evaluating the transaction for a range of purchase prices from $18 to $24 per UOP share.[54] The report stated that at $18, the lowest purchase price considered, Signal's projected earnings for the forthcoming year would be increased 9% while at $24, the highest price, Signal's earnings would increase by only 6%. The spread sheet primarily used Signal financial data. The only UOP data used in preparing the rate of return analysis was the five-year UOP projection plan.[55] The UOP projection plan was disclosed to shareholders of UOP in the proxy materials.[56] Nevertheless, the Delaware Supreme Court held that Signal violated the duty of loyalty encompassing the duty of complete candor, by failing to reveal the report to UOP's outside directors and shareholders.[57] This failure to disclose vitiated UOP shareholder approval of the transaction, which had occurred at $21 per share (a 50% premium over market price).[58] The Delaware Supreme Court held there was lack of

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53. 457 A.2d at 708. Such benefit might include saving costs, facilitating the flow of resources between the companies (including technological interchanges among subsidiaries) and eliminating potential conflicts of interest. The same types of savings may be part of the driving force behind leveraged buyouts.

54. *Id.* at 705. There is substantial factual dispute in the record as to the meaning of the spread sheet. The Delaware Supreme Court construed the report in its first opinion as stating that the acquisition of UOP was a good deal for Signal at any price up to $24 per share. *Id.* at 709, 712. Neither of the authors of the report testified at the first trial as to the meaning of the report or spread sheet. On remand, defendants argued that no one in Signal's management had determined that buying out the minority shareholders at $24 per share was a good investment. Instead, defendants argued that the only prices under active consideration were the $20-$21 figures actually presented to UOP. There was evidence that some Signal managers believed the $21 figure was too high. Defendants' argument was rejected on remand as being inconsistent with the law of the case. *Weinberger v. UOP Inc.*, No. 5642, slip op., Del. Ch. (available on LEXIS, States library, Del. file). However, the confusion over the meaning of the report appears to have been part of the reason for rejection of recessionary damages by the chancellor. The report was completely discounted at this stage and it formed no basis for the chancellor's ultimate decision to award damages of $1 per share and was not even cited in that opinion. *Id.*

55. Management projections of future earnings, even though frequently inaccurate, contain valuable information to investors. Thus, if managers prepared a projection that was unknown to investors (particularly a projection that was more positive than any being distributed by analysts to investors) that would be insider information which could affect the value of UOP. In *Weinberger*, however, it appears that the projection information was already in the total mix. For a discussion of the affirmative duty to disclose projections see Bauman *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L. REV. 935, 972-76 (1979).

56. 457 A.2d at 710-11.

57. *Id.* at 711-12.

58. *Id.* at 712. The transaction was structured so that a majority of the minority

fair dealing and fair price.[59] The case was remanded to the Chancery Court to calculate damages, if any, due to a lack of fairness as a consequence of the failure to disclose.

A significant uncertainty raised by the Delaware Supreme Court's first opinion in *Weinberger* was precisely what shareholder interest failed to be protected by non-disclosure of the Signal report to UOP. One reading of the court's opinion is that the undisclosed Signal report established the parent's view of the enterprise value of the subsidiary and that the shareholders of the subsidiary were entitled to that information because it was the best indication of the "true" intrinsic value of what they were being asked to give up. This approach finds support in the argument that the market price of a controlled subsidiary is systematically distorted by the control relationship and that market value then is not an appropriate measure of intrinsic value for a controlled subsidiary.[60] Some commentators argue the price of the subsidiary is unnaturally discounted because shareholders believe the controlling person can disadvantage the controlled entity in ways that are not easily detected nor remedied. The claim is made that there are systematic impediments to the flow of information concerning the subsidiary which make it difficult for the market to value the subsidiary.

The information impediment argument seems unpersuasive. Managers who withheld information concerning the real value of the controlled entity would reduce the value not only of the subsidiary but of the parent—placing the parent at risk in the market for corporate control. Thus, there is not an incentive to routinely withhold information concerning the subsidiary. In any event, analysts still attempt to collect information concerning both entities, and discount naive methods of hiding the earnings of the subsidiary. Moreover, federal and state law would declare illegal any actual deception by the parent. Finally, in *Weinberger* management's highly positive projection of the subsidiary's future earnings enabled the market to accurately value the subsidiary.

The argument concerning discounting because of the mere existence of a control relationship and whether that discounting should be factored out in a valuation proceeding as the result of a parent-subsidiary merger is

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shareholders was needed to approve the transaction. Fifty-six percent of the minority voted, and 51.9% of the total minority shares approved of the transaction with only 2.2% of the minority shares voting against the merger. *Id.* at 708.

59. *Id.* at 715.

60. Brudney, *Efficient Markets and Fair Values in Parent-Subsidiary Mergers*, 4 J. CORP. LAW. 63 (1978); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974).

theoretically more troubling. A plausible argument can be made that if the market does discount the subsidiary because of the possibility of undetected looting then the parent should not be able to capture that value. This is particularly so when the control relationship is long-standing rather than the product of an integrated transaction where the second-step merger was announced when the control relationship was established. However, the empirical evidence does not support this theoretical concern. Stock market price studies show that where a public minority interest remains after the control transaction, both the shareholders who tender and the shareholders who *do not* tender gain. The gains persist for long periods for the remaining shareholders.[61] Investors thus believe that new management is more valuable to them than the risk of harm.

Another possible reading of the *Weinberger* opinion is that the report discussed the unique (subjective) value of UOP to Signal, and that therefore UOP shareholders were entitled to the information.[62] If the court was concerned about the second type of disclosure, then the opinion really stands for the proposition that gains created by a parent-subsidiary merger, even as a consequence of the special characteristics of the parent, must be disclosed and shared with the shareholders of the subsidiary.[63] The type of interest protected by the disclosure test set forth in *Weinberger* remained an issue in the subsequent determination of the case. Faced with a variety of methods of calculating rescessionary damages, including a calculation which contained a sum for the value of UOP in the hands of Signal (the subjective measure of value), the chancellor on remand rejected all measures of rescissionary damages as overly speculative.[64]

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61. Jensen & Ruback, *The Market For Corporate Control*, 11 J. FIN. ECON. 5 (1983) (citing and collecting studies).

62. For a description of the two possible readings of the disclosure issue see Payson & Inskip, *Weinberger v. UOP, Inc.: Its Practical Significance in the Planning and Defense of Cash-Out Mergers*, 8 DEL. J. CORP. L. 83, 88 (1983). A third approach is that the court was hiding its search for inframarginality in the guise of protecting disclosure interests. *See* Kanda & Levmore, *supra* note 45.

63. *See supra* note 45 for a discussion of the expanded notions of appraisal value adopted by the court.

64. 457 A.2d at 714. Recessionary damages would give plaintiffs the highest value reached at any time after the merger for the value of the interest they gave up less the $21 per share actually received. This measure of damages would be awarded because the merger could not be rescinded and the eggs unscrambled. The trial court was unable to formulate, however, any post-merger value for UOP. There was no trading in UOP stock after the merger and, therefore, no reference to market value could be made. Using data with respect to UOP's actual operations, discounted cash flow analysis, and a comparison with other similar companies and Signal, plaintiffs' expert argued that UOP was worth $60 per share in the Spring of 1983 and $50 per share the following spring. Using similar techniques, defendants' valuation expert believed UOP was worth $20-25 less than

Instead, the chancellor attempted to calculate the value of a share of UOP on the date of the merger, as an ongoing concern as viewed from the perspective of a minority shareholder, applying the expanded methods of valuation for appraisals. This was ostensibly an objective measure of value. No value was to be added to the interests protected by the entire fairness test because of Signal's enhanced ability to aggressively manage the assets of UOP.[65] But even in applying this model of value, once again the chancellor threw up his hands as to determining what UOP's intrinsic value actually was. No *post hoc* method seemed particularly compelling in the face of a fairly established pre-merger market price which was substantially below the acquisition price.

Meeting the test of complete candor, Chancellor Brown noted that if the failure to disclose had been corrected in advance of the shareholders' vote, it would not in all likelihood have changed the outcome of that vote.[66] Despite this, damages of $1 per share were awarded to the plaintiff class. The award was calculated on an *ex post* basis, and was predicated both on the fact that the acquisition had turned out to be extremely advantageous to Signal and based on a comparison with premiums paid in similar transactions. Plaintiffs appealed again. The chancellor's opinion granting $1 of damages per share was affirmed without opinion because plaintiffs' appeal "was without merit since the issues on appeal raising questions of law [were] clearly controlled by settled Delaware law."[67]

The result in *Weinberger* leaves the law of parent-subsidiary mergers in a confused state. On its face, the first Delaware Supreme Court opinion is premised upon failure to disclose. It is generally assumed that the goal of mandatory disclosure[68] is to provide enough information to enable inves-

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plaintiffs' expert. At these lower figures, plaintiffs would have been entitled to nothing, assuming defendants would receive credit for what plaintiffs would have earned for reinvesting the $21 actually received in 1978.

65. While the chancellor stated on remand that the discounted cash flow measurement should be given some consideration in determining fair value, he explicitly discounted the weight given to this method to zero. First, he argued that as a member of the minority, an independent UOP shareholder could never have received the benefits of 100% ownership of UOP. This holding in effect denies minority shareholders the Delaware Supreme Court's model of enterprise value. Second, the chancellor stated in *dicta* that because the discount factor selected to reduce the income stream to present value was a subjective judgment, plaintiffs' valuation method would run afoul of section 262(h).

66. *See supra* note 46 and accompanying text. Under the *TSC* standard of materiality, it then seems that no violation took place.

67. Weinberger v. UOP Inc., Supreme Court of Delaware, order of July 9, 1985 (order available on LEXIS States library, Del. file).

68. Mandatory disclosure, generally refers to the information disclosure requirements of federal securities law. However, in this case the Delaware court created an additional disclosure burden under state law. But the state disclosure requirement appears to be a

tors to make rational investment decisions. In the context of merger transactions, this means that enough information should be given so that investors can determine whether the consideration to be received is greater in value than the securities to be surrendered.[69] In its first *Weinberger* opinion, the Delaware Supreme Court held there was a material omission related to value by tying the violation of fiduciary duty to a failure to disclose. The court so held despite the fact that Signal had not used any inside information in determining whether to propose the merger transaction.[70] In establishing the $14 market price, shareholders had assessed UOP's value in the same way as Signal. Thus there was no omission with respect to the current value of UOP in the absence of Signal's decision to cash out the minority shareholders. Rather, the document that was deemed fatal by the court related solely to possible benefits to Signal. The spread sheet merely stated the return to Signal from the transaction; it contained no information relating to UOP which was unknown to UOP investors.

Under the market value approach, plaintiffs' case on disclosure grounds would have failed, because no material information about the subsidiary was withheld. The market price of UOP accurately reflected the earning potential of the firm as a partially owned subsidiary of Signal. The market model of valuation is particularly powerful where management has disclosed its projections for the controlled subsidiary.[71] The premium price per share offered by Signal was not the product of some hidden secret value undisclosed to the shareholders of UOP, but was instead a partial sharing of the gain arising out of the transaction itself. While the transaction could be forced upon the controlled entity, there was an incentive to share the gain, in order to reduce the risk of after the fact second guessing by the judiciary of the price offered.[72] Without a control transaction there was little opportunity to create an enhanced value for the assets of UOP.[73] The

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fairness in price requirement rather than a disclosure requirement. *See* 457 A.2d at 711-12.

69. Because a cash-out merger is a taxable event, a premium might be paid to compensate shareholders for the required payment of taxes, that might have been avoided or delayed under other circumstances.

70. *See supra* note 52.

71. Where managers have disclosed projected earnings, there can be no question that investors have been given the best evidence of future worth. Walker, *Forecast Disclosure: An Information Economics Perspective*, 12 J. BUS. FIN. & ACCT. 355 (1985). *See also supra* note 55.

72. The market price test of value would not completely remove this incentive to gain share. A high price offered to minority shareholders would reduce the likelihood that these shareholders would sue, attempting to prove the use of material inside information by the directors in determining to go forward with the cashout. Moreover, some amount of premium might be allocated to the tax status of the transaction. *See supra* note 69.

73. This is precisely the point of the chancellor's opinion on remand. Without the

violation of fiduciary duty found by the Delaware Supreme Court in the first opinion in *Weinberger* rejects the market price test of value model. What approach the court adopts is less certain. Undoubtedly, the Delaware court believed firms have worth not measured by the market. The court assumes Signal had information on that point which was not revealed. By affirming after remand, the Delaware Supreme Court seems to be leaning toward the intrinsic objective standard of worth. But the subjective worth of UOP to Signal was not intrinsic by any definition, and the disclosure omissions related more to the unique value of UOP to its parent under a different control relationship.

The first *Weinberger* opinion, particularly when viewed in the light of the case's subsequent history, thus falls between two stools. Disclosure to what end? The failure to disclose Signal's valuation report is not specifically tied to the harm articulated by the court. Subjective valuation to Signal could only have been relevant if the legal rule in Delaware was that gains created by the transaction must be shared. Disclosure of subjective worth would be arguably relevant so that shareholders could seek appraisal to obtain their fair share of the unique value of the subsidiary to the parent.[74] Signal's subjective judgment as to the value of UOP to Signal had no bearing on intrinsic value, which presumably does not include the unique characteristics of the parent.

It is not surprising then that on remand, Chancellor Brown was unable to implement the Delaware Supreme Court's standardless direction to use all relevant factors in valuing UOP. The first opinion did not clearly state whether intrinsic or subjective value is the test of what is owed to the subsidiary's independent shareholders, nor did it give any reasonable guidance as to how to accomplish either valuation. The subsequent affirmance without opinion after remand only added to the confusion. All that can be said is that on an *ad hoc* basis, in this particular case, $1 should be added to the purchase price.[75] In this case, where the market price was undistorted before the cash out merger,[76] a standardless search for a better

control transaction, there would not have been the opportunity to achieve the benefits arising from 100% ownership.

74. Disclosure of subjective value raises many administrative difficulties which counsel against the rule. For example, in drafting disclosure documents complicated drafting issues concerning the bases of subjective value would be presented. To the extent these difficulties raised the risks attendent with the transaction, the parent corporation may determine to forgo the transaction and extract gains in ways less advantageous to minority shareholders.

75. This amounted to some $5.8 million extra consideration to the minority shareholders of UOP.

76. Professor Fischel points out one example of where the market price of the

measure of intrinsic value only leads to ineffectual marching up and down the hill.

What better direction can be given to trial courts in evaluating controlled merger transactions? Mergers of controlled entities do create risks of unfair dealing. A parent may well have access to material nonpublic information concerning the controlled subsidiary, information which by definition would likely affect the price of the subsidiary upon disclosure.[77] This information might be subtle.[78] In an appraisal or fairness proceeding, plaintiff should be given wide latitude in searching for material information not yet reflected in the market price of the subsidiary. But in the absence of proof[79] of such information or distortion in price as a

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controlled subsidiary is distorted by the control relationship. Once the merger is announced (or leaked to a sufficient number of traders), and the controlling corporation has enough shares to ensure that the merger will occur, the market price of the controlled firm will reflect the transaction price almost exclusively. A valuation date should be chosen where the market value of the controlled firm does not reflect the transaction itself. Then, through standard financial techniques, this figure should be recalculated for the merger date. But for the merger transaction, in a rising market but for the merger transaction, the shares of the controlled firm might have risen above the transaction price. Fischel, *supra* note 45, at 893. Of course in a two-tiered tender offer, the transaction price is the blended premium. *But see* Reporter's Study No. 1, *Transactions in Control* (A.L.I. 1985) (first step price is the best evidence of minimum fair value).

Professor Fischel also implies, however, that the mere existence of the control relationship even without the announcement of the merger transaction distorts the market price of the controlled firm though he cites no evidence supporting this notion. The mere existence of the control relationship, particularly where long standing as in *Weinberger*, does not necessarily result in distortion. *See supra* note 61 and accompanying text.

77. The more than minimal possibility that such information could drive the parent to attempt to cash out the independent shareholders counsels for allowing appraisal, even when the shares of the subsidiary are actively traded. The initial burden of going forward would, however, be on the minority to show that the market price of the subsidiary was inaccurate as the consequence of material information unknown to the market. For a discussion of the question of the ultimate burden of proof see *infra* note 79.

Joseph v. Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984), is an example of where a genuine issue with respect to the value of a controlled subsidiary was raised . In *Joseph* there was evidence that the investing public was not aware of the amount of probable oil reserves owned by the subsidiary, a material fact. *Id.* at 341.

78. Because management projections of the future earnings potential of the subsidiary provide information to the market and generally reflect some of the subtle potentially hidden information concerning future worth, a duty to routinely disclose such projections for a time period before the buyout could be required. This type of disclosure duty would ensure that the market price of the subsidiary reflected management's view of future worth and would vitiate any argument that the buyout is predicated on a potential for improved operations of the subsidiary unknown to the market.

79. Using the market price as a strong indicator of value where there is some risk of the use of information not reflected in that price raises the question of whose burden it is to prove that the market price is inaccurate. Within the conventional doctrinal structure of evaluating interested transactions, a possible solution to this problem would be to place the

consequence of the transaction, market price is the best evidence of intrinsic worth.[80]

The question whether there is a duty to gain share due to the subjective worth of the subsidiary to the parent, or because of gains created by the transaction itself, should be determined independently and not in the guise of a determination of the adequacy of disclosure. There is a vigorous debate in the legal literature as to whether mandated gain sharing is in the best interest of the investor community.[81] The facts of *Weinberger* show that one problem with a gain sharing rule is the extremely difficult problems created by the interrelation of disclosure and administration issues. Signal considered a variety of purchase prices for the transaction which implicitly contained a risk-return analysis of its subjective determination of the subsidiary's worth under various outcomes. The fatal non-disclosed spreadsheet was merely predictive and not a declaration by Signal of the value of a wholly owned UOP. Subjective value calculated for a merger, even if relevant, would normally be represented by such a range rather than as a unitary number. Which figure in the range should be disclosed? How

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initial burden of coming forward with some plausible evidence of taint on the plaintiff. The ultimate burden of persuasion would then be on the proponents of the transaction to prove the market price would have been the same had investors known the excluded information.

80. These criticisms of the valuation question in *Weinberger* apply to appraisal proceedings of all types but particularly to appraisals of publicly traded corporations. Professor Seligman has recently collected comprehensive information on the current state of the appraisal remedy. Seligman, *Reappraising the Appraisal Remedy*, 52 GEORGE WASH. L. REV. 829 (1984). He convincingly showed that the presently structured appraisal process as is unpredictable. Most states have followed some version of the now abandoned Delaware block approach which leads to results that are absolutely "arbitrary and capricious." *Id.* at 859. And even if this model is abandoned (as it also has been in New York, see N.Y. Bus. Corp. Law § 623(h)(4) (McKinney's Supp. 1986)) the experience of *Weinberger* suggests that the problem will not disappear. Professor Seligman thus concludes that the stock market exception for arm's length transactions is the appropriate rule. Seligman, *supra* at 866. Professor Seligman, however, would not allow the exception for interested transactions. He would use the market price of a security as the base line for a valuation judgment, and then look to material omissions or misstatements that distorted the pre-existing market price. *Id.* at 867. He would also look for conduct undertaken by managers to distort the market price of the subsidiary so that the merger could be consummated at an unfair price. *Id.* at 868. I do not quarrel with the basic outline of Professor Seligman's proposal. *See also* Kanda & Levmore, *supra* note 45 for a proposal intended to ensure that all material information concerning the subsidiary is known. There is some question of how often such distortions will be found. *See supra* notes 69 & 73 accompanying text.

81. Contrast Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072 (1983); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L. J. 1354 (1978) (gain sharing should be mandated) *but see* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L. J. 698 (1982) (gain sharing requirement may prevent efficient transactions from taking place).

should the uncertainties of outcome based on peculiarities of the parent-subsidiary relationship be presented? How should an uncertain gain be split?[82] There seems to be no way for a court assessing such information after the fact, to sensibly act both as the negotiating agent for the independent shareholders as well as to predict how such a negotiation would be resolved.[83]

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82. Professor Brudney argues that proportionate sharing based on the relative value of the contribution of the merging firms is the appropriate rule for sharing gains in parent-subsidiary merger cases. *See* Brudney, *supra* note 81 at 1098-106. To facilitate the required equal treatment, the subsidiary's public shareholders should usually be paid in the common shares of the resulting combined enterprise. Whatever the kind of consideration minority shareholders should receive, Brudney starts from the premise that the contribution of the parties cannot be measured by market value, rather in implementing gain sharing non-market based intrinsic value must be measured.

83. The Delaware Supreme Court suggested that one way to solve these problems is to appoint an independent committee of outside directors of the subsidiary to negotiate with the parent. Then there could have been arm's length negotiations. In such negotiations, neither side would reveal its subjective judgments, particularly bottom line positions of subjective worth. The court's suggestion then is but another example of the unresolved tension between intrinsic and subjective worth tests of value. For a description of the tensions in the theoretical underpinnings of *Weinberger*, see Burgman & Cox, *Reappraising the Role of the Shareholder in the Modern American Corporation: Weinberger's Procedural Approach to Fairness in Freezeouts*, 1984 WISC. L. REV. 593.

Rosenblatt v. Getty Oil Co., 493 A.2d 929 (Del. 1985), a post-*Weinberger* parent-subsidiary merger decided by the Delaware Supreme Court, highlights the importance of arm's length negotiation between parent and controlled subsidiary in validating the transaction. *Rosenblatt* involved the merger of Skelly Oil Company into Getty Oil Company. *Id.* at 933. Before the merger, Getty owned 80% of Skelly directly and through affiliated entities. *Id.* at 931. The merger was accomplished by an exchange of .5875 share of Getty for each share of Skelly, with the exchange ratio established using the block approach to appraisal. *Id.* at 936. The parties chose this method in anticipation of litigation, before *Weinberger* was decided. *Id.* at 934. The court in *Rosenblatt* interpreted *Weinberger* as not totally abandoning the block method, but only its exclusivity as a tool of evaluation. The parties gave little weight, 5%, to the relative stock market values of the firms; the exchange ratio was established by giving equal weight, 47.5% each, to assets and earnings. *Id.* at 936. The exchange ratio was more in Skelly's favor than a ratio derived from the company's relative stock prices. The court concluded that the process of adversary arm's length negotiations and use of the block approach met the fair dealing and fair price tests of *Weinberger*. *Id.* at 937-38, 942. The court also concluded that the proxy materials met the "complete candor" requirement of *Weinberger*, and that the complete candor requirement was the equivalent of the *TSC v. Northway* federal materiality test. *Id.* at 945. *See supra* note 46.

Plaintiffs discovered a routinely produced internal projection for Getty which was made while the merger negotiations were occurring, showing a substantial projected decrease in after-tax earnings for the next fiscal year. *Id.* at 938. There was some factual dispute as to whether this information was available to Skelly, but the court determined that resolution of this factual dispute was unnecessary because the projections were not prepared in connection with the merger negotiations and they would not have materially affected the exchange ratio negotiations. *Id.* at 938-39. Determining whether the income projection was known should be crucial to a fairness determination. A projected decrease in earnings made

B. Smith v. Van Gorkom and Valuation in Arm's Length Transactions.

The Delaware courts' search for intrinsic value has also played a role in analyzing the duties of managers in arm's length control transactions. In *Smith v. Van Gorkom*[84] the Delaware Supreme Court held that directors of a publicly traded corporation violated their duty of care to the corporation by approving, in a grossly negligent manner, the acquisition of the corporation by an unrelated third party. The court ruled against the directors even though the acquisition had occurred at a substantial premium over current market value.[85] This opinion is highly controversial,[86] with most of the discussion centering on the court's ruling on the the directors' duty of care and application of the business judgment rule. *Van Gorkom* is one only a handful of cases nationwide holding directors liable for their conduct in the absence of a finding of conflict of interest, self-dealing or fraud.[87] The opinion is even more striking because the finding of gross negligence was expressly based upon the decision-making process of the board;[88] the court did not rely on the fact that the price paid by the

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by Getty management would adversely impact the price of Getty when known by the market and directly impact the exchange ratio. The presence of such inside information is precisely the type of information that is most important to investors making buy or sell decisions. The underlying reason that the inside information was produced is irrelevant from the investors' viewpoint. With a market based view of value, the facts of *Rosenblatt* would raise substantial liability questions while *Weinberger* would not.

84. 488 A.2d 858 (Del. 1985).

85. *See id.* at 866 n.5. The transaction price was $55 per share. *Id.* at 866. The highest price Trans Union traded for during the year before the announcement of the transaction was $38¼. *Id.* at 866 n.5.

The court also held that the proxy statement was materially misleading because the statement asserted that the transaction was occurring at a substantial premium without disclosing that the directors had not independently ascertained Trans Union's intrinsic value. *Id.* at 888-93. The failure to disclose violation is dependent on a belief of non-market based intrinsic worth and creates no independent harm. Nevertheless, the court focused on the directors' alleged deficient disclosures despite overwhelming shareholder approval. *Id.* at 889-90.

86. *Compare* Schwartz & Wiles, *Business Judgment Rule Clarified By Delaware's Trans Union Decision*, NATIONAL LAW JOURNAL, 42 (July 8, 1985) (case consistent with prior case law on business judgment rule) *with* Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985) (case represents unwarranted expansion of the duty and is "one of the worst decisions in the history of corporate law"). Professor Fischel's position on the case is derived from the analysis that a search for intrinsic value unconnected to a fairly established market price leads to fundamental error.

87. *See* Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification Of Corporate Directors and Officers*, 77 YALE L. J. 1078 (1968) (citing cases); Phillips, *Principles of Corporate Governance, A Critique of Part IV*, 52 GEO. WASH. L. REV. 653 (1984) (citing cases).

88. 488 A.2d at 874.

purchaser was too low.[89] The decision is significant also because it would hold the directors personally liable for the difference between the acquisition price and the "intrinsic value" of the corporation as subsequently determined by the court.[90] The Delaware court's application of the duty of care and business judgment rule is particularly important because the opinion appears to closely track the approach of the American Law Institute Corporate Governance Project on these issues.[91] Significantly,

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89. *Id.* at 899. While the opinion discussed the process used by the board, those processes only become relevant once the threshold notion is accepted that firms have intrinsic value apart from market value. The level of judicial deference accorded the method of directorial decision making as opposed to the results of the decision making process appears to be insignificant. Business judgment is as much involved in decisions regarding process as in decisions regarding results. Since process decisions affect the timing and cost of transactions, such decisions can fundamentally affect whether a transaction occurs at all.

90. 488 A.2d at 876.

91. *See* The American Law Institute, ***Principles of Corporate Governance and Structure: Analysis and Recommendations*** § 4.01(a)(Tent. Draft No. 4, April 12, 1985)[hereinafter cited as "ALI"]. Section § 4.01(a) provides a definition of the corporate manager's duty of care: "A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances." The ALI believes that the black letter formulation set forth in § 4.01(a) is consistent with present duty of care standard in most states. *See* ALI Comment to § 4.01(a), at 14.

For purposes of emphasis, however, the Institute has added Subsections 4.01(a)(1) and (a)(2). Subsection (a)(1) places on the director or officer the explicit duty to make "such inquiry" as she "reasonably believes to be appropriate under the circumstances" in discharging the § 4.01 duty. *See* ALI § 4.01(a)(1). While the inquiry requirement is absent in almost all current state statutes (except California), the ALI argues that the concept set forth in § 4.01(a)(1) is nevertheless generally recognized in the case law and by commentators. *See* ALI Comment to § 4.01(a)(1)-(a)(2) at 43. The court in ***Van Gorkom*** adopted the inquiry standard for Delaware. *See* 488 A.2d at 872-874.

Subsection 4.01(a)(2) permits the director or officer performing his duties to rely on material and persons, provided that such reliance is in accordance with § 4.02 ("Reliance on Directors, Officers, Employees, Experts, and Other Persons") and § 4.03 ("Reliance on a Committee of the Board"). *See* ALI § 4.01(a)(2). The Institute noted that it believes that § 4.01(a)(2) is generally consistent with the law as it would be interpreted in most jurisdictions, but that it provides broader protection than present law in ways specified in Comments d, e and g to § 401. *See* ALI Comment a to § 4.01(a)(1)-(a)(2), at 43-45; Comment a to § 4.02, at 77; Comment a to § 4.03 at 86-87.

Subsection § 4.01(b) also recognizes a well accepted reality of corporate governance—the authority of the board of directors to delegate functions to committees of the board, individual directors or officers, employees, and other persons. *See* ALI Comment b to § 4.01(b), at 53-54. Like any delegated function, duty of care is measured by the reasonableness of a board's reliance on the person or persons to whom the matter has been delegated. *See* ALI § 4.02-.03. Subsection § 4.01(b) provides that a director is permitted to delegate a function to, and rely on, committees of the board and various persons in fulfilling her duty of care obligations with respect to that function if her reliance is in accordance with §§ 4.02-.03. *See* ALI § 4.01(b).

The Institute points out that while it believes its formulation in Subsection (b) is the ALI approach has been criticized for unduly expanding the potential liability of directors.[92]

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generally consistent with the law as it would be interpreted in most jurisdictions today, it recognizes that Subsection (b) provides broader protection than present law in ways specified in Comments e and g to § 4.02. *See* ALI Comment a to § 4.01(b), at 54.

The ALI states the standards set forth in § 4.01(a) are intended to cover the performance of each of the functions engaged in by directors and officers. *See* ALI Comment d to § 4.01 at 10. In order to protect directors and officers from the risks inherent in hindsight reviews of their unsuccessful decisions, and to avoid the risk of stifling innovation and venturesome business activity, § 4.01(c) particularizes how the duty of care concept, as expressed in statutes, cases, and § 4.01(a), should be applied to business judgments. *Id.* The comment additionally notes that the business judgment rule is a "judicial gloss" on duty of care standards that sharply reduces exposure to liability. *See* ALI Comment d to § 4.01, at 10.

The ALI provides that if a director or officer acts in good faith and in accordance with § 4.01(c)(1) and (2), the standard in § 4.01(c)(3) will insulate him from liability if "he rationally believes that his business judgment is in the best interests of the corporation." ALI § 4.01(c)(3). The Institute points out that this standard is intended to provide directors and officers with a wide ambit of discretion. *See* ALI Comment d to § 4.01, at 10. The Institute recognizes that the word "rational" has been used almost interchangeably by the courts and is tied to the word "reasonable." *Id.* Here, however, the Institute notes that an important distinction is intended to be drawn between the two words. The phrase "rationally believes" is intended to permit a significantly wider range of discretion than the term "reasonable." This would provide a director or officer a safe harbor from liability for business judgments that might arguably fall outside the term "reasonable" but when made are not so far removed from the realm of reason that liability should be incurred. *Id.* at 11.

In summary, the duty of care provisions in Subsection (a) of § 4.01 are intended to interact with the business judgment rule. Provided that a director or officer has complied with the business judgment criteria set forth in § 4.01(c) with respect to business judgment, she will be free from liability under § 4.01. If, however, a challenging party can sustain the burden of proving that a director or officer was not acting in good faith or with disinterest (in accordance with the standards set forth in § 4.01(c)(1)) or was not informed (in accordance with the standards set forth in § 4.01(c)(2)) with respect to a business judgment, then the safe harbor provided by § 4.01(c) will not be available and the director or officer will be judged under the duty of care standards set forth in § 4.01(a). *See* ALI Comment d to § 4.01, at 11.

92. Both the Business Round Table and the American Bar Association Section of Litigation severely criticized Tentative Draft No. 1 as expanding the liability of directors for the exercise of disinterested business judgment and for mandating procedures for making business decisions as exceeding those required by the current state of the law. Statement of the Business Roundtable on the American Law Institute's Proposed *Principles of Corporate Governance and Structure: Restatement and Recommendations*, American Bar Association Section of Litigation Comments to the American Law Institute Project on *Principles of Corporate Governance and Structure: Restatement and Recommendations, Tentative Draft No. 1*. The current version of Part IV, The American Law Institute, *Principles of Corporate Governance and Structure: Analysis and Recommendations* § 4.01(a)(Tent. Draft No. 4, April 12, 1985) tempers the proposed standard somewhat, but continues the basic outline of the duty as established by Tentative Draft No. 1. In one respect the American Law Institute approach is considerably more favorable to officers and directors than *Van Gorkom*. The commentary to § 7.16 of Discussion Draft No. 1 (June 3, 1985) suggests that a ceiling on liability for violations to the duty of care may be

In *Van Gorkom*, the court's notion of intrinsic value played a central role in its disposition of the case. The acquired corporation, Trans Union Corporation (Trans Union), was a diversified holding company primarily engaged in the leasing business.[93] Like many other capital intensive businesses operating in the late 1970s, it had difficulty maximizing use of its investment tax credits.[94] Accordingly, the firm's value was lower than it could have been had the investment tax credits been utilized to their fullest. Two possible solutions to the investment tax credit problem were available to the directors. They could arrange either a leveraged buyout or they could sell Trans Union to a firm with a large amount of taxable income. Rough calculations showed that a leveraged buyout would be easy to accomplish at $50 per share but would be difficult at $60 per share.[95] Van Gorkom, the chairman of the board and chief executive officer of Trans Union, decided to undertake a more detailed study of a purchase of the company at $55 per share before proceeding. The court noted pejoratively that the $55 figure was based only on "the Company's historic stock market price, and Van Gorkom's long association with Trans Union. . . ."[96] The Van Gorkom study had shown that even with a $200 million equity investment from the buyer, the projected cash flow of Trans Union would not pay off the debt incurred to purchase the firm within five years. Nevertheless, Van Gorkom persuaded the Pritzker interests to purchase Trans Union at $55 per share.[97] When they agreed to the transaction, the Pritzker interests received a leg-up option to purchase one million shares at $.75 above the pre-transaction market price. Trans Union ultimately retained the right to obtain superior offers from other third parties.[98]

The major defense raised by the Trans Union board to the claim that it had breached its duty of care to the corporation, in accepting the Pritzker deal, was the adequacy of the premium over the market price of the security.[99] Because of the substantial premium offered, the directors maintained that no further inquiry into intrinsic valuation was necessary.

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appropriate. The Delaware Corporations Act amendments after *Van Gorkom* would allow a corporation to create such a ceiling by amendment to the corporation's charter. *See infra* notes 113-116 and accompanying text.

93. 488 A.2d at 864.

94. *Id.* at 865.

95. *Id.*

96. *Id.* at 866 (footnote omitted).

97. *Id.* at 866.

98. *Id.* at 867-69, 882. The facts on the market test issue are very complex. In broad outline, however, the Trans Union board ultimately obtained the right to seek higher offers. An investment banker was employed to find potential purchasers. No other company would meet the Pritzker price.

99. *Id.* at 875.

Thus, the directors argued that although the deal was approved on short notice at a brief meeting, it was nevertheless the product of informed business judgment. The court rejected this position. The court instead accepted the argument that the market value of Trans Union had been "historically depressed" from true value due to the tax credits problem, and thus, share prices could not have formed the basis of a reasoned judgment of the intrinsic value of the business.[100] In the court's view, further inquiry and judgment on intrinsic value should have been made. The court suggested that there would routinely be a difference between market value of a publicly traded corporation and its control value.[101] Ironically, the proxy materials of the Trans Union board might be read to support the statements on depressed value and separate trading and control value.[102]

The court's analysis is unpersuasive. As previously discussed, investors use the widest available information set in evaluating the bundle of ownership rights in the firm to establish market values. This bundle includes the right to receive part of the corporation's income as dividends, the increase in value of the business as a consequence of reinvested earnings, and the discounted present value of a control transaction at a premium price. The court cites no information unknown to the market concerning Trans Union. The tax credits problem was not secret information. Trans Union was traded on the New York Stock Exchange, the most efficient of trading markets.[103] Both the generic problem for capital intensive businesses and Trans Union's specific problem with tax credits was public information. Moreover, the firm had already been publicly mentioned as a candidate for a leveraged buyout.

The value of Trans Union, as measured by the market price, certainly must have reflected the true value of the firm. As it was currently structured, Trans Union could not completely use the accumulated tax benefits. Some element of the market price, however, reflected the discounted present value of the possibility that a control transaction would occur with a firm that could benefit from the tax credits. In that limited sense, the firm's market price was "depressed," but still correct. The premium paid by Pritzker reflected the *actual* increase in value to a purchasing firm that was in fact able to use the credits.

The court in *Van Gorkom* was correct in stating that the control value of Trans Union (in the hands of someone who could use the tax credits

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100. *Id.* at 875-76.
101. *Id.* at 874-80.
102. *Id.* at 891.
103. *Id.* at 866 n.5.

fully) was higher than its market value. That enhanced value, however, could only be extracted by a control transaction. Thus, while the value of the firm was different after the transaction, both the pre-sale and post-sale valuations were accurate. The thing being measured changed. Under the *Van Gorkom* approach, directors who are faced with proposals to sell the company encounter a dilemma. A deal may be presented that enhances the value of the firm, but that very offer may be used thereafter as evidence of undervaluation. The court suggests that where there is such evidence, directors must investigate further and possibly seek a better offer (hold an auction), always at the risk of rejecting a deal that actually enhances the value of the firm. The essence of business judgment involves the decision whether to take the sure offer (or induce a firm offer through the leg-up option) or to search for a larger premium that may never come.

For arm's length transactions, the conventional model has been to trust directors' judgments as to both the method of making a decision and the substantive decision itself.[104] The reasons for placing *any* liability on managers for bad business decisions are the standard justifications for the tort system, compensation (here to injured shareholders) and deterrence of preventable harmful behavior.[105] However, the conventional approach to the duty of care and business judgment rule has been to give managers wide discretion in the absence of conflicting interests as to the business decisions reached and the methods for reaching those decisions. Only a virtual abdication of rational decision-making methods and choices normally creates liability.[106]

The reasons cited for a high degree of deference are that courts are ill-equipped to evaluate either on an *ex ante* or *ex post* basis uninterested business judgments, a harsh review of business decisions would make directors overly risk averse to the detriment of shareholders, and good directors would be difficult to attract.[107] Moreover, market based forces—the market for corporate control, the market for managers, and the product markets in which the firm operates—significantly constrain managers' shirking, reducing the need for legal backstops.[108] In addition, directors of public corporations usually are covered by some form of insurance paid for by the corporation.[109] Increased judicial interference

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104. *See infra* notes 107-110 and accompanying text for a summary of the arguments supporting the traditional view of the business judgment rule/duty of care.

105. Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93 (1979).

106. *See supra* note 87.

107. Fischel, *supra* note 86 at 1439.

108. *See* Wolfson, THE MODERN CORPORATION, 59 (1984).

109. Oesterle, *Limits on a Corporation Protection of Its Directors and Officers from Personal Liability*, 1983 WISC. L. REV. 513, 562 n.175 (93% of firms on *Fortune* lists

with managerial decisions will raise the cost of such insurance, a cost borne by the shareholders for whom the heightened standard of review is intended to protect. Such effects may already be occurring. Corporations are now reporting that premiums on directors' errors and omissions policies have substantially increased after the Delaware Supreme Court's decision *Van Gorkom*.[110]

Because of the cost of gathering data[111] and the profound timing issues involved in business decision-making,[112] the process by which a decision is made is as much a subtle business judgment as the substantive decision made. If, however, courts overly interfere in process decisions the likely effect is a more risk averse and costly choice of decision-making style. This may deter substantive decisions in the best interest of shareholders. The Delaware Supreme Court wrongly departed from the conventional model as a result of its mistrust of the market price as a true test of value. Only if the market price viewpoint is rejected can there be any question of whether the decision-making processes of the Trans Union board were flawed. The court has directed that managers undertake an expensive and cumbersome process to find non-market based intrinsic value. At the same time, it has offered no standards by which to determine that value. The substantial difficulties with non-market-based appraisal methods suggest that the task is not likely to produce satisfactory, or predictable results. Rather, the evidence shows that the market price of firms like Trans Union is the best unitary measure of the future worth under a variety of outcomes, including a merger or other control transaction at a premium. Especially under circumstances where there is no incentive to conceal information managers should be entitled to rely on the consensus judgment of the market as to value.

In response to *Van Gorkom* and the liability insurance availability problem, the Delaware legislature has amended the corporations act to provide firms with the power to eliminate or limit the liability of directors for breaches of the duty of care.[113] This optional provision recognizes that

carried directors and officers insurance).

110. Lewin, *Director Insurance Drying Up*, N.Y. Times March 7, 1986, § D at 1. Lewin reports in part as a consequence of *Van Gorkom* premiums in the past year have risen substanially while coverage has been decreased. In *Van Gorkom* itself, an insurance settlement was not paid. After the Delaware Supreme Court opinion the case was settled for $13.5 million. This amount was paid by the acquirors.

111. Outside professionals gather and validate financial information for use in a fairness valuation opinion. Such an opinion may cost several hundred thousand dollars.

112. A common negotiating tactic limits the time an offer is open. The essence of business judgment is to determine whether the time limit is a bluff.

113. Section 2, Senate Bill No. 533, 133rd General Assembly, June 18, 1986. The bill

entrepreneurial decisions invariably are risky, and that decisions like *Van Gorkom* may deter profit maximizing behavior.[114] Any corporation opting into the exclusion from liability for violation of the duty of care will rely on the non-legal market-based incentives[115] for managers to act in consensual arm's length control transactions in the shareholders' interest. Managers relying on the market price as a starting point for negotiating a control transaction would be protected against damage actions if the corporation opted into the exclusion, a result which will normally create maximum shareholder wealth.[116]

C. *Managerial Responses to Takeovers and the Valuation Problem*

Perhaps the most controversial topic in current corporate law is the proper role of corporate managers in anticipating and responding to tender offers.[117] Courts and commentators alike have proposed a wide variety of tests to measure such conduct. These proposals range from requiring managers to be completely passive in the face of a takeover, to allowing managers to facilitate auctions for their firm, to permitting managers to undertake the full range of defensive tactics reviewable under the business judgment rule standard.[118] It has been suggested that target managers, might act efficiently as bargaining agents for their shareholders despite potential conflict if bargaining is placed under strict control.[119] Separate rules for treatment of pre-tender structural defenses versus post-tender

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does not allow corporations to limit liability for breaches of the duty of loyalty, acts not in good faith or which involve intentional misconduct or knowing violations of law, payment of illegal dividends or repurchases of stock, or for which the director gained an improper personal benefit. *Id.*

114. *Id.* at 2 (synopsis of legislative purpose).

115. *See supra* notes 107-109 and accompanying text.

116. One view of corporations statutes is that they provide form contracts to structure the relations among investors and management. If the form provided by statute matches that desired by most ventures then transaction cost are minimized. POSNER, THE ECONOMIC ANALYSIS OF LAW (2d ed. 1977), 292-96. Viewed in this light the Delaware legislative response to *Van Gorkom* provides at little cost a method of modifying the contractual relationship between directors and the firm so that the adverse effects of a too broad duty of care are eliminated.

117. The best summary of the debate is contained in Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984).

118. Bebchuk, *The Case For Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (auctioning role appropriate); Easterbrook & Fischel, supra note 25 (complete passivity rule should be adopted); Lipton, *Takover Bids In the Target's Boardroom*, 35 BUS LAW. 101 (1979) (business judgment rule proper).

119. Oesterle, *supra* note 109.

specifically targeted defenses have been proposed.[120]

The premises of the debate are bounded by assumptions with respect to the utility of the market for corporate control and the driving forces behind that market. Those advocating a limited role for managers of targets in tender offers assume that managers are conflicted when faced with a proposed control transaction.[121] The assumption is also made that the stock market accurately measures (or at least is the best measure of) intrinsic value of the firm in the hands of current management.[122] Premium offers therefore invariably create real gain for target shareholders and are an attempt by the acquiror to also capture some of the gain created by the transaction.[123] An active market for corporate control also creates *ex ante* maximum incentive for management to act in the interest of common shareholders.[124] Managerial behavior which does not benefit shareholders will be reflected in the price of the firm's shares. A low share price places the firm at risk in the market for corporate control. Thus, an active market for corporate control will induce behaviors intended to maximize share prices, reducing agency costs caused by the separation of ownership and control in publicly traded corporations. Limiting defensive target management responses maximizes the sum of the tender and monitoring gain. The only debate using this perspective is whether the amount of additional gain arising from an auction model[125] outweighs any loss of *ex ante* monitoring power.

For those who argue that the stock market does not measure intrinsic worth the model for analyzing defensive tactics is very different. They

120. *E.g.* Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Firm*, 71 U. VA. L. REV. 1257 (1985); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN L. REV. 819 (1981). Baysinger and Butler argue that managers should be free to use defensive tactics so long as the authority to do so was granted by shareholders before any tender offer was pending, even if resistance results in the defeat of all offers. *Id.* at 1300. The controlling assumption of the Baysinger-Butler model is that investments even in publicly traded companies are firm-specific, in other words shareholders routinely hold different (inframarginal) values in for their investments in publicly traded corporations despite the uniform market price. *See supra* notes 33-35 and accompanying text.

121. The conflict arises out of the risk of loss of the value of managerial office. Of course, the conflict is not complete. To the extent that managers have significant stock ownership interests they stand to gain from any premium offered.

122. *See supra* notes 117-127 and accompanying text for an analysis the debate concerning valuation of firms in control transactions.

123. *See supra* note 26.

124. Easterbrook & Fischel, *supra* note 25, at 1174.

125. An auction model would allow managers to facilitate competing bids but not undertake defensive tactics intended to defeat all bids. *E.g.*, Gilson, *supra* note 119, at 868-70.

believe many tender offers are driven by the difference between intrinsic value and stock market value. If the market does not measure intrinsic worth and managers are competent to efficiently make such determinations, then hostile takeover bids are no different than any other type of transaction.[126] Managers can evaluate the amount of premium offered and compare that premium with calculated intrinsic value. Under this approach, it is appropriate for managers to exercise their judgment as to whether the unsolicited offer is adequate and in the long-run interest of shareholders. This makes hostile takeovers not fundamentally different than consensual transactions where board approval is needed.[127]

Not surprisingly, Delaware is a leading jurisdiction considering the appropriate standard of behavior for corporate managers in facing a tender offer. Three recent Delaware Supreme Court cases, *Unocal Corp. v. Mesa Petroleum Co,*[128] *Moran v. Household International, Inc.,*[129] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,*[130] discuss in detail the appropriate role of managers in anticipating and responding to tender offers.[131] The Delaware treatment of defensive tactics is based on the theory that a firm has an intrinsic non-market based value. Under the Delaware view, managers are particularly competent to ascertain this value and do not face disabling conflicts when acting to protect intrinsic value.

In *Unocal* the court approved a specifically targeted defensive tactic under a version of the business judgment rule.[132] Mesa, an owner of 13% of the common stock of Unocal, made a cash tender offer for an additional 37% at $54 per share.[133] If this offer was successful, Mesa intended to purchase, through merger, the remaining Unocal shares for subordinated debt, ostensibly priced at $54.[134] Unocal responded with a self-tender

126. Lipton, *Takeover Bids in the Targets Boardroom*, 35 BUS. LAW. 101 (1979).

127. Board approval is typically required for statutory mergers. DEL. CODE ANN., tit 8, § 251 (1982).

128. 493 A.2d 948 (Del. 1985).

129. 500 A.2d 1346 (Del. 1985).

130. 506 A.2d 173 (Del. 1986).

131. Another recent Delaware Supreme Court opinion, Polk v. Good, 507 A.2d 531 (Del. 1986), approved a greenmail stock repurchase under the *Unocal* standard of review.

132. *See* 493 A.2d at 954-56. Once the board has shown that its primary or sole motive is not entrenchment, then the traditional business judgment deference will be given. The defensive tactic adopted must also be reasonable in relation to the threat posed. 493 A.2d at 954-55. The court thus reaffirmed the two-tiered business judgment rule set out in Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964).

133. Before Mesa began its open market purchasing program, Unocal was trading in the mid-$30's range. Mesa's purchases drove the Unocal price to $46-$48 per share. In establishing its beachhead Mesa's average cost per share was $45.

134. 493 A.2d at 949. The court was highly critical of the offer because it viewed the

exchange offer at $72 per share.[135] This offer did not allow Mesa to participate in the Unocal self-tender and, as first structured, the offer would only have become effective if the Mesa offer had succeeded. The Mesa control condition created corporate gridlock. Shareholders wished to participate in the higher priced Unocal back-end offer, but that offer would not become effective unless enough shareholders tendered to Mesa in the first step.[136] There was no way for shareholders to coordinate their responses to ensure that both offers would go forward.[137] Later, Unocal partially waived the Mesa control provision and stated that it would go forward with an offer for 28.8% of its shares at $72 even if Mesa failed to obtain control.[138] The restructured Unocal offer still excluded Mesa from participating. The Unocal offer caused the Mesa offer to be defeated.[139]

The Delaware Supreme Court approved the Unocal restrictive self-tender as a legitimate defensive tactic.[140] Unocal argued that not only was

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offer as two-tiered, with the second tier at a lower price. As a factual matter, the court was probably correct in assuming the market value of the securities to be offered was below $54 per share of Unocal surrendered. Risk arbitraguers, in determining the value of the offer, would price the consideration offered in the second step. This calculation would be communicated to the market through arbitraguers' trades. *See* Boesky, MERGER MANIA (1985). For a discussion of whether two-tiered offers are unduly coercive see *infra* note 150 and accompanying text.

135. 493 A.2d at 951.

136. *Id.*

137. *Id.* There was no independent agent who could take the shares of independent shareholders of Unocal and then tender the appropriate amount to each offeror so that the conditions of both offers.

138. *Id.* at 946, 951.

139. The Delaware Court's decision significantly injured Mesa. Mesa investors were in a position to loss an estimated $180 million as a result. *See* Norman, *At Unocal, A Victory Without The Champagne*, BUS. WK., June 3, 1985, at 41. Mesa investors received a reprieve when Unocal agreed to buyback 32% of the Mesa group's 23.7 million shares at the $72 premium price. Other shareholders were permitted to exchange 38% of their shares. *Id.* Analysts predicted that for Mesa to break even, the group's remaining shares would have to trade at $37 each. *Id.* Pickens'prediction that Mesa shareholders would "not lose a dime" became reality when the company reported an $83 million net gain from its aborted bid for Unocal, despite suffering a $115 million pre-tax loss on the transaction. Cohen, *Mesa To Post $83 Million Gain On Unocal Bid*, Wall St. J., July 2, 1985, at 3, col. 4. The company said that it will report the gain by applying $198 million in Federal tax benefits against the pre-tax loss. *Id.*

Unocal's remaining shareholders, however, were not so fortunate for Unocal's defeat of Mesa's bid carried a substantial price. The oil company reported that its second-quarter earnings fell 35%, chiefly because of the expense of resisting the takeover by Mesa. Rowe, *Unocal Corp. Says Bid By Pickens Cut Its 2nd-Period Net*, Wall St. J., July 30, 1985, at 10, col. 1. Unocal said that its expenses for the second quarter included undisclosed interest costs incurred on long-term notes that the company issued in exchange for common stock. *Id.* The price of Unocal quickly fell back to its pre-transaction price in the mid-$30s. It is now trading below $29 per share.

140. 493 A.2d at 956.

the Mesa offer grossly inadequate, but as a two-tiered offer it was coercive. Unocal also introduced the testimony of an outside expert that the break-up value of the company exceeded $60 per share.[141] The court accepted these arguments as factually legitimate. The court stated that as long as the primary or sole motive of directorial action was not to perpetuate themselves in office, the traditional protection of a broad-based business judgment rule would be used in analyzing the board's conduct.[142] The court ruled that where the board could demonstrate reasonable grounds for its belief that a danger to corporate policy or effectiveness existed, legitimate purpose was present.[143] Unocal's claims of coerciveness and inadequacy satisfied this standard.[144]

The court's analysis of the appropriate role of directors where tender offers are pending plainly rejected the position that directors' discretion in responding to tender offers should be significantly circumscribed.[145] Because the court believed in the notion of intrinsic value, it accepted without any significant discussion the argument that Mesa's offer was inadequate,[146] despite the fact that the offer was at a premium above the market price just before the offer was commenced; a market price that already reflected Mesa's efforts at building a beachhead. In making this judgment, the court did not search for any information to indicate that the market price was inaccurate. Rather, the court accepted uncritically Unocal's assertion that it had an enterprise value above its current market price.[147] In any tender offer battle, the target will be able to produce similar

141. Unocal also criticized Mesa as a greenmailer and claimed that Mesa's selective repurchase was intended to forestall the payment of greenmail. However, the easiest way to forestall a payment of greenmail requires only the simple corporate decision not to buy out the raider.

142. 493 A.2d at 955. *See supra* note 132.

143. The court defined "effect on the corporate enterprise" extremely broadly. In addition to the price, nature and timing of the bid, a board may consider the effect on non-shareholder constituencies and questions of illegality of the offer. *Id.* The plenary power to adopt defensive tactics is limited by the requirement that the measure "must be reasonable in relation to the threat posed." *Unocal*, 493 A.2d at 955.

144. *Id.* at 956.

145. The *Unocal* opinion cites two leading law and economics articles on tender offers suggesting a limited role for directors in adopting defensive measures but dismisses them summarily as not stating the law of Delaware. Aside from a discussion as to the claimed coercive nature of two-tiered tender offers, the court did not as a policy matter discuss the debate concerning the utility of tender offers.

146. In addition to defending on the basis of inadequacy of price or other economic factors, *Unocal* suggests that directors should be able to defend to protect non-shareholder constituencies such as creditors, customers, employees, and perhaps even the community generally. *Id.* at 955.

147. No doubt the self tender for Unocal increased the firm's value, by changing the capital structure of the corporation. Oil companies are prime examples of firms with

evidence that it is undervalued by the market. Just as in appraisal proceedings, expert testimony will be proffered of why the market price does not reflect true enterprise value. Thus, the search for a legitimate purpose, invoking application of the business judgment rule, often will place no real burden on the manager who seeks to defeat a tender offer.

A series of corollary propositions follows from the court's view of the relevance of corporate value to defensive tactics. The court uncritically accepted one study claiming to show that target shareholders gain from defeating tender offers,[148] despite the fact that the best evidence is that shareholders do not benefit from this behavior.[149] Moreover, the court accepted the position that two-tiered tender offers are inherently coercive, without citation to or consideration of contrary argument.[150]

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uncommitted cash flow and the buyback returned this cash to shareholders. But it was the credible threat of a takeover which caused Unocal to undertake the gain creating transaction.

148. *Id.* at 956 n.11.

149. *Id.* at 956. The court used a study prepared by Kidder, Peabody which claimed to show that for a majority of defeated tender offers, the stock of the target later traded at a higher price than the tender price. The court considered the study to be as strong evidence in support of application of the business judgment rule. The Kidder, Peabody study has been devastatingly critiqued by Easterbrook, & Jarrell, *supra.* note 25, at 282. The Easterbrook and Jarrell study used modern financial analysis to measure stock market gains and losses. Not only did it factor the time value of money, it also factored out as a consequence of movement of the market as a whole. When so analyzed, most successful tender offer defenses cause a decline in shareholder returns. *Id.* The court did not cite the Easterbrook and Jarrell study.

150. 493 A.2d at 956. The question whether two-tiered tender offers are unfairly coercive has been the subject of considerable legal literature. The criticisms of two-tiered are not unlike the concerns raised in parent-subsidiary mergers cases. *See* Brudney, *supra* note 81. *See also* Bebchuk, *supra* note 33. Bebchuk argues that two-tiered offers might result in the decision to tender even if the shareholder believed the first step price or the blended premium, accounting for proration (or at least the second step price), was below the independent value of the target. The independent value might be measured against a pre-bid market price of the target or the bid itself might produce significant information raising the independent value of the target above one or all of the appropriate measuring sticks. The criticisms of two-tiered offers are based on faulty premises. With respect to the pre-bid valuation issue, there are not a significant number of inframarginal shareholders holding non-market based valuations of publicly traded corporations. With respect to the post-bid revaluation issue, the increased value is most probably the effect of gains arising from the control transaction. Even if the gain arises from information discovery, that discovery gain can properly be allocated to the discovering party, usually the raiding corporation. Moreover, in the competitively structured market for corporate control, acutal or potential competition forces the raider to share substantially that gain with the shareholders of the target, whatever the source of the gain. Nor does the unsophisticated shareholder need special protections against two-tiered offers. For a detailed consideration of these arguments see Dennis, *supra* note 31. Finally, regardless of the debate concerning the merits of two-tiered offers, defensive tactics create major agency cost problems and lead to socially inefficient expenditures of resourses. Bebchuk *supra* note 33, at 1742-44.

The deference given by the Delaware Supreme Court to managers undertaking specifically targeted defensive tactics is a product of the court's view of intrinsic corporate value. Managers are entitled to manage, in the takeover context, unfettered by substantial judicial review because they are deemed to be the proper corporate agents to determine and protect intrinsic worth. Yet managers in this context have considerable incentive to find intrinsic corporate worth higher than the offering price[151] and the court has no objective standard against which to judge whether managers are acting faithfully. Thus, if the basis for allowing defensive tactics is the protection of existing enterprise value, then there is no real middle ground. Managers will be free to attempt to defeat an offer on the claim that the intrinsic value of the firm exceeds the offering price.[152]

The valuation problem also affected treatment of anticipatory structural defenses such as the issuance of "poison pill" preferred stock. The "poison pill" technique is the latest in a series of structural defensive tactics which attempt to place in the hands of managers the power to thwart unwanted suitors.[153] In *Moran v. Household International, Inc.*,[154] the Delaware Supreme Court held that the issuance of "poison-pill" preferred stock is a legitimate anticipatory defensive tactic.[155] The "poison pill" label

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151. *See supra* notes 37-39 and accompanying text.

152. Perhaps in the instance where a raider made an any and all cash offer, the court would be less sympathetic to the intrinsic value protection argument for defensive tactics. *See infra* notes 185 & 186 and accompanying text.

The specific result in *Unocal* caused the SEC to propose modifications to the rules regulating tender offers under the Williams Act., Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended in various sections at 15 U.S.C.). The Commission first proposed amendments to Rule 13e-4 which would place issuer self-tenders on the same footing as third party offers with respect to offering period, withdrawal rights, and proration. In addition, the amended rules would have required any self-tender to extend to all security holders of the class of securities subject to the offer and to pay to any tendering holder the highest consideration offered to any other security holder at any time during the tender. The all holders, best price requirement would also apply to third party tenders. Proposed Rule 14d-10. *See* SA Rel. No. 33-6595, 33-6596 (July 1, 1985). The SEC then amended both the self-tender and third party tender proposals to provide that all holders be paid the highest consideration paid, rather than the highest price offered. In addition, the Commission sought comment on allowing issuers to opt out of the all holders requirement. *See* SA Rel. No. 33-6619 (Jan. 14, 1986). On July 11, 1986, the SEC adopted its January proposal. *See* SA Rel. No. 33-6653. No opt out provision was adopted.

153. Structural defenses include by-law and charter amendments which deter takeovers by delaying the transfer of control or by making them more costly to the putative raider. Examples include supermajority voting or fair price requirements for second-step merger transactions, staggered election of directors, cumulative voting, or elimination of shareholder action by consent.

154. 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del.1985).

155. While the opinions of the chancery court and the Supreme Court focused on defenses against two-tiered or partial offers, the plan would impact any-and-all offers as

is derived from the "triggering" and "flip-over" features of the preferred stock. The defensive tactic adopted by the Household board shifted substantial power to directors in determining whether an acquiror's tender offer bid would be economically viable. The basic elements of the "poison pill" defense used by Household granted each shareholder one right to buy one hundredth of a share of a new series of participating preferred stock for each share of common stock owned.[156] The rights detach and may be exercised only if certain triggering events occur.[157] Prior to the triggering events the rights were not transferable apart from the common stock, and were redeemable by Household at a price of $.50 per right.[158]

However, under some triggering events, the rights became a permanent part of the company's capital structure. Moreover, if a merger occurred where Household's common shares were exchanged for securities of the acquiror, the right would have "flipped-over" and enabled the holder to purchase common stock of the acquiror at a price reflecting twice the market value of of the firm. The right holder would then be entitled to purchase $200 of the acquiror's common stock for $100. The chancery court noted that the "resultant dilution of the acquiror's capital is immediate and devastating."[159] The power to redeem the rights results in

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well as the formation of groups for the purpose of mounting proxy fights.

156. The right carries a term of ten years. The new preferred, if issued, is nonredeemable and subordinate to other series of the company's preferred stock. The dividend on the preferred is tied directly to the dividend on the common at a rate of 100 times the dividend declared on common stock. 490 A.2d at 1066.

157. In *Moran*, the rights would have been triggered

> if a person (a) acquire[d] 20% of Household's common shares or (b) achieve[d] the right to purchase 20% or (c) achieve[d] the right to vote 20% or (d) announce[d] the formation of a group of persons holding 20% to act together. . . .[or (e)] upon the announcement of a tender offer or exchange offer for 30% of Household's outstanding stock.

Id.

158. *Id.*

159. The flip-over right could be redeemable for the $.50 figure by the Household board even after the 30% tender or exchange offer announcement trigger. The chancery court noted that the very complexity of the plan is intended to create uncertainty for an acquiror. At a minimum, the offeror would have to structure the offer so that all tendering shareholders also tender an equivalent amount of rights as shares tendered so as to avoid dilution of the acquiror's capital as a consequence of the flip-over right. This means that the offer would have to be contingent on the tender of a very high minimum number of shares being tendered. However, Household's officers and employee benefit plan owned some 7% of the outstanding shares of the firm. In a hostile tender offer, it would be highly likely that these shares would not be tendered. Moran asserted that at least an additional 7.5% of the shares of Household were held by those friendly to management who would not tender in a hostile transaction. Therefore because of the structure of the ownership of Household stock, even in an any-and-all offer, it is likely that at least 20% of the shares would not be tendered. The additional shares not tendered are the result of shareholders who are not vigilant with

the board having the power to determine whether shareholders will be able to tender.[160]

The adoption of the plan was viewed by a majority of the Household Board as necessary to deter "hostile, bust-up takeovers."[161] The plan was challenged by certain shareholders of Household. The basis of plaintiffs' attack was that it rendered "Household virtually raid-proof by depriving its shareholders of the opportunity to sell their shares at a premium in order to confer upon Household's Board unprecedented authority to determine the success of any contemplated acquisition of the company."[162] The chancery court viewed the plan from precisely the opposite position. It reasoned that there was no legal basis for any "right" of shareholders to participate in tender offers. Since the court viewed the plan was adopted primarily to restrict partial or two-tiered offers, it found that it was not created merely to entrench the position of management.[163] Thus, the

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respect to the opportunity to tender causing a minimum dilution effect of $1.2 billion. As a result of the flip-over provisions, the capital structure of the purchasing firm would be diluted by $600 million for each 10% of the shares of Household not tendered. The market value at the time at this litigation of all the outstanding common stock of Household is approximately $2 billion.

160. Under Delaware law, the issues before the court were whether the rights allowing the subsequent issuing of the "poison pill" preferred stock were authorized by sections 151(g) and 157 of the Delware Corporations Act. In addition, the court was faced with the issue of whether the business judgment rule should measure the directorial decision to issue the rights. Section 151(b) broadly authorizes the board to issue shares with various voting power, preferences, and other characteristics. Section 157 provides that options or rights can be issued for the purchases of any capital shares of the corporation. The Delaware Supreme Court held that even if the purpose of the rights was wholly for their anti-takeover effect (and not directed at any financing purpose) they were authorized by the statute and were not sham rights. The court also adopted the *Cheff/Unocal* version of the business judgment rule as the appropriate reviewing standard for the directors' decision. 500 A.2d at 1356.

161. 490 A.2d at 1064. In February 1984, "Household management became concerned about the company's vulnerability as a takeover target." *Id.* Moran, one of its own directors, acting on behalf of Household's single largest shareholder, Dyson-Kissner-Moran Corporation ("D-K-M") began to actively investigate such a transaction. On the basis of financial studies performed by the D-K-M personnel, Moran concluded that Household's stock was significantly undervalued in relation to the company's break-up value. At the time the Plan was adopted, Household's common stock had a market value of $30-33, as compared to Moran's estimate of a $52 break-up value per share. *Id.* at 1066, 1077. Accordingly, Household's component assets potentially could be partially liquidated to defray any costs of acquisition in a leveraged buy-out. *Moran*, 490 A.2d at 1064. Although D-K-M purchased an additional 500,000 shares of Household's stock on the open market, it is significant that no tender offer was actually made by D-K-M prior to the adoption of the Plan. *Id.* Nor did management adopt a liquidation program which would have increased shareholder wealth.

162. *Id.* at 1074.

163. *Id.* at 1079, 1082.

chancery court viewed "the adoption of the Rights Plan [as] an appropriate exercise of managerial judgement under the business judgement rule."[164] The Delaware Supreme Court adopted this reasoning.[165] The court believed that the plan did not result in any fundamental shift of decision-making authority from shareholders to the board. It viewed the plan as no different than the whole range of other available defensive tactics such as filing law suits, entering into leg-up options with competing bidders, or entering into greenmail transactions.[166] This reasoning adopts the argument that within the structure of corporate decision-making tender offers are no different than other fundamental corporate decisions, decisions that usually require board approval as a prerequisite.[167] Thus, the court rejected as significant the unique *ex ante* monitoring power of the market for corporate control as a significant basis for legal rulemaking.

The *Moran* opinion reaffirmed the great latitude which a board possesses in making decisions believed to be in the corporation's interest so as to protect intrinsic enterprise value. For all practical purposes, however, the plan made Household "takeover proof" without the approval of the board. Unless the rights are redeemed, the extra consideration that an acquiror would have to pay would make the transaction economically unviable.[168] It was established in *Moran* that the current market value of Household's securities at the time of the attempted takeover approximated $2 billion.[169] The effect of the "poison pill" plan was that any tendering

164. *Id.* at 1083. The court's analysis of the validity of the "poison pill" plan under the business judgment rule is modelled on Note, *Protecting Shareholders Against Partial and Two Tiered Takeovers: The Poison-Pill Preferred*, 97 HARV. L. REV. 1964, 1969-73 (1984) ("Directors issuing poison-pill preferred stock should be able to satisfy the substantial business purpose test.")

165. 500 A.2d at 1348.

166. *Id.* at 1354.

167. Lipton, *supra* note 118.

168. There may be some ways of limiting the dilutive effect of the "poison pill." An offeror could condition its offer on receiving a very high minimum percentage of shares tendered. But because of the structure of share ownership and the dynamics of offers, it would be unlikely that enough shares would be tendered to avoid substantial dilution. An additional possible solution would be to reduce the consideration on the first step to reflect the costs of the flip-over. This probably is not economically practical because the price of the first step would have to be reduced below the current market price of the target, removing all of the incentive to tender.

169. 490 A.2d at 1066. It was further estimated, by Moran that Household had a break-up value of $52 per share. This placed Moran in the ironic position of also claiming that Household's stock was significantly undervalued. The court accepted this non-market valuation in concluding that the Board's selection of $100 for the poison pill warrants was not "without economic justification." *Id.* at 1077. Moran's claim of undervaluation was not inconsistent with my approach. Indeed Household may have had such a break-up value, but that figure is only relevant if management is willing to liquidate the firm or participate in

company would have to pay a substantial dilution penalty because of the structure of Household's share ownership.[170]

Basic to the court's decision is the assumption that hostile two-tiered offers or partial offers are destructive to the interests of most shareholders and that "poison pills" prevent such offers, although the Household plan was not limited to controlling two-tiered or partial offers.[171] The court justified the "poison pill" defensive tactic as a method of preventing stampedes of shareholders tendering in order to receive the first tier premium and as a device to protect shareholders from inadequate second-step offers. As a consequence, the decision permits the directors to determine when an acquisition price is high enough to allow shareholders to sell their stock.

The stock market has reacted adversely to placing plenary negotiating power in the hands of managers. One stock market price movement study shows that shareholders lose a small but significant amount of value when "poison pills" are adopted.[172] A convincing explanation for this effect is

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some other kind of transaction, such as a leveraged buyout, that could be used to extract the break-up value. The market obviously had considerable and justifiable doubts as to whether Household would willingly facilitate a control transaction.

170. The effect of the dilution penalty converts any offer into an offer where non-tenderors are likely to be paid more, in effect a "back-end loaded offer." One of plaintiffs expert witnesses, Professor Michael Bradley, concluded that in no single instance has a "back-end loaded" tender offer succeeded. 490 A.2d at 1068 This is because all shareholders would seek to participate in the higher priced back-end rather than tender.

171. The court concluded that "the coercive nature of [two-tier] . . . tender offers because of the risk that some shareholders will be 'frozen out' of any premium once control is achieved is well documented. *Id.* at 1078 (citing the Advisory Committee On Tender Offers, Sec. & Exch. Comm. Report Of Recommendations (1983)). As an empirical matter this is incorrect. The remaining shares of the target trade at a higher than pre-tender price and, because of the dynamics of the market for corporate control, the second-step transaction also occurs at a premium over the pre-bid price.

The court expressly rejected plaintiffs' academic experts, Professor Jensen and Bradley, who stated that two-tiered tender offers usually result in significant economic benefits to shareholders. *Id.* Based on data contained in a Goldman & Sachs study of May 29,1984 and material collected by the SEC staff, Jensen concluded that "the market price of a target company gains an average 30% in the month surrounding a tender offer." *Id.* Furthermore, even in two-tier offers, the combined premium received in the first and second phases was found to be a significant increase over the pre-bid market price. Jensen's conclusions were supported by the testimony at Professor Michael Bradley's, of the Graduate School of Business of the University of Michigan. *Id.*

Similarly, the court ignored the testimony of Richard C. Abbott, former head of mergers and acquisitions at Morgan, Stanley & Co., that the plan eliminated the "competitive climate which maximizes share ownership value to stockholders." *Id.* at 1067.

172. The chief economist for the SEC studied stock price movements of 37 firms that adopted poison pills during the period between 1983 and 1985. Such studies are the routine method of determining the impact of new information concerning a firm. If the price of a firm, net of market, increases then the market has determined that the new information is

that investors believe the potential for enhanced value from a successful premium offer has been reduced more than the potential for enhanced value through coordinated negotiation by management resulting in higher bids.[173] Not only was this effect ignored by the Delaware Supreme Court, but the court did not consider any loss *ex ante* of monitoring effect as a consequence of the reduced likelihood of any tender offer.[174] At least with specifically targeted defensive tactics such as in *Unocal* the dynamics of the market for corporate control usually requires that some gain be created for the uninterested shareholders (such as by the self-tender) for the defensive tactic to be successful. In the "poison pill" situation, managers are provided with all the opportunity to deter any control transaction, rather than redirect the result.[175]

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positive. The Chief Economist's study showed an opposite bad news effect, a statistically significant decrease in value of approximately 2.4%, indicating that poison pills do not routinely benefit shareholders. The chief economist stated, however, that the amount of the decrease in value and the varied firm-specific results that the market has some ability to discriminate in ascertaining which pills will be used in the most abusive manner and that some pills will be defeated by determined bidders or defeated by the courts. Office of the Chief Economist, *A Study of the Economics of Poison Pills*, Fed. Sec. L. Rep. (CCH) ¶ 83,971 (March 5, 1986).

173. The presence of negotiating power in the hands of managers certainly increases the risk of successfully defeating all offers. This risk reduces the amount of risk arbitrage investment in a particular transaction. As a consequence the pre-bid price is lower and spreads between the market price and the transaction price, while a deal is pending, should be higher. The non-professional trader is injured by this effect, since the amount of risk that can be shifted to arbitraguers is reduced. This is the opposite result of the effect claimed for poison pills.

174. The court seems to assume the only risk created by the plan is that it will be used incorrectly when the request to redeem is made. Yet a real loss occurs even if no offer is ever made.

175. Other courts have also analyzed the legality of a variety of "poison pills." Two federal district court opinions interpreting New Jersey law invalidated "poison pills." Ministar Acquiring Corp. v. AMF Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985), declared illegal issuing a poison pill right which was given only to common shareholders who held as of a certain record date. The right was also non-transferable. The court declared that record date limitation and the absolute restriction on transferability were illegal under the New Jersey corporations statute. In *Minstar*, the target argued that the "poison pill" defensive tactic was legitimate because because "taken as a whole—*the offer was inadequate and not in the best interest of the corporation or its shareholders.* The Board stated that it was concerned with the detrimental effect a two-tiered takeover would have on the non-tendering shareholder. Specifically, it believed that the *remaining shareholders would be unable to realize the fair market value for their shares.*" (*Id.* at 1255 emphasis supplied). The offeror countered that "the defensive tactics do not set a fair price for the second stage, but rather, sound the death knell to the tender offer, thereby denying the shareholders the basic right of tendering for a premium according to market forces." Similarly, in Asarco Inc. v. M. R. H. Holmes A Court, 611 F. Supp. 468 (D. N. J. 1985), the court disapproved on statutory construction grounds a "poison pill" which granted different voting rights to shareholders of the same class of stock. One federal district court opinion, invalidated on

The *Moran* court's hostility to two-tiered and partial tender offers combined the intrinsic valuation approach with an *ex post* perspective. What the court ignored is that the dynamics of the market for corporate control and the Williams Act proration rules caused the blended premiums in partial and two-tiered tender offers to be substantially above the pre-tender market price of the target.[176] All shareholders have the opportunity to participate in the higher first tier price. Moreover, two-tiered offers only appear unfair to those receiving the lower second-step price when viewed

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statutory construction grounds, applying Delaware law, a poison pill similar to the *Asarco* pill. Unilever Acquistion Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985). In contrast in Horwitz v. Southwest Forest Indus., Inc., 604 F. Supp. 1130 (D. Nev. 1985), a federal district court applying Nevada law approved adoption of a poison pill on negotiating model theory.

Another series of non-Delaware "poison pill" opinions that shows the effect of valuation issues on analysis of "poison pills" involves the rights plans adopted by CTS Corporation in its control battle with Dynamics Corporation of America. CTS is an Indiana corporation. The legality of the various CTS poison pill plans under state law were litigated in federal court. Since there was no direct Indiana case on point the federal opinions looked (as would an Indiana state court) to Delaware law to test legality. The first district court opinion preliminarly enjoined a poison pill because the court found sufficient evidence that the primary purpose of the plan was to entrench management and the plan was not reasonably related to the the threat posed by a pending Dynamics partial tender offer and proxy fight. The district court found the plan was devised to prevent all partial offers and that the CTS failed to determine whether the value of company justified this judgment. Dynamics Corp. of Amer. v. CTS Corp., Fed. Sec. L. Rep. (CCH) ¶ 92,736 (N.D. Ill. 1986). The district court was affirmed by the Seventh Circuit in an opinion by Judge Posner. Dynamics Corp. of Amer. v. CTS Corp., Nos. 86-1601, 86-1608, slip op. (7th Cir. April 23, 1986). Judge Posner's opinion summarized the debate concerning the proper role of managers faced with a battle for corporate control. He suggested that some defensive tactics may increase target shareholder wealth and protect against coercive front-loading of offers. He noted these potential gains may be off-set by *ex ante* loss of monitoring power and a reduced investment in the market for corporate control. Without resolving the basic policy dispute Judge Posner affirmed the district court opinion. In three respects Judge Posner read Delaware law narrowly. First, he construed *Revlon* as mandating shareholder wealth maximization as the only goal of defensive tactics. Delaware cases allow protection of other corporate interests such as employee interests except in the instance where a decision to liquidate has already been made. Second, Judge Posner discounted the value of approval of a defensive technique by disinterested directors which the *Moran* court gave considerable weight. Third, Judge Posner showed less concern for the claimed coercive effect of partial offers than would the Delaware courts. As a factual matter, Judge Posner was also willingly to second guess the operational management skills of the current control group, a practice that Delaware courts have not used in evaluating defensive tactics.

In response to the first district court opinion, CTS adopted a new rights plan which created a back ended loading requirement at $50 per share, at a time when CTS was trading in the mid $30s. The district court refused to preliminarily enjoin this plan because it determined the plan might assist an orderly auctioning of the company. Dynamcis Corp. of Amer. v. CTS Corp., Current Transfer Binder 1985 Fed. Sec. L. Rep. (CCH) ¶ 92,743 (N.D. Ill. 1986).

176. *See supra* notes 150 & 151 and accompanying text.

from after the fact. And as the empirical data show, even the second-step offers are invariably at a large premium above pre-existing market value and if the offer was partial the price of the target persistently remains above the pre-tender price. Because the blended premiums (and even the second-step premiums) are above the pre-transaction market price, such offers can only be considered coercive if market value is not considered an appropriate measure of enterprise value.

Nevertheless, it might be argued that the flip-over provision was not *per se* illegal because it could be waived. The provision could be used as a device to bargain with potential acquirors. Bargaining and auctions can themselves create gain.[177] It has been suggested that waivable defensive tactics are not inherently bad and that the real issue is whether the courts will properly scrutinize the target board's decision with respect to waiver. This approach would reduce the *ex ante* monitoring effect of tender offers, but in some instances a rule prohibiting target management from negotiating also has costs.[178] A relatively heavy burden of proof could be placed on directors whose negotiating fails to lead to a takeover. This would reduce the opportunity for directors to use defensive tactics simply for entrenchment.

The negotiating proposal is moderate and sensible. But to adopt the negotiating model would take a significant change in the attitude of the Delaware courts toward takeovers. The courts would have to realize that the justification for allowing use of defensive measures was not to protect intrinsic value but rather to increase the gain for all participants in the transaction. Arguments supporting defensive tactics because the raider has disruptive (such as potentially value enhancing liquidation) plans

177. As Professor Oesterle noted, bargaining can cause the transaction to be reformulated in a way that increases the gain for all. For example, after bargaining the raider may determine to buy only some of the assets of the target, rather than the target as a whole. Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53 (1985). Any gains from bargaining must be weighed against some reduced incentives to be a first bidder. *See infra* note 186.

178. The ability of managers to potentially frustrate first bidders (and even defeat all offers) reduces the strength of the market for corporate control. Easterbrook & Fischel, *supra* note 25, at 1161. From an *ex ante* perspective, the ability to oppose tender offers might then reduce shareholder wealth even though in a particular case opposition leads to a higher priced offer. In addition to Professor Oesterle's suggestion that the passivity rule forgoes gains from joint bargaining, the passivity rule might lead to inefficient transactions, prevent assets moving with minimum transaction costs to their highest use, and a suspicion among non-institutional invests as to whether the stock market is a fair game. Oesterle, *supra* note 177 at 60; Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COL. L. REV. 1145 (1984).

would have to be rejected under the negotiating model. The court would have to be genuinely suspicious concerning all successful defenses. The results in *Unocal* and *Moran* show that this suspicion is not currently present. In sum, neither the negotiating nor auction models are inconsistent with the market value viewpoint. Under either approach, it is assumed that the gain thru increased transaction prices offsets any *ex ante* reduction in monitoring power. The Delaware cases start from a very different viewpoint. They assume firms can be bought too cheaply as measured against pre-bid market price. This gives managers much more power in attempting to forestall or defeat any offers.

The picture of the Delaware approach to defensive tactics presented by *Moran* and *Unocal* may only be limited by the analysis presented in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[179] In *Revlon*, the Delaware Supreme Court invalidated a lock-up option and no-shop agreement where a final determination had been made to break up the firm and sell it in parts to several bidders.[180] The court held that the Revlon managers' adoption of a "poison pill" after the commencement of a tender offer, which placed negotiating power in the board and spurred several rounds of bidding for the firm, was legitimate.[181] In addition, a share repurchase program was approved. Both tactics were validated as a method of protecting intrinsic value as well as non-shareholder interests.[182] But once a board decision had been made to facilitate a liquidation of the firm, the board was required only to consider in its decision-making process

179. 506 A.2d 173 (Del. 1986).

180. *See* 507 A.2d at 176-77. The court also enjoined payment of a $25 million cancellation fee. The opinion involved complex competing acquisition plans for Revlon. In June 1985 Pantry Pride made a hostile tender for Revlon at $45 per share. Revlon's board believed this offer was inadeqaute. It responded by adopting a poison-pill rights purchase plan and repurchased 17% of its outstanding common. These defensive tactics were justified as a way of requiring a potential acquiror to negotiate with the Revlon board. In response to increased offers from Panty Pride, the Revlon board repurchased an additional one-third of the company's common for a combination of newly issued notes and preferred stock. Pantry Pride continued to increase the value of its offers. Then Revlon began negotiations with Forstmann Little attempting to organize a leveraged buyout. The buyout plan would have required the sale of two major Revlon divisions to third parties. In addition, Forstmann Little would assume the debt issued in the second repurchase transaction. In a further response to yet another increased Pantry Pride offer to $56.25 per share, the leveraged buyout price was increased to $57.25 and at this point the lock-up option and ño-shop agreement were granted by Revlon. Forstmann also agreed to issue new notes to substitute for the repurchase debt which it had assumed. This was intended to protect the Revlon directors from threatened litigation by the note holders. *See id.* at 178-84.

181. *Id.* at 180-81.

182. *Id.* at 181. The court also believed these defensive tactics appropriately protected other corporate constituencies against a precipitous break-up of the firm.

the price received by the common shareholders.[183] Thus, the court held that while lock-ups and no-shop clauses are not *per se* illegal, the final Revlon-Forstmann agreement was void because the court believed the agreement did not significantly facilitate the obtaining of a meaningfully higher bid.[184]

Revlon presents a confused picture of the director's duties with respect to takeover defensive tactics. The intrinsic value theory continued to legitimate powerful defensive measures such as initial adoption of the "poison pill" and a share repurchase program without significant review of the effect on common shareholders of these tactics. A "poison pill" may mean that no bid is ever made. Nevertheless, the opinion approved the board adopting the role as plenary negotiator for the shareholders through the use of "poison pills." But if negotiation is the appropriate model for board behavior, lock-ups may be useful to induce competing bids. For a lock-up that increases a bid more than a nominal amount[185] of the consideration received, it is difficult to imagine how a reviewing court could evaluate whether it was a good business decision to reach such an agreement.[186] Thus, *Revlon* can be understood within the context of other Delaware control transaction cases, its heightened standard of review of managerial behavior is invoked in the peculiar circumstance of where a definite decision to liquidate the company had been made and an auction is already ongoing. In this instance price is the only determinative factor and, in the Delaware court's view, the lock-up is not needed to further the

183. In *Revlon*, however, the board's decision to favor the leveraged buyout proposal was colored by the fact that the leveraged buyout gave the board protection against liability related to issuing the repurchase notes. The court suggested that this fact brings the case within something like a duty of loyalty analysis. While the court stated at one point in the opinion "[t]he principal object, contrary to the board's duty of care, appears to have been protection of the noteholders over the shareholders' interests. . . ." *Id.* at 184. At another point stated "the Revlon board could not make the requisite showing of good faith [to invoke the business judgment rule] by preferring the noteholdrs and ignoring its duty of loyalty to the shareholders." *Id.* at 182.

184. *Id.* at 184. This holding was buttressed because of the interest the directors had as a consequence of the potential liability to the note holders.

185. As noted, one problem in *Revlon* is that the court viewed the additional consideration received as a consequence of the lock-up as insignificant. In fact, the next highest competing bid under some measures was identical.

186. Professor Osterle argues for any-and-all offers like *Relvon* that managers should be disabled from favoring one bidder over another, except when there is clear and convincing evidence that one bidder cannot consummate the transaction or will loot the corporation and injure any remaining shareholders. He bases this position on an empirical judgment that lock-ups are not required to induce competing bids and thus agreement to the lock-up is unjustified acceptance of a negotiating bluff. The Delaware court does not appear to go that far in limiting lock-ups. It instead significantly limits the ability to grant lock-ups in the liquidation context. Oesterle, *supra* note 177, at 92-93.

bidding contest.

IV. Conclusion

Modern financial theory has had a significant impact on the academic corporate community. Recent academic corporate scholarship has focused on concepts such as agency monitoring costs, the *ex ante* perspective, and the use of sophisticated financial studies to measure the effect of legal rules. Yet, with few exceptions,[187] the law and economics approach has had little impact on judges making decisions. For example, virtually none of this scholarship is utilized by the Delaware courts in deciding cases.[188] The Delaware experience shows that in the corporate area, courts still view arguments concerning fairness from an *ex post* rather than *ex ante* perspective. Moreover, arguments based on the marginal valuations are still viewed skeptically. Model building using economic argumentation does not seem persuasive. In the market for corporate control, an area of substantial economic significance, the result has been unfortunate.

187. For example, federal courts have explicitly used modern financial theory in deciding disclosure questions. *See, e.g.*, Seaboard World Airlines v. Tiger Int'l Inc., 600 F.2d 355 (2d. Cir. 1979).

188. This not an unusual circumstance. Judge Becker observed that the methodology applied does not often get presented in the courtroom, nor are judges typically comfortable with this style of discourse. Becker, *The Uses of "Law and Economics" by Judges*, 33 J. LEG. ED. 306 (1983).