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Saints and Sinners: How Does Delaware Corporate Law Work?

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INTRODUCTION

How is it that millions of people entrust trillions of dollars to corporate managers over whom they have little control and on whose discretion their profits depend? How is it that most managers most of the time seem to do a pretty good job looking out for shareholders' interests? This, for me, is the central mystery of corporate law, made especially intriguing by the apparent infirmity of the various legal, institutional, and market checks on managers' discretion.

Sixty years ago, one might have predicted from Berle and Means' detailed analysis of shareholders' exposure to unconstrained managers, that a rational investor would shift assets away from equities and into bonds.[1] But such a prediction would have been wrong. Investors did not abandon

1. ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

equity and were right: Stocks significantly outperformed corporate bonds.[2] The assumptions of this Article are that shareholders made the right decision, and that they did so, at least in part, because managers generally perform pretty well.

How is it that most managers do a good job most of the time? How is it that most managers most of the time are worthy of the trust of investors? The traditional corporate law answers to these core questions fall into three types. First, there are the legal constraints: The courts, through the enforcement of specific legal prohibitions (like laws outlawing theft, embezzlement, insider trading, and the like), and through the enforcement of more vague legal constraints (the duty of care and the duty of loyalty), sometimes catch errant managers. Second, institutional structures such as the board of directors, outside directors, shareholder voting, proxy contests, and derivative suits may keep managers in line. Third, pressure from the various markets that impinge on the corporation and managers (the product markets, the managerial labor market, capital markets, and the market for corporate control) may keep managers in line.

But on examination, none of these checks, with the exception of competitive product markets, when they exist, seems to provide a very robust check on managers. Each seems to help a little some of the time, and only occasionally seems to help a lot. At the end of a term in which I teach the basic Corporations course or a seminar on Corporate Governance, after weeks of exploring the weaknesses of each of the checks on managers, I find myself most impressed by the apparent impotence of the constraints.[3]

But, more importantly, the standard answers tell us little of the *mechanism* by which these checks constrain managers. Implicitly, the various answers seem to assume a crudely behaviorist model of managerial behavior, a "stick-and-carrot" approach. The implicit assumption seems to be that the sanction imposed, discounted by the likelihood of detection and punishment, outweighs the benefit to the agent of sloth or theft. To take but one familiar example, in the standard 1980s story, if managers mismanage,

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2. *See, e.g.*, STEPHEN ROSS ET AL., CORPORATE FINANCE 232–36 (2d ed. 1988). This is hardly conclusive proof that managers, on the whole, behave well. Indeed, finance theory teaches us that, in equilibrium, one would expect that higher variance assets, like equities, will outperform lower variance assets, such as bonds, of the same corporation.

3. For a comprehensive survey of the (at least apparent) impotence of corporate law constraints on managerial discretion, see CHRISTOPHER D. STONE. WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR (1975).

the stock price will drop and a takeover entrepreneur will buy up the shares to gain control, replacing bad managers with good managers. The threat of such a takeover, the story asserts, will lead all managers to manage better.[4]

In the corporate context, however, the assumption of "direct deterrence" is particularly implausible: There are hundreds of corporations, the directors and officers of which have comprehensive liability insurance; damage liability is extremely rare; and, after the enactment by Delaware of section 102(b)(7) of the General Corporation Law,[5] which allows Delaware corporations to opt out of director liability for breach of the duty of care, damage liability has become even rarer. If the principal sanction is not directly financial but reputational, then one must explain how this sanction works, an account entirely absent from the standard account.

And yet, the system seems to work. The triplet of restraints—legal, institutional, and market—seems to constrain managers generally to act for shareholders, despite their manifest looseness (if not impotence). How is it that they do so? What is the mechanism that connects these constraints with managerial behavior? In this Article, I do not claim that the traditional constraints do not "work," that is, do not generally constrain managers to act for shareholders. Rather, I assume that they *do* work, and I try to figure out *how*. The theory outlined in the following pages is incomplete, perhaps at times implausible, and certainly only partially verified. But it is a theory of how corporate law works, and, in evaluating it, it is worth keeping in mind the old Chicago School maxim: It takes a theory to beat a theory.[6] In part, my aim here is to highlight the absence of any developed theory to explain how corporate law works.

This leads me back to my original question: How is it that managers at least try to do a good job most of the time? This is, of course, part of a more general question: How is it that *most* people most of the time try to do a pretty good job, even though the likelihood of sanctions is objectively

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4. *See, e.g.* Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

5. DEL. CODE ANN. tit. 8, § 102(b)(7) (1994). This is not the place for an extended discussion of the strengths and weaknesses of a direct deterrence model of corporate duties. For recent discussions reviewing such models, see John Braithwaite & Brent Fisse, *On the Plausibility of Corporate Crime Theory*, in 2 ADVANCES IN CRIMINOLOGICAL THEORY 15 (William S. Laufer & Freda Adler eds., 1990); John Braithwaite & Toni Makkai, *Testing an Expected Utility Model of Corporate Deterrence*, 25 L. & SOC'Y REV. 7 (1991).

6. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 434 (1993); Richard A. Epstein, *Common Law, Labor Law and Reality: A Rejoinder to Professors Getman and Kohler*, 92 YALE L.J. 1435, 1435 (1983).

slight? How is it that most tenured law professors (at least at Penn) try to teach well, even though we all know that we will not be fired if we do not?

The beginning of a thicker answer is that all of us internalize rules and standards of conduct with which we generally try to comply. We do this not only because we may fear some sanction, formal or informal, but also because doing so is important to our sense of self-worth, because we believe that doing a good job is the right thing to do. How are these rules and standards, which are the rails along which so much of our lives run, generated and maintained? For most employees of the firm, the set of formal and informal systems of socialization, detection, and sanction are sufficient. Thus, for the typical middle manager, the example of other managers, the gossip around the coffee machine, and the possibility of discharge by a more senior manager can provide an adequate set of instructions and sanctions.

The problem faced by such a "norm-based" account of managerial behavior is that senior managers and directors are, by design, the chief criticizers and the chief sanctioners. As such, they are less constrained by gossip around the coffee machine. What replaces gossip and other sanctions for this critically important group? How are the rules and standards that govern the behavior of senior managers and directors generated and maintained? A claim of this Article is that the Delaware courts provide a supplemental source of gossip, criticism, and sanction for this set of actors who are beyond the reach of the firm's normal systems of social control.

The subjects of the study of U.S. corporate governance—the senior managers and directors of large, publicly held corporations, and the lawyers who advise them—form a surprisingly small and close-knit community. The directors of large, publicly held corporations number roughly four to five thousand.[7] A small group of lawyers, centered in New York and Wilmington, with others in Chicago and Los Angeles, specialize in Delaware corporate law. The community has its own court, the Delaware Chancery Court, with review by the Delaware Supreme Court. It has its own newspapers: the *Wall Street Journal* and, for the lawyers, the *New York Law Journal*. People know each other and, as we will see below, apparently care about their reputation in the community. The story I tell in this Article is very

7. According to HEIDRICK & STRUGGLES, THE CHANGING BOARD (1988), the average board of a Fortune 500 company has 13 directors. *Id.* at 2. Thus, there are approximately 6500 directorships of Fortune 500 companies. One must subtract from this the number of directors who serve on more than one board. Again, according to Heidrick and Struggles, 18.3% of directors hold one directorship in addition to their own company, 28% hold two, 17.9% hold three, 14% hold four, and 3.9% hold more than four. *Id.* at 13.

much the story of how a small community imposes formal and informal, legal and nonlegal, sanctions on its members.[8]

From this perspective, three questions immediately present themselves: First, how is the content of corporate law rules and standards determined? Second, how are they generated? And third, how are they communicated to officers and directors? In this Article, I ignore the first question, which goes to the substance of corporate law, and has been the subject of much scholarship.[9] Instead, I focus on the second and third questions, which go to the mechanisms of corporate law and have been almost entirely ignored.

There is a persistent tendency to acknowledge that Delaware corporate law largely involves standards, but then to try to reduce it to a set of rules.[10] Take, for example, the following description: "Under Delaware law, when a potential acquirer makes a serious bid for a target, the target's Board of Directors is required to act as would 'auctioneers charged with

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8. *See generally* ROBERT ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES (1991) (noting that people often handle their disputes in a cooperative manner without relying on the applicable law).

A contemporary anecdote illustrates the close-knit quality of the Delaware corporate law community, and its ability to sanction members who depart significantly from generally accepted conduct. In Delaware, judges of the chancery and supreme courts are nominated by the governor, and confirmed by the Senate, for a 12-year term. DEL. CONST. art. IV, § 3. The practice is that the governor may only choose from a list of candidates assembled by a nominating commission, members of which are appointed by the governor and include both lawyers and nonlawyers. *See generally* Guy v. Judicial Nominating Comm'n, 659 A.2d 777 (Del. 1995). As the term of Justice Andrew Moore drew to a close, the nominating commission did not put his name forward, *even* as one among several qualified candidates. Observers agreed that this was not because of any question regarding the competence of his judicial opinions—indeed, his opinions were and are generally well respected—but, rather, because of his practice of humiliating lawyers who appeared before him. Richard B. Schmitt, *Reappointment Seems Unlikely for Moore*, WALL ST. J., May 18, 1994, at B7.

9. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

10. On rules versus standards, see, for example, Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983); Ronald M. Dworkin, *The Model of Rules*, 35 U. CHI. L. REV. 14 (1967); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976).

For examples of this tendency within corporate law, see, for example, Marcel Kahan's excellent discussion of the *Viacom* case in which he tries to identify the factors that explain the outcomes of the various Delaware takeover cases. Marcel Kahan, Paramount *or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994); *see also* Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 85 (1991) ("As few suits produce a legal rule (only two in this sample), this [public goods] explanation of lawsuit efficacy turns on the need for a large number of lawsuits in order to obtain a ruling.").

getting the best price for the stock-holders at a sale of the company.'"[11] This description views Delaware law as largely substantive: When a potential acquirer makes a serious bid for control, the target board must act as a neutral auctioneer, regardless of what sort of process it might follow in coming to the conclusion that it should not act as an auctioneer. Likewise, on this view, the Delaware cases established a rule for the conduct of target managers: If a potential acquirer makes a serious bid for control, then target management must act as a neutral auctioneer.

I mean to contrast this view—a view which naturally emerges from teaching Corporations and trying to help students synthesize cases into useful principles or algorithms—with a fundamentally different view that provides a much better description of Delaware fiduciary duty law. In the 1960s, when Delaware was revising its corporation law, Samuel Arsht, a leading figure of the Delaware corporate bar, is said to have proposed that the law be simplified to the following principle: Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith. This principle—which is, in my view, a completely accurate description of Delaware fiduciary duty law—conceptualizes Delaware fiduciary duty law in process terms (boards can do whatever they want as long as they follow the right process) and as setting standards as opposed to rules (boards must act in good faith). Most importantly, the formulation is largely empty until the concept of good faith is defined. As I describe more fully below, in what is a central claim of this Article, the Delaware courts fill out the concept of "good faith" through fact-intensive, normatively saturated descriptions of manager, director, and lawyer conduct, and of process—descriptions that are not reducible to rules of the sort described above. Indeed, most such rules, like the one above, turn out to be manifestly incorrect descriptions of Delaware law.[12]

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11. Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L. ECON. & ORG. 27, 27 (1991) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)).

12. *Revlon* does not stand for the proposition described by Cramton and Schwartz, and, even if *Revlon* could be read for that holding, subsequent cases make clear that it does not represent a general principle. *Cf.* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990). As I will discuss below, the once common reading of *Time-Warner* as standing for the proposition that target management can "just say no" was likewise inaccurate, much to the chagrin of Paramount. *See* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994) (Viacom joined Paramount as a plaintiff in this action); *infra* text accompanying notes 174–224.

To put my point differently, in this Article I seek to take the standard-like quality of Delaware fiduciary duty law seriously. At the core of my analysis is a claim that standards work very differently than rules, that standards are typically generated and articulated through a distinctively narrative process, leading to a set of stories that is typically not reducible to a rule.[13]

My claim here—which is a descriptive claim—is that the Delaware courts generate in the first instance the legal standards of conduct (which influence the development of the social norms of directors, officers, and lawyers) largely through what can best be thought of as "corporate law sermons." These richly detailed and judgmental factual recitations, combined with explicitly judgmental conclusions, sometimes impose legal sanctions but surprisingly often do not.[14] Taken as a whole, the Delaware opinions can be understood as providing a set of parables—instructive tales—of good managers and bad managers, of good lawyers and bad lawyers, that, in combination, fill out the normative job description of these critical players. My intuition is that we come much closer to understanding the role of courts in corporate law if we think of judges more as preachers than as policemen.[15]

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13. *See generally* MARTHA C. NUSSBAUM, LOVE'S KNOWLEDGE: ESSAYS ON PHILOSOPHY AND LITERATURE (1990) (especially Chapter 1). My Hebrew University colleague Ruth Gavison argues that standards are *always* articulated through narratives. If this argument is correct—and I think it is—then what one sees in Delaware fiduciary duty cases is an example of a more general legal phenomenon played out in a small community.

This insight raises the question of why Delaware courts rely on such detailed narratives when other courts interpreting standards, such as the requirement of good faith under § 1-203 of the U.C.C., rely on far briefer descriptions. My intuition is that the difference reflects a difference in the size of the relevant communities and not a difference between parties engaged in repeat interactions, but a full comparative analysis is beyond the reach of this Article. As I discuss in more detail below, in a small community with repeat players, the potential to generate norms through critical description without direct legal sanction seems to be greater.

14. I briefly discuss this claim in Edward B. Rock, *Preaching to Managers*, 17 J. CORP. L. 605 (1992) (reviewing LOUIS LOWENSTEIN, SENSE AND NONSENSE IN CORPORATE FINANCE (1991)).

15. This work owes an enormous debt to the work of Robert Cover in the conceptualization of judicial narratives as sacred texts and in the role of "legal" narrative in constituting community. *See* Robert M. Cover, *The Folktales of Justice: Tales of Jurisdiction*, 14 CAP. U. L. REV. 179 (1985) [hereinafter Cover, *Folktales*]; Robert M. Cover, *Forward: Nomos and Narrative*, 97 HARV. L. REV. 4 (1983). It also owes a debt to the rich discussion of the role of narrative in law over the last decade. For discussions of that literature, see, for example, Kathryn Abrams, *Hearing the Call of Stories*, 79 CAL. L. REV. 971 (1991); Jane B. Baron & Julia Epstein, *Is Law Narrative?*, 45 BUFF. L. REV. (forthcoming Winter 1997); Anne M. Coughlin, *Regulating the Self: Autobiographical Performances in Outsider Scholarship*, 81 VA. L. REV. 1229 (1995); Daniel A. Farber & Suzanna Sherry, *Telling Stories Out of School: An Essay on Legal Narratives*, 45 STAN. L. REV. 807 (1993); Kim Lane Scheppele, *Foreword: Telling Stories*, 87 MICH. L. REV. 2073 (1989); Jane B. Baron, *The Many Promises of Storytelling in Law*, 23 RUTGERS L.J. 79 (1991) (book review). *See also* LAW'S STORIES: NARRATIVE AND RHETORIC IN THE LAW (Peter Brooks & Paul

My claim is not that Delaware law is unpredictable and indefinite. In fact, as we will see below, despite the fact-specific, narrative quality of Delaware opinions, over time they yield reasonably determinate guidelines. My claim is, rather, that the *process* that leads to reasonably precise standards proceeds through the elaboration of the concepts of independence, good faith, and due care through richly detailed narratives of good and bad behavior, of positive and negative examples, that are not reducible to rules or algorithms.

The second part of my claim is a causal claim that I can only begin to defend here: that these standards of conduct are communicated to managers by corporate counsel, and that the judgments of the courts play an important role in the evolution of (nonlegal) norms of conduct. As I will try to show below, these claims, if true, have fundamental implications for how we think about corporate law.

To sketch out this picture of corporate law, I examine the emergence during the 1980s of new corporate law standards—or, equivalently, the elaboration of the same old standards in a new factual context—to govern management buyouts of large, publicly held corporations (MBOs). I focus on the situation in which managers who do not hold a controlling equity interest rely on outside financing ultimately secured by the assets of the corporation to buy the corporation from the public shareholders. This

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Gewirtz eds., 1996) [hereinafter LAW'S STORIES].

The approach to cases implicit in this Article is similar to that described in KIM LANE SCHEPPELE, LEGAL SECRETS: EQUALITY AND EFFICIENCY IN THE COMMON LAW 86–108 (1988), in a chapter entitled: "A Theory of Legal Interpretation: The Mutual Construction of Rules and Facts." Scheppele uses the common law to examine norms of secrecy; I use the Delaware fiduciary duty law to understand norms of corporate governance. *See also* Robert C. Post, *The Social Foundations of Privacy: Community and Self in the Common Law Tort*, 77 CAL. L. REV. 957 (1989) (discussing the ways that privacy torts both express community norms of privacy and, at the same time, protect and reinforce those norms and help to create the very community that underlies the norms).

As the law-and-narrative literature has emphasized, legal analysis often involves storytelling. What, for me, is so striking about the Delaware cases is that storytelling is so prominent in the decisions and so unabashedly normative. Moreover, through what is probably an accident of academic specialization, (i.e., law-and-narrative folks do not generally teach Corporations), corporate law opinions have been almost entirely absent from the law-and-narrative discussions. For example, in LAW'S STORIES, *supra*, in a volume of papers presented at a recent Yale conference on law as narrative, there seems to be not a single reference to Delaware corporate law opinions, nor any entry in the index to corporate law. As Sanford Levinson notes in his contribution to the Yale conference, this parochialism may skew the sample. Sanford Levinson, *The Rhetoric of the Judicial Opinion*, in LAW'S STORIES, *supra*, at 187, 189–90 ("[Constitutional law] is, to put it mildly, but one small branch (or genre) of one legal system. No doubt someone whose expertise was different, even within the U.S. legal system, would stress different aspects of judicial opinions . . . ."). For a notable exception, see David Skeel, Saul and David and Corporate Takeover Law (Oct. 12, 1995) (unpublished manuscript, on file with author).

situation must be distinguished, on the one hand, from management buyouts of divisions (when the selling company can fully protect the interests of its shareholders), and from parent-subsidiary freeze-out mergers, when the parent company already has control. Although each of these other situations is important, neither poses the same dramatic conflict between managers' self interest (which is to buy the company for the lowest possible price) and their duty to shareholders (which is to sell for the highest possible price) in the context of widely dispersed public shareholders. As such, MBOs pose particularly hard questions of duty for the officers and directors that cannot be answered by reference to general social norms.[16]

As many of the cases discussed here demonstrate, the "kindergarten" norms, like loyalty and cooperation, provide limited guidance when directors are faced with a conflict between loyalty to and cooperation with senior managers, with whom they have worked for years, and loyalty to the much more abstract "shareholders." This conflict is muddied further by the notion that directors owe their duties of loyalty and care to the "corporation," where "corporation" is left undefined, but, in practice at least, is often thought not to be identical with the shareholders. As we see below in many of the management buyout cases, when some "outsider" comes along and "threatens" one's friends, the managers for whom one has the greatest respect, the directors' "right" response, at least on the unreflective application of general social norms, may appear to be the support of management.[17] It is in situations such as these—when general social norms provide insufficient guidance or may be in conflict with the goals or fundamental principles of corporate governance—that the generation and pro-

16. The definition and identification of MBOs is necessarily somewhat imprecise. Is it an MBO, for example, when an unrelated third party bids for control and offers incumbent management an equity stake and long-term employment contracts? Does it matter whether the offer of an equity stake was made before or after the bidder achieved control? In each case, the question is whether the management is "interested." As we will see below, because of the case-by-case approach taken by the Delaware courts, the definitional question of what is and what is not an MBO is not critical.

17. In this connection, the path-breaking article by James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, LAW & CONTEMP. PROBS., Summer 1985, at 83, is clearly relevant. *See also* Donald C. Langevoort, Beliefs, Biases and Organizational Behavior: The Epistemology of Corporate-Securities Lawyering (Nov. 1996) (unpublished manuscript, on file with author).

mulgation of role-specific standards for managers and directors become so critical. On this view, the Delaware decisions can be viewed as part of the definition and description of the "roles" that managers and directors are expected to fill.[18]

Because MBOs of significant publicly held companies suddenly assumed prominence in the 1980s, they provide a case study in which we can watch Delaware corporate law in action: the development and articulation of standards of conduct and the communication of those standards to officers, directors, and lawyers. The evolution of the standards of conduct relating to MBOs is a sufficiently narrow example so that I can focus on the mechanics of their generation—on the language of the opinions—in sufficient detail to make the claim plausible. Finally, MBOs provide a useful context to consider the ebb and flow of corporate law: how quickly cases appear, how many cases there are relative to the number of transactions, and how much it costs (at least in terms of plaintiffs' attorneys' fees) to develop new norms.

In Part I of this Article, I trace out this evolution in the MBO opinions of the Delaware Chancery and Supreme Courts. In Part II, I begin to trace the transmission of these standards to their ultimate target by examining press accounts (both trade and popular), extra-judicial utterances, and the interesting but little discussed legal genre, the "memorandum to our clients," that a number of prominent Wall Street firms use to keep their clients apprised of developments in the law. The critical empirical

18. Because my target here is how corporate law works, I leave to one side the dispute over the morality of "role morality." For discussions of role morality in the corporate context, see, for example, PETER A. FRENCH, COLLECTIVE AND CORPORATE RESPONSIBILITY (1984); ELIZABETH WOLGAST, ETHICS OF AN ARTIFICIAL PERSON: LOST RESPONSIBILITY IN PROFESSIONS AND ORGANIZATIONS (1992); Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477 (1995). *See also, e.g.*, DAVID LUBAN, LAWYERS AND JUSTICE: AN ETHICAL STUDY (1988); Michael O. Hardimon, *Role Obligations*, 91 J. PHIL. 333 (1994) (discussing role morality as an issue in moral philosophy); Gerald J. Postema, *Moral Responsibility in Professional Ethics*, 55 N.Y.U. L. REV. 63 (1980); Richard Wasserstrom, *Roles and Morality*, *in* THE GOOD LAWYER: LAWYERS' ROLES AND LAWYERS' ETHICS 25 (David Luban ed., 1983) (discussing role morality in the legal context).

Part of what makes these cases interesting is that the situations generally do not involve conflicts between demands of private morality and role obligations, but, rather, are situations in which the guidance provided by ordinary morality runs out.

work—the investigation not of what the courts are saying, but of what the directors and their lawyers are hearing—is a separate project.[19]

In Part III, I explore some of the implications of this normative/narrative theory of corporate law. This view of Delaware fiduciary duty law has important implications for how lawyers should advise their clients, as a review of the *QVC v. Viacom*[20] cases demonstrates. It also has important implications for how we think about shareholder litigation in the Delaware courts. In particular, a review of the quantity and timing of Delaware MBO opinions, in the context of the development of MBOs as a transactional form, suggests that the problem with shareholder litigation in Delaware courts could be just the opposite of the conventional wisdom: too little rather than too much. Moreover, a further implication is that the generation of legal standards or nonlegal norms, both of which are public goods, should be thought of as the primary and not the tertiary function of shareholder litigation.[21] I close with a brief conclusion and an outline of further research.[22]

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19. Michael Useem and I are working on a project to examine what lawyers tell boards and what boards hear about their fiduciary duties through interviews with the relevant actors. We use an approach similar to that of JAY W. LORSCH, DIRECTORS: PAWNS OR POTENTATES (1989), and MYLES MACE, DIRECTORS: MYTH AND REALITY (1971). *See* MICHAEL USEEM, EXECUTIVE DEFENSE: SHAREHOLDER POWER AND CORPORATE REORGANIZATION: THE REALITY OF AMERICA'S CORPORATE BOARDS (1993).

20. QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994).

21. On this view, but beyond the reach of this Article, it may make more sense to construe incentive compensation and criminal liability—i.e., positive and negative inducements to managers—as important insofar as they assist in the articulation or promulgation of legal standards and social norms, or because of their role in expressing such standards and norms, and not because they act to constrain managers in any direct way.

22. Deborah A. DeMott is struck by many of the same features of the Delaware case law that I examine in detail here. The approach I take in this Article is somewhat similar to her approach in Deborah A. DeMott, *Puzzles and Parables: Defining Good Faith in the MBO Context*, 25 WAKE FOREST L. REV. 15 (1990), which analyzes the MBO cases as giving examples of what counts as "bad faith." Other aspects of this analysis are briefly alluded to in Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985), and Melvin Aron Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 GEO. WASH. L. REV. 582, 589–90, 594 (1984), which describe corporate law as norm generative and role descriptive. *See also* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 271 (1989).

I. When Managers Try to Buy the Company: A Case Study in the Emergence of Corporate Norms

A. Setting the Stage: The Leverage Buyout Boom

Leveraged buyouts of publicly held companies date at least to the early 1970s.[23] During this first wave, controlling shareholders of small companies that had gone public in the hot new issues market of the late 1960s and early 1970s found that the costs of being publicly held outweighed the benefits in the recession-battered market of the mid-1970s.[24] In response, some of these companies were "taken private" by their managers/controlling shareholders.[25] Although there was a certain amount of attention paid to these transactions, and much criticism,[26] these transactions were economically insignificant.

All this changed in 1979 when Kohlberg, Kravis and Roberts (KKR) organized a leveraged buyout of Houdaille, a Fortune 500 machine tool company.[27] KKR's ability to acquire Houdaille, combined with William Simon's enormous and widely publicized profits on the 1984 public offering of Gibson Greetings, which had been acquired in a divisional leveraged buyout from RCA just three years before,[28] stimulated the growth of LBOs and, with that, the growth of the subset, MBOs.

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23. Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 730 (1985). In a leveraged buyout (LBO), a company is acquired from its public shareholders, using borrowed money which is ultimately secured by the assets of the target company. In a management buyout (MBO), the managers of the company participate in the acquisition group.

24. *Id.*

25. Thus, these transactions were often known as "going-private" transactions.

26. *See, e.g.*, Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Victor Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); A.A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility*, [1974–1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010 (Nov. 20, 1974).

27. *See* GEORGE ANDERS, MERCHANTS OF DEBT: KKR AND THE MORTGAGING OF AMERICAN BUSINESS 19–41 (1992); EDWARD K. CRAWFORD, A MANAGEMENT GUIDE TO LEVERAGED BUYOUTS 3–5 (1987); Lowenstein, *supra* note 23.

28. ANDERS, *supra* note 27, at 37.

In addition to the potential for large profits, hostile tender offers,[29] which likewise increased in frequency in the early 1980s, provided the other stimulus for the growth of MBOs. As managers' jobs became more insecure, the attraction of securing control through an MBO grew.

And the numbers of LBOs and MBOs grew dramatically. Table I summarizes the growth of LBOs between 1981 and 1990.[30] In the two years after the Houdaille MBO in 1979, MBOs passed the $2 billion threshold. By 1984, there were around sixty deals worth about $13 billion. By 1986, the value of the forty-three going-private transactions was around $25 billion. By 1988, when, as we will see below, the Delaware jurisprudence on MBOs reached its maturity, there had already been around 250 deals worth around $75 billion. In the space of a decade, there were around 400 buyouts valued at more than $160 billion. As I will develop in more detail, these numbers pose one of the most striking features of the development of the Delaware MBO norms: compared to the pace of the deal-making and the vast amounts at stake, these cases arose late.

B. Management Buyouts in the Delaware Courts

In an MBO, when senior managers with outside financial partners buy control of the company from the public shareholders, they face obvious and severe conflicts of interest between their self-interest (to acquire the company for a low price) and their duty to shareholders (to sell the company for a high price). Moreover, this conflict arises in a context in which managers inevitably have inside information regarding the corporation, information

29. In a hostile tender offer, a bidding company seeks control of a target company by acquiring the target company's shares directly from the target shareholders over the opposition of the target management.

30. Table I, drawn from *Leveraged Buyout Trends 1981 Through First Half 1987*, MERGERS & ACQUISITIONS, Nov.–Dec. 1987, at 81, 81 [hereinafter *Leveraged Buyout Trends*], and *LBO Signposts*, MERGERS & ACQUISITIONS, Nov.–Dec. 1991, at 61, 61, includes all "going private transactions" involving publicly held companies, but excludes divisional leveraged buyouts. *See* Table I *infra* p. 1091. As such, it is somewhat over-inclusive in that a small number of going-private leveraged buyout transactions cannot fairly be characterized as MBOs because management does not participate. For example, see the KKR buyout of RJR Nabisco in which KKR outbid the CEO's buyout group. *In re* RJR Nabisco, Inc. Shareholders Litig., No. CIV.A.10389, 1989 Del. Ch. LEXIS 9, at *5 (Feb. 14, 1989). The numbers in Table I are consistent with the numbers of MBOs identified in other studies. *See, e.g.*, Robert L. Kieschnick, Jr., *Management Buyouts of Public Corporations: An Analysis of Prior Characteristics*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 35, 47 tbl.2-1 (Yakov Amihud ed., 1989) (listing statistics for going-private transactions from 1981 to 1985); John Easterwood et al., Limits on Managerial Discretion in Management Buyouts: The Effectiveness of Institutional, Market and Legal Mechanisms (Dec. 1995) (unpublished manuscript, on file with author). For my purposes here, the exact numbers are less important than the order of magnitude.

that they have acquired in the course of their employment and at firm expense. In addition, management is also sometimes in the position to control the timing of the transaction, again based on its inside information. This severe conflict of interest likewise puts the board of directors in an awkward position: Directors often have personal ties with the very managers who are seeking to buy the company. Indeed, those managers are often themselves members of the board.

Although the existence and severity of the conflict is obvious, the appropriate solution is not. Professors Brudney and Chirelstein, two of the earliest commentators, took the position that the conflicts were so severe, the potential benefits so slight, and the mechanisms for controlling conflicts so feeble, that management buyouts should be per se illegal.[31]

But Delaware courts do not rely on such per se rules. Instead, in a quite remarkable series of decisions over the latter part of the 1980s, the Delaware courts elaborated a set of principles governing the behavior of officers, directors, and lawyers involved in management buyouts. It is this development that I wish to survey here.

1. The Doctrinal Background

Management buyout cases were analyzed within the classic doctrinal structure of Delaware fiduciary duty law, that is, under either the business judgment rule or the entire fairness standard.[32] Under the business judgment rule, there are three core elements to the analysis: First, as a threshold matter, the directors must be "independent" in the sense of financially disinterested; second, the directors must have acted with good faith; third, they must have acted with due care, that is, not with gross negligence.[33]

When the requirements of the business judgment rule are not satisfied, the "entire fairness" standard applies, under which the directors have the

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31. Brudney & Chirelstein, *supra* note 26, at 1365–70.

32. In its classic articulation, the business judgment rule shields directors from liability and shields a decision from injunction, if the decision is made by independent directors acting in good faith and with due care. *See, e.g.*, *RJR Nabisco*, 1989 Del. Ch. LEXIS 9, at *39. *See generally* ROBERT C. CLARK, CORPORATE LAW § 3.4 (1986).

33. A question lurks in the discussion of *RJR Nabisco* whether, in addition to independence, good faith, and due care, the decision must also be "reasonable" or "rational." *See, e.g.*, *RJR Nabisco*, 1989 Del. Ch. LEXIS 9; *see also* ALI, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) (discussing the pros and cons of reasonable test versus good faith test). Whether the irrationality of a decision is an independent basis for liability or injunction, or whether it is simply evidence of lack of good faith and due care is unclear and of little practical importance.

burden of establishing that the transaction is entirely fair to the corporation. In such cases, the courts review the terms of the transaction and not simply the process leading up to it. According to the Delaware courts, the entire fairness standard has two aspects: fair dealing and fair price.[34]

The MBO cases were analyzed within this bipolar framework. In cases in which managers were, in fact, on both sides of the transaction, the review was under the entire fairness standard.[35] In cases in which a special committee was involved, the review was, in the first instance, conducted pursuant to the business judgment rule and, if its conditions did not obtain, then under the entire fairness standard.[36] Although perhaps odd to those unaccustomed to Delaware case law, the doctrinal discussions in the MBO cases did not go beyond the identification and description of these two basic standards.[37]

What is important to see about each of these standards of review is that they are standards, not rules.[38] The critical concepts of the business judgment rule are "independence," "good faith," and "due care." The critical concepts of the entire fairness standard are "fair dealing" and "fair price." These are the classic terms used for signaling the presence of "standards" and, as we see both in the MBO cases and more generally in Delaware law, are only given content in the distinctive narratives of the Delaware courts.

2. The Doctrinal Pre-History

As we will see below, a striking feature of the Delaware case law is that although MBOs were prominent and common from at least 1981, manage-

34. Rabkin v. Philip A. Hunt Chemical Corp., 498 A.2d 1099 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

35. *See, e.g.*, the early cases of EAC *Industries* and *Greenfield*, discussed *infra* Parts I.B.4.a and I.B.4.b, respectively.

36. *See, e.g.*, the critical trilogy, *Macmillan*, *Fort Howard*, and *RJR Nabisco*, discussed *infra* Part I.B.5.

37. In cases dealing with hostile tender offers, the Delaware courts also developed what may either be considered an intermediate standard of review, or alternatively, an application of the business judgment rule in a particular recurring factual context. *See generally* Gilson & Kraakman, *supra* note 22 (discussing the Delaware proportionality test). In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), the court, recognizing that directors face a potential conflict of interest when a hostile tender offer has been made, reviewed director action under a "proportionality" standard. Under this standard, one first looks to see if there was a "threat" to the corporation and, if so, whether the directors' actions in response were "proportional" to the threat. The *Unocal* standard was not generally relied upon in MBO cases.

38. This is so despite the business judgment rule's name.

ment buyout *cases* did not begin to appear in the Delaware courts in appreciable numbers until 1985 or 1986 (depending on whether one considers the *Revlon*[39] case to be in part an MBO case), and the norms governing MBOs were not worked out until 1988–1989. When the cases did arise, however, they arose against the background of the earlier cases in which a parent acquired minority shares of a partially owned subsidiary, and in which management bought a division from a parent corporation.

In Delaware, one line of cases addressed the question of when and how a parent corporation can freeze out minority shareholders of a subsidiary. During the 1970s, Delaware flirted with prohibiting such mergers absent an independent "business purpose."[40] And even if a merger did have such a purpose, the burden was placed on the controlling shareholders to demonstrate "entire fairness."[41] This "business purpose" requirement was quickly undermined when the Delaware Supreme Court held, a month later, that a business purpose of the parent corporation sufficed.[42]

In 1983, the Delaware Supreme Court decided *Weinberger v. UOP, Inc.*,[43] a case that finally abandoned the business purpose test in parent-subsidiary mergers, and that set the doctrinal stage for Delaware's analysis of MBOs. The Signal Companies owned 50.5% of UOP, and nominated and elected six of the thirteen members of the UOP board. After two Signal officers, who were also directors of UOP, concluded in a feasibility study that acquiring the remaining shares of UOP would be a good investment for Signal at any price up to $24 per share, Signal decided to acquire the remaining shares. Signal offered to merge with UOP, with the UOP minority shareholders receiving $21 per share.

The UOP board, advised by its investment banker, considered and ultimately accepted the Signal offer, but, according to the court, was never informed of the existence or content of the feasibility study developed by two of the UOP directors for Signal's use. In particular, the non-Signal directors were never informed that the feasibility study concluded that a price up to $24 per share would be a good investment for Signal. It was this failure by Signal-affiliated directors that the court found to be the primary breach of fiduciary duty.

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39. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

40. Singer v. Magnavox Co., 380 A.2d 969, 978–80 (Del. 1977), *overruled by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

41. *Id.* at 980.

42. Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1124 (Del. 1977).

43. 457 A.2d 701 (Del. 1983). The factual account is drawn from the Delaware Supreme Court opinion. *See id.* at 704–08.

In holding that Signal had breached its fiduciary duties in cashing out the minority shareholders of UOP, the court emphasized the absence of an independent committee to represent the public shareholders:

> [T]he result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued.[44]

This language in *Weinberger* led to the near universal use of "special committees" of independent directors in MBOs. The story of management buyouts thus becomes a set of stories about how managers should behave, on the one hand, and how special committees should behave in representing the interests of the corporation or the shareholders on the other.[45]

The first Delaware case involving a management buyout of a division that I have been able to identify is the 1982 case of *Field v. Allyn*.[46] In that case, incumbent management participated in what we would now characterize as a management buyout of Penn Central's 92.6% interest in the Pittsburgh and Lake Erie Railroad. From today's vantage point, two things stand out. First, the majority shareholder, Penn Central, actively protected its own interests, by shopping for competing bids, as well as the minority shareholders' interests, by insisting that it would not sell its shares to anyone who would not immediately make a tender offer for the minority shares at an identical price.

Second, the opinion makes clear that the court was writing on a clean slate. Plaintiffs, although convinced that something was deeply improper about management participating in a buyout of the company when 100% of the purchase price was ultimately secured by the company's own assets, had great difficulty in, as the court said, "placing their finger on precisely what it is that is wrong."[47] The court, noting "the absence of any direct prece-

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44. *Id.* at 709 n.7 (citation omitted).

45. The use of special committees in the context of derivative suits, *see, e.g.*, Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), and uninvited and (from management's perspective) unwelcome bids for control, *see, e.g.*, *In re* TWA, Inc. Shareholders Litig., No. CIV.A.9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988), provided additional points of reference for the court's appraisal of special committees in MBO transactions.

46. 457 A.2d 1089 (Del. Ch.), *aff'd per curiam*, 467 A.2d 1274 (Del. 1983). The factual account is drawn from the Delaware Supreme Chancery Court opinion. *See id.* at 1090–96.

47. *Id.* at 1090.

dent cited by the plaintiffs under the law of Delaware or elsewhere,"[48] reviewed the transaction, found nothing improper, and granted summary judgment to defendants.

3. The Normative Backdrop: Two Plausible Views

In order to appreciate the dilemma facing directors during this period, and the role that Delaware courts played in developing role specific norms for MBOs, one must briefly reconstruct the competing normative frameworks within which directors functioned. In particular, one must recall the radically different views of takeovers, in general, and the role of the board of directors in MBOs, derivatively, that clashed during the 1980s.

Two inconsistent views competed both intellectually and practically. According to one view—the "managerialist" view—hostile tender offers were bad for companies, communities, and society as a whole. From this perspective, the 1980s were a dangerous time, with sharks circling proud and once-proud companies, looking for any sign of weakness, and then moving in for the kill. In the process, enormous debt was incurred, companies were destroyed, assets sold off, the work of generations of expansion lost, and the nation mortgaged its future.

According to the competing view—the "free market" view—tender offers were the great engine of managerial accountability and efficiency. They were a sign that markets worked. When managers mismanaged, the market price of the stock dropped, providing an opportunity for an entrepreneur to enter, buy up the shares at a premium above market price, fix the problems in the company, and profit thereby. When managers of companies with free cash flow spent it on inefficient expansion or diversification, the solution was to break up the company and sell off pieces to people who knew how to manage them more efficiently. On this view, takeover entrepreneurs benefited shareholders and society as a whole by moving assets to their highest and best use, by disciplining bad managers, and by paying premia to target shareholders.

If one adopted the managerialist view—as many managers and directors instinctively did—then one might plausibly conclude that the best solution for a company was to "remain independent." When, however, sharks had been spotted, a second-best solution was to sell the company to the managers, thereby protecting the company from the depredations of a hostile takeover. From this perspective, it was plausible to take the position that it

48. *Id.* at 1091.

made sense to sell the company to the managers, if they could pay a fair price. If, however, managers could not afford a fair price, other defensive measures should be used to prevent a leveraged bust-up takeover.

If, by contrast, one started from a "free market" position, it was wrong to sell the company to managers for a "fair price" without first checking the market to see if the shareholders were getting the *highest* price for their shares, whether from managers or from a takeover entrepreneur. If one started with the premise that the company belongs to the shareholders, and the managers' and directors' duty was to maximize shareholder value, then it followed immediately that the company should not be sold to managers without first making sure that shareholders were receiving top dollar.

In the Delaware MBO cases that follow, one witnesses the managerialist intuitions of managers and directors in confrontation with a changing, increasingly market-driven environment, with the chancery court serving as referee. One sees an evolution—under the critical and often caustic eye of the Delaware courts—in what directors believe to be the right thing to do, a change that is both reflected in, and apparently at least in part caused by, the Delaware decisions.

4. The Early MBO Cases

a. *EAC Industries, Inc. v. Frantz Manufacturing Co.* (1985)

The first Delaware MBO case involving a publicly held company seems to have been the 1985 case of *EAC Industries, Inc. v. Frantz Manufacturing Co.*[49] In that case, the CEO's attempt to acquire the company in an MBO transaction was frustrated when the retiring chairman of the board sold his shares to a third party, EAC, thereby giving it a fifty-one percent stake. The chancery court, in an opinion later affirmed by the supreme court, enjoined the transfer of a block of stock to an employee stock ownership plan ("ESOP") that would have diluted the EAC's holding to below fifty percent, and blocked other measures adopted by the board to interfere with EAC's acquisition of control over the corporation.

The *EAC* case provides an early example of what not to do if you were a manager. Vice Chancellor Walsh painted a vivid picture of the actions of Musgrove, Frantz's CEO, in response to EAC's acquisition of a control

49. No. CIV.A.8003, 1985 WL 3200 (Del. Ch. June 28, 1985), *aff'd*, 501 A.2d 401 (Del. 1985). The factual account is drawn from the Delaware Chancery Court opinion, *id.* at *1–*5, and the Delaware Supreme Court opinion, 501 A.2d at 401–06.

position and EAC's changes to the by-laws:[50] "Musgrove, confronted with what appeared to be a fait accompli, nevertheless acted promptly to limit EAC's attempt at control."[51] The court detailed Musgrove's tactics, including the accelerated issuance of shares to the proposed (but not yet established) ESOP, the trustees of which were Musgrove and "two subordinate officers of Frantz."[52] Moreover, the trustees chose suboptimal financing to circumvent the "EAC sponsored bylaw changes requiring unanimous director approval [that] foreclosed board action necessary to guarantee the ESOP loan."[53] Finally, Musgrove called a board meeting at which counsel to the corporation moved for the adoption of a resolution establishing an executive committee, consisting of Musgrove, a former employee, and a local banker, with authority to discharge the duties of the board.[54]

The case held that, under these circumstances, issuance of the shares to the ESOP would be enjoined on the grounds that "funding an ESOP in response to a shift in ownership of a corporation is not valid because the directors' action was not taken under the provision of the then valid bylaws."[55] But to focus on that holding is to miss the point of the opinion. What stands out is the depiction of Musgrove—in both the chancery and supreme court opinions—as a manager willing to do anything, even to take steps to dilute the majority control of an arms-length purchaser, EAC, in order to preserve his position as CEO. As the *Restaurant Associates* case, which I will discuss shortly, makes clear, it would not be

50. Under Delaware law, bylaws (like other corporate actions) may be authorized by a consent solicitation. DEL. CODE ANN. tit. 8, § 228(a) (1994). Here, EAC presented several modifications of Frantz's bylaws designed to prevent the Frantz board from interfering with its acquisition of control.

51. *EAC Indus.*, 1985 WL 3200, at *4.

52. *Id.*

53. *Id.*

54. There is also a passing reference to MBOs in *Moran v. Household International, Inc.*, 490 A.2d 1059, 1082 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985), in the course of the court's discussion of Household's counterclaim against the plaintiffs. One of the members of the plaintiff tender offerors was Moran, a former director of Household. The chancery court rejected Household's claim that "Moran [had] used his position as a director to gain access to confidential information concerning Household's assets for the purpose of formulating a leveraged buy-out . . . for [his own] benefit and at the expense of [the] other shareholders." *Id.* Although the evidence presented supported Household's claim that Moran conducted detailed analyses of Household, the court found that "there was nothing secret about that activity," nor was any of that information used "in a manner hostile to Household's interests." *Id.* "To the contrary, the consistent theme which runs through Moran and D-K-M's acquisition interest in Household was a desire to involve management in a leveraged buy-out, a goal Moran was legally free to pursue if he wished. Field v. Allyn, supra." *Id.* (citing Field v. Allyn, 457 A.2d 1089, 1098 (1983)).

55. Frantz Mfg. Co. v. EAC Indus., Inc., 501 A.2d 401, 409 (Del. 1985).

correct to conclude from this opinion that managers and directors cannot ever take steps to dilute the working control of a shareholder group. Rather, what we learn from this case is that it is improper to do so with Musgrove's lack of good faith.

b. *Greenfield v. National Medical Care* (1986)

The next Delaware MBO case seems to have been *Greenfield v. National Medical Care, Inc.*[56] Following an aborted merger, National Medical Care considered a variety of options. After preliminary merger negotiations with W.R. Grace became deadlocked over NMC's president's insistence that the price not fall below that of the aborted merger, Grace suggested a leveraged buyout in which management would have a substantial equity interest (around twenty-five percent), a proposal which, after modifications, was ultimately recommended by a special committee of NMC directors and approved by the board. Plaintiff shareholders challenged the merger on the grounds that the NMC officers "breached their fiduciary duties by depriving NMC's public stockholders of their investment at a grossly inadequate price."[57]

In an opinion denying defendants' motion to dismiss, Vice Chancellor Berger relied on the plaintiffs' complaint challenging the independence of the NMC board, in combination with the plaintiffs' claims that the price was unfair and the lockup prevented the stockholders from obtaining a higher offer, to hold that the complaint "sufficiently states a claim for breach of fiduciary duty":[58]

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56. Nos. 7720, 7765, 1986 WL 6505 (Del. Ch. June 6, 1986). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *1–*2. Although the famous *Revlon* case is not often thought of as an MBO case, it does have an MBO aspect: In response to Ronald Perelman's attempt to acquire Revlon, Revlon's board "approved a plan to enter into a leveraged buyout agreement with Forstmann Little in which each shareholder would receive $56 cash per share with Revlon's management given an opportunity to acquire an equity interest in the corporation." MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1245 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986). But management's potential equity interest in the Forstmann Little LBO did not figure prominently in the court's discussion. Much more central to the analysis was the CEO's "strong personal antipathy to Mr. Perelman," *Revlon*, 506 A.2d at 176, and the directors' personal interest in avoiding potential liability to noteholders. *Revlon*, 501 A.2d at 1250.

57. *Greenfield*, 1986 WL 6505, at *3.

58. *Id.* at *4 (citing Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986)).

The *Hanson Trust* case seems to have been the first significant MBO case in any court and was often cited in the Delaware opinions. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1284, 1286 (Del. 1989); West Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. Shareholders Litig.), 542 A.2d 770, 784 (Del. Ch. 1988); *Greenfield*, 1986 WL

> [The complaint] goes on to charge that the individual defendants are interested because certain officers and directors and other key management personnel of NMC will be substantial stockholders in NMC Holding or otherwise benefit from the merger. The Proxy Statement reveals that Messrs. Hampers, Lowrie and Hager [all NMC directors and officers] were to own approximately 25% of the common stock of NMC Holding at the effective time of the merger. Mr. Paganucci [another NMC director] is a director of a Grace subsidiary and the Vice President-Finance of Dartmouth College. NMC Holding agreed, if the merger were effected, to contribute $2.5 million to Dartmouth College over a period of years. . . .
>
> . . . The special committee is also attacked on the grounds that one of its members—Dr. Hager—was a paid consultant to NMC, later was asked to become a director of and was allowed to purchase stock in NMC Holding and did not withdraw from the committee until after it had recommended the merger.[59]

As a "legal" matter, the court simply denied defendants' motion to dismiss: It did not find against the defendants on the underlying claim, it did not impose any liability, and it did not issue any injunction. And yet, in refusing to grant the motion to dismiss, and in focusing on these specific allegations of the plaintiffs' complaint, the court sent a strong message, both to the parties directly involved in the case, as well as to others.

This case, like the *EAC* case, provides an example of improper motivation and improper conduct. In both opinions, the courts provide vivid depictions of managers hobbled by conflicts of interest, acting to protect their own interests in conflict with the interests of the shareholders who they were obliged to serve.

c. *Restaurant Associates I* (1987)

The first full account we get of the performance of a special committee in the context of a proposed management buyout is *Freedman v. Restaurant Associates Industries, Inc.* (*Restaurant Associates I*).[60] The case falls on the

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6505, at *4. The *Hanson Trust* case involved an attempt by management to use a lockup agreement on critical assets to protect a management buyout plan, which emerged in response to a hostile tender offer for control. The Second Circuit reversed the district court's denial of a request for a preliminary injunction enjoining the lockup agreement.

59. *Greenfield*, 1986 WL 6505, at *3.

60. No. CIV.A.9212, 1987 WL 14323 (Del. Ch. Oct. 16, 1987). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *1–*5.

boundary between going-private cases (because the management group had effective voting control of the company, controlling about forty-eight percent of the votes) and MBO cases (because the controlling shareholders were also the managers). Plaintiffs sought a preliminary injunction enjoining the closing of a tender offer on the grounds that the management/controlling shareholder group advanced their personal interests as buyers and blocked the development of competing bids.

What stands out in Chancellor Allen's opinion denying the plaintiffs' motion for a preliminary injunction is his detailed account of how effectively the special committee represented the interests of the outside shareholders, despite management's voting control. The committee, comprised of independent directors with no financial interest in the proposed buyout, promptly hired Skadden, Arps, Slate, Meagher and Flom as its legal adviser and Prudential Bache to provide it with financial advice. When, shortly after the management group publicly disclosed its intention to make a tender offer, the shareholders had the good fortune to receive a competing proposal, the committee did what it could to facilitate a bidding contest.

After considering the two proposals, the committee informed the board that management's proposal was unacceptable. The committee then met with the other bidder and told him that, although the management group opposed his proposal, he would be considered a qualified bidder once he delivered a proposed letter from his contemplated source of financing, which he soon provided.

Despite somewhat higher bids from the management group, the committee continued to reject management's offers, insisting that it would conduct further discussions with the competing bidder. That bidder, after reviewing confidential information from the company, indicated that he would increase his offer further, provided that financing was obtained and the due diligence investigation was satisfactory. In response, the managers informed the committee that they would refuse to sell their shares to the bidder, that they would vote against the proposed merger, and that unless management's lower offer was accepted on that same day, the offer would be withdrawn.

Here, in the court's account, the special committee, rather than caving in to management's demand, showed its true independence:

> Given the management group's strategic position in the Company's capital structure and its unwavering hostility to Soliman's proposal, the special committee suggested that Soliman make a proposal under which Soliman would be able to buy one million authorized, but as yet unissued, Class B treasury shares at $19 per share. . . . Effectua-

> tion of this proposal would dilute the management group's voting power to approximately 40%, at which level a hostile tender offer was thought more feasible.[61]

But because Soliman, the competing bidder, had not yet conducted his due diligence, he was unwilling to proceed on this basis. The committee again conferred and proposed "recommend[ing] that Restaurant's board grant a ten day option to Soliman to purchase at least one million authorized but unissued Class B shares at $19 per share. In exchange, Soliman would make a non-refundable payment of $2 million. The ten day option would allow Soliman to conduct a due diligence investigation before buying the stock."[62]

When the full board subsequently met, the management directors opposed the granting of the option to Soliman, voting it down 6–5. At the same meeting, the special committee recommended rejecting management's $16 per share offer. The special committee met again on September 12, at which time it resolved not to approve any management group proposal that would pay the public shareholders less that $18 per share. Ultimately, the management group raised its offer to the public shareholders to $18 per share, whereupon a merger agreement was negotiated and executed. Even then, the merger agreement "contained a provision permitting the board to withdraw if the circumstances indicated that fiduciary duties might be violated by going forward,"[63] a provision interpreted by counsel for the special committee as not precluding further proposals by Soliman. Soliman made several further proposals at prices above $18 per share, none of which were unconditioned, and ultimately sold his interest. The management group commenced its tender offer at $18 per share.

Against this detailed factual context, the court denied plaintiffs' motion for a preliminary injunction against the completion of the tender offer, and, likewise, denied plaintiffs' request that Soliman be granted a "lockup" option to encourage and facilitate an unconditioned bid. Not surprisingly, given the court's description of the behavior of the special committee, the court held that

> cases such as this demonstrate that [the use of specially constituted committees of disinterested directors when transactions involve elements of self dealing], when pursued in good faith, is a close surrogate for the structure that ordinarily provides protection to

61. *Id.* at *4.
62. *Id.*
63. *Id.* at *5.

> shareholders. Here there is no structural reason to doubt the effectiveness of the independent committee—it was appropriately constituted, well advised and active. Moreover, the results it achieved bespeak an aggressive and effective attempt to maximize public shareholder values.[64]

Thus, in this context, the special committee's attempt to dilute the management group's working control over the corporation by issuing authorized but unissued shares to Soliman, far from being an example of improper behavior (as it was in *EAC*), is itself strong evidence of the special committee's vigorous efforts on behalf of the shareholders. Moreover, one would predict that, if the board composition had been slightly different (with one fewer management director and one more outside director), and the board had voted six to five in favor of issuing the option to Soliman, the court would not have enjoined that issuance.

Despite the court's refusal to enjoin the transaction, and despite the special committee's efforts, the management tender offer did not close as expected. On October 19, 1987, two days after the court's decision, the market crashed, leading management to cancel and renegotiate the terms of the transaction. As we will see below, the court issued a second opinion three years later, which demonstrates the extent to which norms had developed and been clarified.

d. *Rosman v. Shoe-Town I* (1988)

While *Restaurant Associates I* presented an effective special committee, the next MBO case provided another negative example. In *Rosman v. Shoe-Town (Shoe-Town I)*,[65] although Vice Chancellor Hartnett denied plaintiffs' motion for a preliminary injunction because plaintiffs failed to establish inadequate disclosure, he cast a jaundiced eye on the transaction:

> I also find that some aspects of the transaction are troublesome. These include that the corporation has a history of going private and then going public and then going private again which has resulted in the capital of the public stockholders being used by the corporation

64. *Id.* at *7.

65. No. CIV.A.9483, 1988 WL 3638 (Del. Ch. Jan. 18, 1988). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *1–*2.

> with little benefit to the investors. It also appears that several of the directors have been active participants in these manuevers [sic].[66]

Plaintiffs also correctly pointed out that a special committee appointed to supervise the sale of the corporation was instructed not to be concerned with price and that Shearson-Lehman, which was hired by the directors to advise the special committee, never expressed an opinion as to the price the corporation would be expected to bring.[67]

Although plaintiffs lost their preliminary injunction motion, the case continued.[68] The court's skepticism returned to haunt defendants. In *Shoe-Town II*,[69] Vice Chancellor Chandler, who had taken over the case from Vice Chancellor Hartnett, refused to grant the directors' motion to dismiss the breach of fiduciary duty claims, instead finding that plaintiffs had stated a claim:

> Plaintiffs have challenged the independence and effectiveness of the special committee. Central to this challenge is their contention that the special committee was dominated by Kaye. The complaint also alleges that one of the two purported independent directors comprising the special committee (Lachman) was not actively involved in the process. The other (Cohn) is charged with lacking independence because he is related to a member of the management group. In addition, it is alleged that the special committee was not authorized to consider the fairness of any proposed transaction, except as to procedure. The special committee is purported to have not actively negotiated with any potential acquirers. Even this limited function was supposedly hampered by the fact that the special committee was not permitted to retain independent counsel. Plaintiffs have also challenged the disinterestedness of the board majority that approved the transaction. . . .
>
> In light of the specific allegations of the complaint, combined with the averments that the transaction was approved by an interested board and that the special committee was a sham, I conclude

66. *Id.* at *1.

67. Here we also see a clear example of the managerialist intuition, described earlier.

68. Plaintiffs may well have desired to lose this motion, as they probably had little interest in passing up the offering price at a premium above market—at least so long as the subsequent action for damages was not foreclosed.

69. *In re* Shoe-Town, Inc. Stockholders Litig., No. C.A.9483, 1990 WL 13475 (Del. Ch. Feb. 12, 1990).

> that the complaint states a claim for breach of fiduciary duty sufficient to withstand a motion to dismiss. *Cf.* Greenfield v. National Medical Care, Inc., Del. Ch., C.A. Nos. 7720, 7765, Berger, V.C. . . . (citing Hanson Trust PLC v. ML SCM Acquisition, Inc., 2d Cir., 781 F.2d 264 (1986)).[70]

Without actually finding that the defendants breached their fiduciary duties—on a motion to dismiss, the plaintiffs' allegations are taken as true—the court thus provided a clear indication that a special committee acting as alleged would breach its fiduciary duties.[71] The case ultimately settled for $2.15 million.

Note several themes that emerge in *Shoe Town I*. First, the court reacted critically to the instruction to the special committee not to be concerned with price. Second, the court found troublesome the fact that an investment banker supposedly serving shareholder interests never expressed an opinion regarding the price the corporation could be expected to bring. In *Shoe Town I*, then, the court—without enjoining the transaction—identified relevant characteristics of the process that would likely be influential in future determinations of good faith and fair dealing.[72]

e. *In re J.P. Stevens & Co. Shareholders Litigation* (1988)

Finally, the last and most important of the early MBO/special committee cases is the decision in the battle for J.P. Stevens & Co., a large textile

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70. *Id.* at *5.

71. In *Shingala v. Becor Western Inc.*, No. CIV.A.8858, 1988 WL 7390 (Del. Ch. Feb. 3, 1988), Vice Chancellor Berger approved a settlement in an MBO situation. In this case, the board appointed a special committee that retained independent counsel and a financial advisor after management indicated that it was interested in proposing a buyout. Lawsuits were filed after the special committee and the management group entered into a merger agreement that included a "no shop" provision, but one that "was expressly subject to a 'fiduciary out' clause allowing the Becor board to act if the failure to do so would conflict with the proper discharge of the directors' fiduciary duties." *Id.* at *1. Shortly thereafter, Becor received an acquisition offer from a third party and expressions of interest from others. The settlement of the litigation provided a mechanism for an auction of Becor. The board then took over and conducted an auction that, as described by the court in its decision approving the settlement, seems to have been conducted in a way that was calculated to maximize, and likely did maximize, the value that public shareholders received for their shares.

72. *Shoe-Town II*, a later case, shows the evolution in the specificity of the norms governing the behavior of special committees and belongs in that later set of cases.

manufacturer.[73] In the *Stevens* case, management informed the board of its plan to take the company private in an LBO. The board immediately created a special committee charged with considering management's proposal and with considering and making recommendations with respect to any other available alternatives, including proposals from third parties. A press release disclosed all this within two days, and triggered a bidding war between West Point-Pepperell, another textile firm, and Odyssey Partners, an investment partnership, which quickly surpassed management's bid. Because West Point was a competitor, its bid raised some antitrust concerns. Odyssey, on the other hand, was an investment partnership with no operating capacity, which, along the way, invited the management group to join. The court detailed various ways in which Odyssey received preferential treatment over West Point, including, most importantly, better access to confidential information.[74] Ultimately, the special committee recommended accepting Odyssey's slightly lower offer because it did not have West Point's potential antitrust problems. West Point sought, inter alia, a preliminary injunction enjoining provisions that provided for reimbursement of expenses and a "topping fee," and the completion of the Odyssey offer, so as to permit West Point to consider making a higher offer based on information wrongfully withheld until shortly before.[75]

The core of West Point's claim was that the special committee acted to protect management's interests. When it became clear that management could not meet the other offers, the special committee, according to West Point, did the next best thing by pushing the transaction towards management affiliated Odyssey.

Although the court refused to enjoin the transaction, because West Point did not carry its burden of establishing lack of good faith, it was still troubled and, in what is characteristic of this set of cases and, I believe, Delaware fiduciary duty cases more generally, made a point of expressing its concerns:

> Thus, [in West Point's view,] Odyssey, rather than being an arm's-length bidder, as West Point is, appears in this version to be a white knight, favored by management and by a Special Committee that

73. West Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. Shareholders Litig.), 542 A.2d 770 (Del. Ch. 1988). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at 773–78.

74. *Id.* at 777.

75. *Id.* at 772.

> vibrates sympathetically to management's desires. Maybe that is true; it surely is plausible. For example, one is left with the suspicion that the need to reach a final decision may not have been so great as to require the Special Committee to decide by March 13th to sign a merger agreement, when another month might have resolved the antitrust question that presented the reason for preferring a lower offer. And if one is inclined to second guess board decisions, the decision to agree to a $1 per share break-up payment on March 13 seems a likely candidate for review. Odyssey had just submitted a proposal materially *lower* than West Point. If Odyssey really wanted to acquire the Company, how much leverage did it have, in those circumstances, to insist on a $17 million break-up fee? So the claim that the real purpose of that fee provision was to disadvantage West Point is not altogether hollow. And why did the Special Committee so easily accept Odyssey's threat to retract its March 28th $64 offer, if it was not accepted immediately? Would not the practicality of the matter suggest to the Special Committee that if Odyssey was willing to pay $64 on the 28th, it would be willing to do so a few days later?
>
> Other legitimate questions could be asked, but, in the end, plaintiffs' plausible story is not, in my opinion, sufficiently supported by the evidence at this time to permit the conclusion that it is reasonably likely that at trial it would be found that the Special Committee sought to promote the interests of management by advantaging Odyssey at the possible expense of the shareholders.[76]

As it turned out, the bidding war continued, with West Point making additional bids and resolving the antitrust concerns. Ultimately, Odyssey and West Point entered into a bidding agreement with each other, ending the auction.[77]

From one perspective, the opinion is rather peculiar. What is one to make of the court's ruminations if it ultimately denies the motion for a preliminary injunction? If plaintiff has failed to carry its burden of establishing lack of good faith, who should care whether plaintiff's story is "plausible"? Who should care whether one can make plausible arguments against the easy grant of a lockup option to Odyssey Partners?

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76. *Id.* at 779–80.

77. On the antitrust issues raised by such a bidding agreement, see Edward B. Rock, *Antitrust and the Market for Corporate Control*, 77 CAL. L. REV. 1365 (1989).

The answer is obvious: Anyone who cares about whether this transaction will ultimately proceed, and anyone who cares about whether future transactions will be permitted to proceed, will read the court's words with great care and attention. And they will read them primarily because they give insight into how someone with the power to block a transaction reacts to certain recurrent features. To those who structure transactions, the words send an unambiguous message: If you want your next transaction to proceed, pay attention.

f. Summary

Between 1985 and early 1988, the Delaware Chancery Court thus issued five significant opinions evaluating management buyouts. In only one of these cases (EAC) did the chancery court enjoin the transaction. In one (*Restaurant Associates*), the court expressed its approval of the special committee's performance. In the rest, the court expressed varying degrees of disapproval, suspicion, and doubt about the performance of management and the special committees, leaving open the possibility of damages.

These opinions illustrate a striking feature of the Delaware fiduciary duty cases, specifically, the multivalent character of the outcomes. In these cases, and in the ones that follow, the courts avail themselves of one of three options: denying the request for an injunction and blessing the behavior; denying the motion for an injunction and criticizing defendants' behavior; or granting the injunction. The intermediate position plays three roles. First, it provides guidance applicable to future cases, that is, what kind of behavior the courts are likely to find to be a breach of fiduciary duty. Second, in these intermediate cases, although the court denies plaintiffs' motion for a preliminary injunction, it also typically denies defendants' motion to dismiss, leaving defendants with some substantial damages exposure. Finally, and perhaps most importantly—and certainly least noticed—it tells directors, who we may suppose are generally trying to do a good job, what they should do. This pattern continued in the most important MBO cases.

5. The Defining Trilogy: *Macmillan*, *Fort Howard*, and *RJR Nabisco*

After these early discussions, we come to the critical trilogy of 1988 and 1989: *Macmillan*, *Fort Howard*, and, finally, the biggest deal of all time, *RJR Nabisco*. These cases build on the experience of the earlier cases, and

give us detailed and dramatic accounts with a vivid set of heroes and villains. In what follows, I have struggled with striking the right balance between demonstrating the fact-specific, normatively charged quality of the opinions through the quotation of the courts' language, and readability. The following descriptions of the Delaware opinions are a pale substitute for reading the opinions themselves. The confirmation or falsification of my claims can only be found there. At the same time, I am acutely aware of the limited extent to which one can impose on one's audience.

a. The Battle for *Macmillan*

(1) Macmillan I *(July 14, 1988)*

In the wake of takeover bids in the publishing industry, the management of Macmillan, Inc., a prominent publishing company, became concerned that the firm might become a target. Management's response to this concern led to two chancery court opinions[78] and one supreme court opinion[79] providing vivid and sharply critical descriptions of managerial corruption, of director passivity, and of investment banker manipulation. Together the opinions provide Exhibit A for how not to behave in an MBO.

Macmillan's two "inside" directors, Edward Evans ("Evans"), the chairman and CEO, and William F. Reilly ("Reilly"), the president and chief operating officer, turned out to be the principal villains in what even the courts thought of as a "drama." From start to finish, Vice Chancellor Jacobs tells us in his opinion,

> two central concepts remained constant. First, Evans, Reilly, and certain other members of management would end up owning absolute majority control of the restructured company. Second, management would acquire that majority control, not by investing new capital at prevailing market prices, but by being granted several

78. Robert M. Bass Group, Inc. v. Evans (*In re* Macmillan, Inc. Shareholders Litig.), 552 A.2d 1227 (Del. Ch. 1988) (*Macmillan I*); Mills Acquisition Co. v. Macmillan, Inc., No. CIV.A.10168, 1988 WL 108332 (Del. Ch. Oct. 18, 1988) (*Macmillan II*).

79. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989). The factual account is drawn from the Delaware Chancery Court opinion. *See Macmillan I*, 552 A.2d at 1228–38.

> hundred thousand restricted Macmillan shares and stock options. Those shares and options would then be "exchanged" . . . into several million shares of the recapitalized company.[80]

How Evans and Reilly pursued this goal forms the core of all three opinions. To appreciate fully the nature of these opinions, it is necessary to examine how the Delaware Chancery and Delaware Supreme Courts tell the story.

Vice Chancellor Jacobs tells a sad tale: In the first step of Evans and Reilly's campaign (June 1987), they asked the board, and the board agreed, inter alia: to grant Evans and Reilly additional shares of restricted stock and new employment contracts with "golden parachutes"; to approve a loan of $60 million that the [already existing] ESOP would then borrow to fund its purchase of one million Macmillan shares; to replace Citibank as ESOP trustee, substituting Evans, Reilly, and two Macmillan employees, who would thereby obtain voting control of all unallocated shares deposited in the ESOP. In the second step, management proposed a restructuring of the corporation that would, in effect, have given the management group control.

Management's worries about a hostile tender offer turned out to have foundation: On October 21, 1987, two days after the October 19 market crash, an investment group led by Robert Bass disclosed that it held approximately 7.5% of Macmillan stock. In response, Macmillan management called a special board meeting at which Bass, the chancery court tells us, "was portrayed to the board as a 'greenmailer' whose modus operandi was to 'creep' to a control position in publicly held companies. . . . Based on that presentation, the Board determined that the Bass Group's history and the volatile market situation constituted a threat to Macmillan and its shareholders."[81]

But, says Vice Chancellor Jacobs, management did not accurately inform the board. In fact, officials of companies supposedly victimized "submitted affidavits attesting that the management of those firms had requested Bass (or affiliates) to join their respective boards of directors and/or to join in investments with them."[82] In light of this evidence,

80. *Macmillan I*, 552 A.2d 1227, 1229–30.
81. *Id.* at 1232.
82. *Id.*

Jacobs concluded, "management's pejorative characterizations of the Bass Group, even if honestly believed, served more to propagandize the Board than to enlighten it."[83]

Around this same time, management decided to form a special committee of the board to evaluate its restructuring proposal. The court details the steps that Evans and Reilly took to corrupt the process from its inception, by extensively interviewing and eventually selecting the special committees' investment banker without ever disclosing these contacts to the committee eventually appointed.[84]

The special committee subsequently met, again with Evans, Reilly, and other members of the management group, to hear a presentation by Lazard, the compromised investment banker for the special committee that, in the court's telling, was focused entirely on how to facilitate management's restructuring (which would give the management group control) and how to defeat the Bass group's proposal.[85] Then, without any negotiation, the special committee recommended (and the board approved) management's proposed restructuring and rejected the Bass bid, based in part on Lazard's opinion that the $64-per-share offer was "inadequate."[86] Subsequently, in response to a sweetened Bass offer, Lazard, in the court's account, again revealing the extent to which it was management's tool, "concluded that it could furnish an 'adequacy' opinion that would enable the Special Committee to reject the $73 per share cash portion of the Bass offer."[87] Ultimately, the special committee and the board rejected both Bass offers.

After this detailed narrative of the behavior of Evans, Reilly, and the directors, the court appraised their conduct. Rejecting defendants' claim that the Bass Group represented a threat to Macmillan because of their

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83. *Id.*

84. "In total, Lazard professionals worked with management on the proposed restructuring for over 500 hours before their 'client,' the Special Committee, formally came into existence and retained them." *Id.* at 1233–34. Indeed, the court noted in a footnote:

> On May 18, the day after the Bass Group offer, a Lazard partner working on the restructuring wrote a letter to Mr. Evans ("Dear Ned"), stating that "all of us at Lazard are keenly interested in working with you in any way that we can in connection with . . . the Bass Group offer]."

Id. at 1234 n.19 (alterations in original).

85. *Id.* at 1235.

86. *Id.* at 1236.

87. *Id.* at 1237.

supposed reputation as "greenmailers" as unsupported by the record, the court condemned both the special committee and management.[88]

> Neither [the Board nor the Special Committee] took reasonable measures to uncover the facts. . . . Where, as here, corporate directors decide to resist a takeover bid on the ground that it constitutes a threat, *Unocal* requires that their decision rest upon a reasonable investigation and be made in good faith. That decision cannot rest upon a studied avoidance of a reasonable investigation, in order to rely upon self-serving conclusions without basis in fact.[89]

(2) Macmillan II *(October 18, 1988)*

Three months later, in *Macmillan II*, we see Evans and Reilly continuing to undermine the integrity of the process.[90] In the wake of *Macmillan I*, management abandoned its restructuring plan. On the very day that the restructuring plan was enjoined, Macmillan's management began looking for a (management-) friendly bidder. After Kohlberg, Kravis and Roberts ("KKR") contacted Macmillan, the two firms had extensive discussions "concerning a possible leveraged buyout of all of Macmillan's stockholders, in which Macmillan senior management would participate."[91] At around the same time, Robert Maxwell, through Maxwell Communications Corp.

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88. *See id.* at 1240:

> The Special Committee made no effort, directly or through its advisers, to investigate the Bass offer. Management's investigation consisted of sending Mr. McCurdy to have a single cursory meeting with Mr. Scully, a Bass representative. That encounter was little more than a charade, because Mr.McCurdy was instructed not to (and therefore did not) negotiate or substantively discuss the terms of the Bass offer.

89. *Id.* at 1241. The court then went on to note two other "offending qualities [of the restructuring] that exacerbate its unreasonableness and which therefore merit comment." *Id.* at 1244. First, the court pointed out, the restructuring would render the part of the restructured company that held Macmillan's information-based businesses "takeover proof" because it would tend to entrench the management group. Second, management's proposed 39% ownership "[was] derived from valuation methods that [were] either incorrect or, at the very least, highly questionable." *Id.* Finding that the restructuring proposal posed the threat of irreparable harm to shareholders, and that the balance of the equities favored the plaintiffs, the court preliminarily enjoined the restructuring. *Id.* at 1246–47.

90. *See* Mills Acquisition Co. v. Macmillan, Inc., No. CIV.A.10168, 1988 WL 108332 (Del. Ch. Oct. 18, 1988). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *3–*11.

91. *Id.* at *3.

("MCC"), also indicated an interest in acquiring Macmillan. In its opinion, the court details the extent to which management aided KKR while discouraging Maxwell. Management gave KKR access to company personnel and nonpublic information, including presentations by senior management. By contrast, Macmillan did not even respond to Maxwell's proposal for five weeks. Proceeding anyway, Maxwell announced an $80 all-cash, all-share tender offer on August 12, topping the Bass offer by a significant amount.

Despite efforts to equalize the information given to the competing bidders by developing a common "script," Evans and Reilly, the villains of *Macmillan I*, undermined the process by making an unauthorized telephone call to KKR, tipping MCC's bid to KKR (presumably so that they could outbid it in the final round). Neither Evans, Reilly, nor KKR disclosed to Macmillan's financial or legal advisers that Evans had tipped off KKR. Nor did Evans and Reilly inform their fellow directors. In the final round of bidding, after a further conversation with each bidder in which Bruce Wasserstein, the investment banker for the *management* group, who inexplicably also ran the auction, again gave KKR more information than MCC, KKR came out on top.

In the chancery court opinion, Vice Chancellor Jacobs makes clear that Evans and Reilly breached their fiduciary duties by tipping off KKR. But, while the court found Evans' and Reilly's behavior improper, and unfair to MCC, it was unconvinced that the auction failed to promote shareholders' interest—in his eyes, the critical measure—in achieving the highest available price. The court thus condemned the behavior but refused to enjoin the "lockup." At the same time, the court concluded that the poison pill no longer served any purpose, and ordered it withdrawn, giving MCC the opportunity to proceed with its offer, either by waiving its condition that the lockup be declared invalid or by successfully invalidating it on appeal.

Maxwell then appealed to the Delaware Supreme Court, which invalidated the lockup in an oral opinion on November 2, followed by a written opinion on May 3, 1989. As we will see, the Delaware Supreme Court's opinion is even more contemptuous of Evans and Reilly, their investment bankers, and the board than was the chancery court's. This decision opened the way to MCC's ultimate acquisition of Macmillan at $90.25 per share. It is to that opinion I now turn.

(3) *The Delaware Supreme Court's* Macmillan *(May 3, 1989)*

In the Delaware Supreme Court opinion,[92] Justice Moore agreed with Vice Chancellor Jacobs in his overall view of the transactions. In summarizing Vice Chancellor Jacobs findings, the Delaware Supreme Court touched on each of the highlights: the central goal of making sure that Evans and Reilly ended up in control without investing new capital; the domination of the allegedly "independent" board by the financially interested members of management; the "directors' evident passivity in the face of their fiduciary duties"; the "rather grim and uncomplimentary picture of Bass and its supposed 'modus operandi' in prior investments," including the inaccurate claim that it was a "greenmailer"; the increases in nonemployee director compensation and the creation of a nonemployee director retirement plan. Like the chancery court, the supreme court focused on the corruption of the special committee process by Evans and Reilly.[93] Like the chancery court, the supreme court focused on the extensive and undisclosed dealings between the management group and Lazard, the special committee's investment banker, before the special committee was formed, and its subsequent passivity.

Having summarized *Macmillan I*—the Bass offer—with its passive special committee, corrupt managers, and manipulative investment bankers, the court moved on to *Macmillan II*. As the supreme court put it, clearly conscious of the extent to which this was a morality play:

> Thus, *Macmillan I* essentially ended on July 14, 1988 [with the chancery court's preliminary injunction]. However, it only set the stage for the saga of *Macmillan II* to begin that same day. It opened with

92. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989). The factual account is drawn from the Delaware Supreme Court opinion. *See id.* at 1265–78.

93. *See id.* at 1267:

> Due to the significant financial interests of Evans, Reilly, Chell, McCurdy and other managers in the proposed restructuring, management decided in February or March to establish a "Special Committee" of the Board to serve as an "independent" evaluator of the plan. The Special Committee was hand picked by Evans, but not actually formed until the May 18, 1988 board meeting. This fact is significant because the events that transpired between the time that the Special Committee was conceived and the time it was formed illuminate the actual working relationship between management and the allegedly "independent" directors. It calls into serious question the actual independence of the board in *Macmillan I* and *II*.

> Macmillan's senior management holding extensive discussions with KKR in an attempt to develop defensive measures to thwart the Bass Group offer.[94]

The biggest development, of course, was the entry of Robert Maxwell. Despite Maxwell's overtures and tender offer, no Macmillan representative ever attempted to negotiate with Maxwell. Instead, in Moore's story, "representatives of Macmillan and KKR met to negotiate and finalize KKR's buyout of the company. In this transaction Macmillan senior management would receive up to 20% ownership in the newly formed company."[95]

Now that a deal with KKR had been struck, Evans instructed Macmillan's financial advisors to notify the

> six remaining potential bidders, during September 7 and 8, that "the process seems to be coming to a close" and that any bids for Macmillan were due by Friday afternoon, September 9. It is particularly noteworthy that Maxwell was given less than 24 hours to prepare its bid, not having received this notification until the night of September 8.[96]

Against this background, the court then described the auction process as one that was systematically corrupted by management and their investment bankers, and in which the special committee utterly failed in its task. In the supreme court's opinion, like the chancery court's opinion, the court describes the critical unauthorized tip to KKR and the other efforts made to further KKR's bid.

In response to these failures, the supreme court (without addressing the question of whether Evans' and Reilly's breaches of fiduciary duty likely resulted in a lower price for shareholders) reversed the chancery court's refusal to enjoin the lockup agreement with KKR, again using harsh language to describe the behavior of the various participants:

> Evans' and Reilly's conduct throughout was resolutely intended to deliver the company to themselves in *Macmillan I*, and to their

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94. *Id.* at 1272.

95. *Id.* at 1273.

96. *Id.* Equally central to the supreme court's summary is that Evans, rather than the special committee, seems to have been doing all the negotiating on behalf of Macmillan:

> In a September 8 meeting with Robert Maxwell and his representatives, Evans announced that the company's management planned to recommend a management-KKR leveraged buyout to the directors of Macmillan, and that he would not consider Maxwell's outstanding offer despite Maxwell's stated claim that he would pay "top dollar" for the entire company.

Id.

> favored bidder, KKR, and thus themselves, in *Macmillan II*. The board was torpid, if not supine, in its efforts to establish a truly independent auction, free of Evans' interference and access to confidential data. By placing the entire process in the hands of Evans, through his own chosen financial advisors, with little or no board oversight, the board materially contributed to the unprincipled conduct of those upon whom it looked with a blind eye.[97]

Finally, the court invalidated the lockup granted to KKR, setting the stage for Maxwell's ultimate acquisition of Macmillan.

When grouped together, these three opinions in *Macmillan* establish Evans and Reilly as among the villains of Delaware corporate law, with Wasserstein as an archetype of the unprincipled investment banker. The very language of the opinions proclaims its identity as a morality play: "management's pejorative characterizations of the Bass group, even if honestly believed, served more to propagandize the Board than to enlighten it"; "little more than a charade"; "they chose to close their eyes"; "studied avoidance of a reasonable investigation, in order to rely upon self-serving conclusions without basis in fact"; "offending qualities that exacerbate its unreasonableness"; "domination of the allegedly 'independent' board by the financially interested members of management, coupled with the directors' evident passivity"; "tainted process"; "Wasserstein falsely claimed"; "Wasserstein mistakenly assured"; "clandestinely and wrongfully"; "Evans' and Reilly's deliberate concealment of material information"; "the board was torpid, if not supine"; "the unprincipled conduct of those upon whom it looked with a blind eye"; "fails all basic standards of fairness."

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97. *Id.* at 1279–80. The court goes on to state:

> It is clear that on July 14, 1988, the day that the Court of Chancery enjoined the management-induced reorganization, and with Bass' $73 offer outstanding, Macmillan's management met with KKR to discuss a management sponsored buyout. This was done without prior board approval. By early September, Macmillan's financial and legal advisors, originally chosen by Evans, independently constructed and managed the process by which bids for the company were solicited. Although the Macmillan board was fully aware of its ultimate responsibility for ensuring the integrity of the auction, the directors wholly delegated the creation and administration of the auction to an array of Evans' hand-picked investment advisors. It is undisputed that Wasserstein, who was originally retained as an investment advisor to Macmillan's senior management, was a principal, if not the primary, "auctioneer" of the company. While it is unnecessary to hold that Wasserstein lacked independence, or was necessarily "beholden" to management, it appears that Lazard Freres, allegedly the investment advisor to the independent directors, was a far more appropriate candidate to conduct this process on behalf of the board. Yet, both the board and Lazard acceded to Wasserstein's, and through him Evans', primacy.

Id. at 1281.

And, if this were not enough, Evans and Reilly, as well as Macmillan's general counsel, Beverly Chell, were charged by the SEC with violating section 13(d) of the Securities Exchange Act for filing a misleading disclosure regarding the ESOP established in connection with management's buyout offer and to fend off other bids. All they disclosed was that the ESOP plan was buying Macmillan shares "to allow participating employees to acquire stock ownership interests in the company."[98]

Consider how Evans, Reilly, or Wasserstein felt when reading these opinions. Consider how the members of the special committee, identified by name in the opinion,[99] must have felt to be characterized as "torpid, if not supine" by the Delaware Supreme Court,[100] combined with the equally strong terms used by the chancery court. Consider what it must be like to live with such a public shaming, to see in acquaintances' eyes the unasked question, "How could you have stood by and allowed this to happen?" Imagine how other managers and directors, when they read or heard about these opinions, felt about the prospect of being similarly pilloried.[101] Anecdotal evidence confirms what we all would expect: No one, including directors and officers of Delaware corporations, Wall Street investment bankers, and Wall Street lawyers, enjoys being held up to this sort of public condemnation.

Different people can be expected to be affected in different ways by this sort of attention. Edward Evans seems to have retired from public life. He does not serve as a director of any publicly traded company except for Fansteel, a small metals firm largely owned by his family.[102] According to

98. Kevin G. Salwen & David B. Hilder, *Macmillan Officers Charged in Failure to Disclose ESOP Was Takeover Defense*, WALL ST. J., Dec. 7, 1989, at A6.

99. "The Special Committee consisted of Lewis A. Lapham, an old college classmate of Evans' father, (Chairman), James H. Knowles, Jr., Dorsey A. Gardner, Abraham L. Gitlow and Eric M. Hart. Hart failed to attend a single meeting of the Committee." *Mills Acquisition Co.*, 559 A.2d at 1268 n.9.

100. *Id.* at 1280.

101. *See, e.g.*, Cynthia Crossen & Karen Blumenthal, *An Anti-Takeover Arsenal That Failed: Macmillan Tried Many Defenses to Stop Suitors*, WALL ST. J., Nov. 4, 1988, at B1 [hereinafter Crossen & Blumenthal, *An Anti-Takeover Arsenal*] (summarizing the Delaware Supreme Court's criticism of Evans and Reilly); Cynthia Crossen & Karen Blumenthal, *Macmillan, Inc. Restructuring Blocked in Court*, WALL ST. J., July 15, 1988, at 20 [hereinafter Crossen & Blumenthal, *Macmillan, Inc.*] (summarizing the Delaware Chancery Court opinion in *Macmillan I*); David B. Hilder, *As Wasserstein Perella Climbs to Top Rank, Criticism Grows*, WALL ST. J., Dec. 11, 1989, at C1 (summarizing the Delaware Supreme Court's criticism of Wasserstein in *Macmillan* and the Delaware Chancery Court's criticism in *Interco*).

102. Fansteel Inc. Proxy Statement (Mar. 24, 1995), *available in* LEXIS, Fedsec Library, Proxy File, at *4 (noting that Edward Evans' father, T.M. Evans, owns 47.11% of Fansteel). Edward Evans is also a director of HBD Industries, Inc., another firm controlled by his father. *Id.*; Crane Co. Proxy Statement (Mar. 15, 1995), *available in* LEXIS, Fedsec Library, Proxy File, at *16 (not-

their annual proxy statement, "[s]ince 1989, E.P. Evans has engaged in personal investments." Moreover, forever more, Evans must disclose in proxy statements that "[i]n December 1989, Mr. E.P. Evans, without admitting or denying any allegations contained in a complaint filed by the Securities and Exchange Commission, consented to the entry of final judgment of permanent injunction prohibiting him from violating Section 13(d) of the Exchange Act and Rules 13d-1 and 13d-2 thereunder."[103]

By contrast, William Reilly has maintained a higher profile, staying on to run Macmillan for a year or so after the Maxwell buyout and then going on to serve as Chairman and CEO of K-III, a high profile KKR leveraged investment vehicle which he has built into a publishing conglomerate by acquiring magazines from Rupert Murdoch and other media properties.[104] Reilly is also a director of FMC Corporation, a large, publicly held diversified chemicals company.[105]

b. *Fort Howard* (August 8, 1988)

Macmillan I was decided July 14, 1988, by Vice Chancellor Jacobs. Almost immediately thereafter, Chancellor Allen was presented with another special committee in another management buyout case, this time involving Fort Howard Corporation, a paper company.[106] Although, as we will see, the participants behaved substantially better than those in *Macmillan*, and Chancellor Allen did not enjoin the transaction, he did severely criticize the performance of the special committee, providing another cautionary tale for managers and directors involved in MBO transactions.

The scene is, by now, an increasingly familiar one (for both the reader and for the Delaware Chancery Court). In the spring of 1988, Fort Howard's management, concerned that a temporarily depressed stock price (post–October 1987) might lead it to be the target of an unfairly low and perhaps coercive takeover attempt, began to meet with an investment bank, Morgan Stanley, to discuss ways to elevate its stock price. Shortly

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ing that HBD Industries is controlled by T.M. Evans).

103. Fansteel Inc. Proxy Statement, *supra* note 102, at *4.

104. *See generally* Patrick M. Reilly, *Classroom Ruler: A KKR Vehicle Finds Profit and Education a Rich but Uneasy Mix*, WALL ST. J., Oct. 12, 1994, at A1.

105. K-III Communications Corp. Proxy Statement (April 24, 1996), *available in* LEXIS, Fedsec Library, Proxy File, at *4.

106. *In re* Fort Howard Corp. Shareholders Litig., No. CIV.A.9991, 1988 WL 83147 (Del. Ch. Aug. 8, 1988). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *2–*9.

thereafter, Morgan Stanley presented various options, recommending a leveraged buyout and indicating its interest in participating with senior management in such a transaction. Subsequently, Fort Howard's CEO informed Morgan Stanley that he and others of the senior management were interested in pursuing such a transaction. That same day, he met with a friendly, veteran director. The CEO informed the director, a law school classmate, that a special committee of the board would have to be formed to consider the buyout proposal and that the CEO wanted that director to serve as its chairman. They discussed other possible members of a special committee and agreed on two others.

At the next board meeting, the CEO presented his "proposal to make a proposal" to the board, and informed the board that Morgan Stanley and the three management directors were interested in exploring an LBO of Fort Howard. The management directors then left the meeting, and outside legal counsel guided the remaining directors through the adoption of the necessary resolutions to appoint a special committee and to select outside legal counsel and a financial adviser. The membership of the special committee was exactly as the CEO had suggested.

At its first meeting, the special committee made a determination to keep the developments confidential. Peter Atkins, a partner at Skadden, Arps, Slate, Meagher and Flom, and the committee's outside legal counsel, advised that disclosure was not legally required at that time. In the absence of advice that there was a legal obligation to disclose, the special committee here, like the special committee in *Restaurant Associates I*, discussed earlier, elected secrecy.[107] Meanwhile, the special committee retained First Boston as its financial adviser.

Subsequently, in the course of a meeting to review draft merger documents, a report of high trading volume was received. The volume indicated that there had been a leak of information concerning the possibility of a buyout. Again, the question of disclosure was raised. The special committee concluded that a press release should be issued, which Atkins drafted. But after telephone discussions with the management group, which did not want any press release, the special committee again agreed not to proceed. The next day, after a telephone inquiry to the company about a rumored management LBO in the works, Fort Howard finally issued a press release.

The special committee met over the next several days, and ultimately accepted an offer from the management group without having actively

107. As before, this reflected a preference for the company to remain independent if management could not finance an MBO at a "fair" price.

solicited competing bids. The special committee did, however, make clear in the initial press releases that the company had the right to and would entertain alternative proposals, and, furthermore, would cooperate with any such person in the development of a competing bid. Within days of the press release, eight inquiries were received.

First Boston, on instructions of the special committee, screened the inquiries initially and provided each serious inquiry with all of the materials that had been given to Morgan Stanley and First Boston. All eight were provided with the materials but, ultimately, no other bidders entered the fray.

Without doubt, the Fort Howard Special Committee performed more effectively than the Macmillan committee. But, although the court did not enjoin the transaction, it still found fault with the special committee's performance:

> [T]here are aspects [of the Special Committee's performance] that supply a suspicious mind with fuel to feed its flame.
>
> It cannot, for example, be the best practice to have the interested CEO in effect handpick the members of the Special Committee as was, I am satisfied, done here. Nor can it be the best procedure for him to, in effect, choose special counsel for the committee as it appears was done here. It is obvious that no role is more critical with respect to protection of shareholder interests in these matters than that of the expert lawyers who guide sometimes inexperienced directors through the process. A suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary. The June 7 decision to keep the management interest secret, in a sense, represents a decision to sell the Company to management if it would pay a fair price, but not to inquire whether another would pay a fair price if management would not do so. It implies a bias that, while as explained below, I accept as valid for purpose of this motion, nevertheless is a source of concern to a suspicious mind. Similarly, the requested meeting between First Boston and Morgan Stanley. For present purposes, I cannot conclude that plaintiffs' reading of that affair will be shown to be correct. But it is still odd for the Special Committee to risk infecting the independence of the valuation upon which it would necessarily place such weight, by requiring its expert to talk directly with Morgan Stanley. And that risk is run for what can only be seen as a minor benefit to the convenience of the individuals involved. So there is ground for suspicion with respect to the good faith of the

> Special Committee, but, on balance, not such that seem at this stage persuasive.[108]

In refusing to draw any inference of bad faith, the court relied heavily on the effectiveness of the limited market test in probing the market for alternative possible transactions, and the wholehearted response to the eight inquiries received.

What is most striking, here as before, is the way the court, without enjoining the transaction, nonetheless makes clear that the behavior of the special committee fell below the appropriate standard. Although the Fort Howard committee did not behave as badly as the "torpid, if not supine" committee in Macmillan, and although Fort Howard's management acted better than Evans and Reilly did (by, for example, leaving the meeting after announcing their interest in pursuing an LBO, and not tipping confidential information during the bidding), the relationship between management and the special committee, and between their supposedly independent investment bankers, was nonetheless too cozy. The opinion made clear to the planners of all future deals that the court expects a higher standard of behavior.[109]

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108. *Fort Howard*, 1988 WL 83147, at *12.

109. At just about the same time, Chancellor Allen wrote a second opinion reviewing the performance of a special committee in an MBO transaction. *See In re* Amsted Indus. Inc. Litig., No. CIV.A.8224, 1988 WL 92736 (Del. Ch. Aug. 24, 1988). In ruling on a settlement motion (which Allen ultimately approved), Allen expressed concern with how the special committee performed:

> The Committee was authorized to receive, review and evaluate the fairness of any such LBO proposal and also to evaluate the fairness of any other acquisition proposal that might be made by a third party. The Special Committee was, however, specifically directed not to engage in a search for alternative transactions.
>
> . . . .
>
> I conclude that the claims that could be made in this instance with regard to the propriety of the process as it relates to securing the best available transaction are significantly stronger than those frequently encountered in transactions of this type. Importantly here, the record discloses no active effort by the Special Committee to attempt to shop the Company or to engage in an alternative form of proceeding designed to encourage the emergence of an offer that would compete with the management sponsored ESOP LBO transaction. Compare In re Fort Howard Corporation Shareholders Litigation, Del. Ch. C.A. No. 9991 (August 8, 1988).
>
> . . . The board relied upon the investment banker who was of the view that the tax advantages that the ESOP enjoyed permitted it to pay a price higher than that which a non-tax advantaged buyer would be able to pay. If the investment banker was correct about that, the price offered *was* the highest available. But where the transaction is so important to the shareholders as this one was, the question does arise, "why did the independent Committee of the board—if it was motivated in good faith to achieve the best transaction for the shareholders—not check that opinion by shopping the Company, or at least negotiating for a period in which it could publicly encourage any interested party to come forward?" I discount the defendants' position that the market had been fully, though passively, checked.

Why might this be influential? If the court does not punish at time one, why should people feel that there is a higher standard at time two? First, such an opinion puts actors on notice that higher standards are liable to be applied to future deals, perhaps because of a notion that the court let the present deal go through because of insufficient precedent. Second, to the extent that actors internalize the articulated standard, they may well change their behavior irrespective of whether or not they face personal liability. Third, the criticism signals that the court will not subsequently grant a defendant's motion to dismiss, thereby substantially increasing the settlement value of a case.

c. *RJR Nabisco* (January 31, 1989)

The lessons of *Fort Howard*, it appears, were immediately taken to heart in the next big deal, the biggest LBO of all time, the buyout of RJR

Amsted, 1988 WL 92736, at *3, *7.

Chancellor Allen had another case involving the performance of a special committee in the context of a parent subsidiary merger around the same time. *See In re* TWA, Inc. Shareholders Litig., No. CIV.A.9844, 1988 WL 111271 (Del. Ch. Oct. 21, 1988). Consistent with his opinions in *Fort Howard* and *Amsted*, he preached about how a special committee should behave:

> First, as pointed out above, the directors did not seem to understand that their duty was to strive to negotiate the highest or best available transaction for the shareholders whom they undertook to represent. Second, it is not clear that Dillon Read itself thought its responsibility was to push for the best available price rather than one it could regard as falling within a range of fairness.
>
> . . . Third, Dillon Read never brought its various analyses down to a single range of value for TWA shares. . . . Thus, the special committee was not apprised whether Dillon Read, had it forced itself through the analytical step between the analysis it did and the opinion it expressed, would have regarded the price offered as at the lowest edge of a broad range of arguably fair prices, or at some other position on such a scale. That information would be quite pertinent to a negotiator who understood that a "fair price" is always an arguable point on a range; who understood that, while a self-dealing fiduciary must offer a "fair" price, minority shareholders—particularly where a majority of minority voting provision is employed—have no obligation to accept a price that falls within some range of fair prices; and, who sought not merely to bless a transaction that a banker was willing to call fair, but who sought to negotiate the highest possible price. But the special committee in this case, appearing to reflect a complacency referable to an imperfect appreciation of the proper scope and purpose of such a special committee, did not ask its advisor to express a view about a range of fair value for TWA shares held by the minority shareholders.

Id. at *4–*5. Based on these findings, the court declined to permit the presence of a special committee to result in the application of the business judgment rule. On the contrary, finding that the "special committee did not supply an acceptable surrogate for the energetic, informed and aggressive negotiation that one would reasonably expect from an arm's length adversary," *id.* at *7, the court held that the defendants would bear the burden of establishing entire fairness at trial.

Nabisco.[110] Luck, and a very small community, resulted in Peter Atkins again representing the special committee, and this time the committee performed in an exemplary fashion. We will never know whether he did so because of a desire to avoid criticism, to ensure that the deal withstood scrutiny, or a bit of both.[111]

On October 19, 1988, at an RJR board meeting, F. Ross Johnson, RJR's president and CEO, informed the board that he and a management group were seeking to develop a transaction to take the company private in a leveraged buyout, and suggested a price of $75 per share. Charles Hugel, chairman of RJR's board but not an officer of the company, had some advance notice that this subject would be brought up, and had invited Peter Atkins to be present. On October 20, the very next day, the board issued a press release announcing the proposed transaction and the appointment of a special committee, with Hugel as chairman. The special committee immediately retained two financial advisors, Dillon Read (the company's regular investment banker) and Lazard Freres, as well as Mr. Atkins' firm, Skadden, Arps, Slate, Meagher and Flom.

The contrast between *Fort Howard* and *RJR Nabisco* is sharp. In *Fort Howard*, the management group handpicked the special committee and its advisors. Here, the chairman of the board, apparently on his own initia-

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110. *In re* RJR Nabisco, Inc. Shareholders Litig., No. CIV.A.10389, 1989 Del. Ch. LEXIS 9 (Feb. 14, 1989). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *12–*35.

111. *See* DeMott, *supra* note 22, at 34. In their book on the RJR Nabisco buyout, Bryan Burrough and John Helyar quote the lawyer who represented F. Ross Johnson, when he heard that Peter Atkins had been chosen to represent the special committee, as saying "Oh God":

> Goldstone groaned when he heard Hugel had brought along Atkins. Until that moment he had held out some hope the board wouldn't disclose Johnson's presentation that night, giving the management group a chance to finish its negotiations in secrecy. Now he knew that an announcement was all but certain.
>
> The clincher was Atkins's past. . . . Atkins had been selected to advise Fort Howard by the company's chief executive, the man making the bid, a fact that troubled the court and called into question Atkins's actions in favor of secrecy. "It is obvious that no role is more critical with respect to protection of shareholder interests in these matters than that of the expert lawyers who guide sometimes inexperienced directors through the process," the court said. "A suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary." Atkins's choice of secrecy, the judge noted, was "a source of concern to a suspicious mind."
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> The opinion all but accused Atkins of selling out his neutrality to a buyout group. Goldstone guessed he was still stinging from the rebuke. Jack Nusbaum concurred. "It was clear Atkins was going to be living down Fort Howard," Nusbaum recalled. "We figured he was going to be holier than Caesar's wife."

BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO 181–82 (1990).

tive, brought in outside counsel at the first indication of a management buyout. In *Fort Howard*, the special committee deferred to the management group's desire for secrecy and did not make any disclosure, even after a report of unusual trading volume indicated a leak of information, until a rumor of a management buyout left them no choice. By contrast, here full disclosure of the possible management buyout was made the very next day, effectively broadcasting the message that the company was for sale.

Within four days, KKR informed the special committee that it was planning to make an offer to acquire RJR at $90 per share in cash and securities, and, on October 27, commenced a tender offer. Thereafter, the special committee acted as auctioneer, issuing a press release announcing that it was interested in receiving proposals to acquire the company. Again there is a stark contrast with *Fort Howard*, in which the committee did not take any steps to solicit competing bids until after it had reached an agreement with the management group.

Ultimately, three bids were made by the deadline, and, in the ensuing auction rounds, the price escalated from Johnson's initial suggestion of $75 per share, past KKR's opening bid of $90 per share, to KKR's ultimately successful bid of around $110 per share in cash and securities. The special committee was so independent of the management group that, in the shareholders' class action that was brought, plaintiffs were put in the position of arguing that the special committee was "inappropriately motivated to repudiate, and more importantly, to be seen publicly as repudiating the Company's management."[112] To avoid being tarred by the public criticism directed at the management group, it was essential to the special committee that KKR win, or so the plaintiffs argued.

The court focused on the special committee's conduct of the auction—applying the supreme court's *Macmillan* holding—and concluded that the committee acted in good faith and with due care in ending the auction when it did, without returning to the bidders for one more round of bids as plaintiffs argued they should have done.[113] But the core of the case seems to lie in the independence of the committee from the start. Unlike the committees in *Macmillan* or *Fort Howard*, this was not a committee that could supply a suspicious mind with fuel to feed its flame.

When *RJR Nabisco* is placed next to *Macmillan* and *Fort Howard*, we see several things. First, we see a detailed example of how an effective special committee behaves in a management buyout transaction. Second,

112. *RJR Nabisco*, 1989 Del. Ch. LEXIS 9, at *6.
113. *Id.* at *65–*66.

we see graphic evidence of how conduct seems to be shaped by Delaware opinions, even when the plaintiffs "lose," as they did in the *Fort Howard* preliminary injunction motion. Peter Atkins' performance in *Fort Howard* received a negative review from the most important of the critics, the Delaware Chancery Court. He had an opportunity to try again two months after his bad review, and he took that opportunity, leading one reviewer of *Barbarians at the Gate: The Fall of RJR Nabisco* to characterize Atkins as one of the book's few heroes.[114] Finally, when you put together the strongly negative portrayal of managers and directors in *Macmillan*, the somewhat less negative, but still negative, portrayal in *Fort Howard*, and the very positive portrayal in *RJR Nabisco*, you have a pretty clear set of guideposts for how managers and directors in management buyout transactions should behave.

In retrospect, the lessons may seem obvious. But at the time, the norms were substantially less clear. What led the directors astray in *Macmillan* and *Fort Howard* was a lack of clarity with respect to their roles. Were they to represent the interests of shareholders actively? Were they to facilitate the managers' buyout so long as the price was within the "range of fairness"? Were they to protect managers and perhaps shareholders from a hostile tender offer in the event that managers could not finance a buyout at a price within the range of fairness? Up until the *Macmillan*, *Fort Howard*, *RJR Nabisco* trilogy, there were relatively few and relatively vague guideposts. After these cases, the norms became fairly clear, sufficiently so that managers and directors who, by and large, were trying to do the right thing had sufficient guidance to figure out what the right thing was.

6. Other Important Stories

The *Macmillan, Fort Howard*, *RJR Nabisco* trilogy went a long way towards describing the norms of conduct in management buyout transactions. At this point, the style of the Delaware courts' opinions changed somewhat, leaning towards the confident application of reasonably well-established norms, with less need to articulate those norms explicitly through the detailed narratives of the earlier cases.

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114. Thomas J. Andre, Jr., *Barbarians at the Gate: The Fall of RJR Nabisco*, 59 U. CIN. L. REV. 479 (1990) (book review).

a. *In re Amsted Industries Inc. Litigation* (1986–1989)

The *Amsted Industries*[115] litigation provided another opportunity for the courts to articulate norms of conduct, although it was complicated somewhat by the fact that the review of management's behavior was in the context of whether to approve settlement of a class action.[116] Here, as in cases like *Fort Howard*, one finds the court refusing to set aside the transaction at the same time that it expresses grave reservations about the behavior of the board.[117]

b. *In re Formica Corp. Shareholders Litigation* (1989)

The Formica Corporation was created in a management buyout of a division of a large conglomerate.[118] Two years after the original buyout, the company went public. Then, two years after its IPO, management, in the wake of some vague threats of a hostile takeover, thought that it might make sense to go private again. Management ultimately decided to try an MBO and informed the board that it planned to make an offer at $18 per share. Here, Vice Chancellor Jacobs shows us another example of an effective special committee chair, Stephen Bershad, a former investment banker. Bershad rejected management's desire to rely on an investment bank valuation in place of a market test, arguing that "whatever might be the merits of investment banker-generated analytic models, only the marketplace could determine Formica's real value, and that value would not be known unless the company was shopped."[119] Moreover, Bershad drove a tough bargain in negotiating a breakup fee and expense reimbursement arrangement that would be sufficient to assure that management's MBO bid

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115. *In re* Amsted Indus. Inc. Litig., No. CIV.A.8224, 1988 WL 92736 (Del. Ch. Aug. 24, 1988).

116. For discussions of the difficulties that a court has in evaluating the strength of a case in the context of a settlement, see, for example, John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986); Geoffrey C. Hazard, Jr., *The Settlement Black Box*, 75 B.U. L. REV. 1257 (1995); Jack B. Weinstein & Karin S. Schwartz, *Notes from the Cave: Some Problems of Judges in Dealing with Class Action Settlements*, 163 F.R.D. 369 (1995).

117. *See supra* note 109.

118. *In re* Formica Corp. Shareholders Litig., No. CIV.A.10598, 1989 WL 25812 (Del. Ch. Mar. 22, 1989). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at *1–*7.

119. *Id.* at *6.

would remain in place while the company shopped, but not so big as to deter other bidders.[120]

Here, unlike in *Macmillan*, Jacobs concluded that the special committee could be relied upon. Moreover, the language of his opinion has the confidence and clarity that comes from having decided several similar cases.[121]

But, although the committee performed well, the court did not miss the opportunity to criticize some features of the structure used. In particular, Vice Chancellor Jacobs noted that permitting the CEO to explore the company's strategic alternatives when he was actively considering an MBO and employing an investment banker with ties to management to represent the special committee were inappropriate. The court found that it would have been preferable (though not required) to assign the tasks to unconflicted parties.

c. *Braunschweiger v. American Home Shield Corp.* (1989)

The *American Home Shield* case, decided in the fall of 1989,[122] shows a similar familiarity with accepted approaches by the court, but not yet by the parties. Although Chancellor Allen did not grant a preliminary injunction, because he believed both that it would not be in the interests of the shareholders (for fear that no higher bid would be forthcoming) and that

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120. For example, negotiations hit a stumbling block with regard to expense reimbursement: management's investment banker would not agree to any cap. Again the special committee proved its independence: "A press release rejecting the proposal and authorizing Shearson to shop the company was prepared and circulated, but ultimately, the investor group relented and agreed to a $5.5 million cap on reimbursable expenses." *Id.* at *7.

121. Vice Chancellor Jacobs wrote:

> [T]his case is not one (as plaintiffs suggest) where an acquisition proposal materializes out of nowhere, and unknowledgeable directors are hastily impressed into "special committee" service, but given no adequate time or resources to discharge their duties. Here, the process that eventually resulted in the management LBO proposal began when Glazer first surfaced in August, 1988. The independent directors, most notably Messrs. Bershad, Dunphy, and Cruickshank, were actively and knowledgeably involved in that process from that time forward. They carried out their duties in "hands on" fashion, independently of Mr. Langone, in their capacities as directors, and later, as the Special Committee. During that period, those directors had to and did, make certain judgments. And while certain of those judgments arguably might be subject to criticism, the evidence does not support a conclusion that they were made without appropriate due care.

Id. at *10.

122. Braunschweiger v. American Home Shield Corp., No. CIV.A.10755, 1989 WL 128571 (Del. Ch. Oct. 26, 1989).

monetary damages would be adequate, he harshly criticized the defendants, sending a strong signal to them that summary judgment would not be granted and that they faced significant exposure in a full trial:

> There is surely room to litigate the claims asserting that the directors, in whose hands consideration of the ServiceMaster proposal was placed, failed to inform themselves adequately of what opportunities or alternatives were available to the Company if a cash out merger was to be negotiated and recommended to the shareholders. . . . Here, while there had earlier been inquiry by the Company's management of available finance-oriented deals, it is not apparent that any serious check was done to uncover potential strategic buyers either before announcement of the acceptance of ServiceMaster's proposal or after it.[123]

Subsequently, after shareholders approved the transaction, the court denied defendants' motion for summary judgment because, the court held, defendants' disclosures to shareholders were insufficient, thereby undermining any effect a shareholder vote might have.[124]

d. *Restaurant Associates II* (1990)

By 1989, then, the really interesting part of the story is over. The norms of conduct for MBOs, although not reduced or reducible to a set of "safe harbor" rules, nonetheless are sufficiently well mapped out such that informed and experienced counsel should know how to guide the board and the special committee through an MBO transaction. From the courts' perspective, the general norms are pretty clear, even if they have not reached all of the parties, especially managers of smaller companies not advised by the core group of corporate law firms. Not surprisingly, the courts' view of appropriate behavior evolved over the period during which the norms were formulated. This becomes clear when one returns to the

123. *Id.* at *6.

124. Additional MBO cases from this period include *In re KDI Corp. Shareholders Litigation*, No. CIV.A.10278, 1988 WL 116448 (Del. Ch. Nov. 1, 1988) (denying motion for preliminary injunction), *In re KDI Corp. Shareholders Litigation*, No. CIV.A.10278, 1990 WL 201385 (Del. Ch. Dec. 13, 1990) (granting defendants' motion to dismiss); *Roberts v. General Instrument Corp.*, No. CIV.A.11639, 1990 WL 118356 (Del. Ch. Aug. 13, 1990) (denying motion for preliminary injunction); and *Norberg v. Young's Market Co.*, No. CIV.A.11208, 11253, 1989 WL 155462 (Del. Ch. Dec. 19, 1989) (denying motion for preliminary injunction).

second act of *Restaurant Associates*,[125] which had been one of the very early MBO cases to result in an opinion.

To recall briefly, in *Restaurant Associates I*,[126] the court seemingly had been very impressed with the strength and independence of the special committee. In the first opinion, the court recounted how the special committee, despite obstacles by the managers who controlled forty-eight percent of the votes, went so far as to propose dilution of management's votes in order to encourage a competing bidder to offer a better deal for shareholders. Ultimately, no bid was forthcoming and even management's bid was withdrawn after the October 1987 market crash.

But now, three years later, the court had a more refined sense of appropriate behavior. The managers and the special committee after the market crash promptly renegotiated the price downwards from $18 per share to $14.25 per share. In refusing to dismiss the plaintiffs' claims against the outside directors, the court found fault in the committee's failure to shop the company:

> While the special committee has no per se duty to shop the company, it did have a duty to proceed reasonably to maximize shareholder value. The plaintiffs, in alleging that the special committee did not shop the company and agreed to the sale of the company at a point in time, immediately following the October 1987 market break, when its stock price was particularly depressed (and given what preceded that agreement) have alleged circumstances that, if true, might support a conclusion that the special committee did not act reasonably.[127]

C. What Is the Delaware Standard Governing MBOs?

Can the Delaware MBO cases be reduced to a reasonably predictable standard or rule? Can one provide an algorithm to figure out what the courts will do? If so, what does it look like? This Article argues that, collectively, the cases do provide such guidance, but in a distinctive way that differs fundamentally from the rule-based view.

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125. Freedman v. Restaurant Assocs. Indus., No. CIV.A.9212, 1990 WL 135923 (Del. Ch. Sept. 21, 1990). The factual account is drawn from the Chancery Court opinion. *See id.* at *2–*3.

126. Freedman v. Restaurant Assocs. Indus., No. CIVA.9212, 1987 WL 14323 (Del. Ch. Oct. 16, 1987).

127. *Freedman*, 1990 WL 135923, at *8.

Consider a plausible substantive candidate for a rule governing MBOs:[128] Managers may buy the company if and only if independent directors have auctioned the company and managers submit the highest bid. Although a plausible rule, this is clearly not Delaware law. It is clear, for example, that the special committee need not auction the company before selling the company to management; a post-agreement "market test" is sometimes enough.[129] Moreover, directors may sometimes sell the company for less than the highest bid, if other factors make the lower bid more attractive (e.g., less uncertainty).[130] Moreover, directors may, under certain circumstances, decide not to sell the company at all.[131] In other words, the submission by managers of the highest bid in an auction of the company is neither a necessary nor a sufficient condition for buying the company.

Now consider the standard as articulated by Vice Chancellor Jacobs in the relatively late case of *In re Formica Corp.*:[132]

> In any transaction where corporate management seeks to acquire the equity interest owned by the public shareholders, a conflict of interest is inherent. Management's personal motivation as a potential buyer is to pay as little as possible. Management's duty as a fiduciary is to obtain the highest available value for the stockholders. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., Del. Supr., 506 A.2d 173 (1986); In Re: Trans World Airlines, Inc. Shareholders Litig., Del. Ch., C.A. No. 9844, Allen, C. (October 21, 1988).* Because of that inherent conflict, the responsibility to represent the shareholders' interests adequately falls upon the independent directors, who must exercise the utmost good faith and the appropriate degree of care to assure "the most scrupulous adherence to ordinary principles of fairness in the conduct of an auction for the sale of the corporate enterprise." Mills Acquisition, Co. v. Macmillan, Inc.,

128. Another plausible candidate would be per se prohibition, as advocated by Brudney and Chirelstein. *See supra* note 26. As the cases show, that is clearly not the rule that developed in Delaware.

129. *See, e.g.*, *In re* Formica Corp. Shareholders Litig., No. CIV.A.10598, 1989 WL 25812 (Del. Ch. Mar. 22, 1989); *In re* Fort Howard Corp. Shareholders Litig., No. CIV.A.9991, 1988 WL 83147 (Del. Ch. Aug. 8, 1988).

130. *See, e.g.*, *In re* RJR Nabisco, Inc. Shareholders Litig., No. CIV.A.10389, 1989 Del. Ch. LEXIS 9 (Feb. 14, 1989); West Point-Pepperell, Inc. v. J.P. Stevens & Co. (*In re* J.P. Stevens & Co. Shareholders Litig.), 542 A.2d 770 (Del. Ch. 1988).

131. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

132. *Formica*, 1989 WL 25812.

Del. Supr., Nos. 415 and 416, Consol., Moore, J. (Bench Ruling, Nov. 2, 1988, Opinion Pending).[133]

This summary, while on its face vague, is reasonably clear to those who have read the underlying cases, including those specifically cited. In conjunction with those cases, it provides substantial guidance on how to structure a management buyout transaction. A special committee should be established to negotiate with management and third parties. The special committee should retain its own investment bankers and legal counsel. In establishing the special committee, counsel should make sure that the managers do not appoint the members or their investment banker. The special committee should issue a press release announcing that management has made a bid and should be forthcoming in providing information to prospective bidders for control. If third parties enter the contest, the special committee should behave in an evenhanded manner and should not favor the management group. In any event, the special committee should test the market, although it need not conduct an auction, to see if competing offers are reasonably likely to be available.

Jacobs' summary is a summary, not a standard. The narratives are not the scaffolding—the investigative process—by which the norm is constructed, which can then be jettisoned once the standard is formed and articulated. On the contrary, the articulated "standard" does nothing more than stand in for the cases: The narratives it summarizes are the content of the norm.[134] In the application of the standard—at least by a court, if not by the actor himself—the narratives become critical in characterizing the new fact pattern and extending the legal norm to a new situation.

Indeed, this interpretation is the only way to explain the coexistence of the typically open-textured and extremely vague statement of the legal norm under Delaware law (in an MBO, "independent directors, . . . must exercise the utmost good faith and the appropriate degree of care to assure 'the most scrupulous adherence to ordinary principles of fairness in the conduct of an auction for the sale of the corporate enterprise'")[135] and the reasonable predictability of Delaware outcomes that is essential to business planners. It is only if the statement is a summary that stands in for the set

133. *Id.* at *10.

134. This view of Delaware fiduciary duty law is consistent with (but does not require) the more general claim that standards can only be articulated through narrative.

135. *Formica*, 1989 WL 25812, at *10 (quoting Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1285 (Del. 1989)).

of cases that constitute the norm—with the guidance being provided by those cases, with all their factual specificity—that there could be sufficient certainty.

Confusion emerges in several situations: First, when there are too few cases from which to triangulate the norm; second, when a player confuses the summary with the constitutive narratives; third, when a player interprets the cases as establishing a substantive safe harbor, rather than explicating a conduct norm.

D. Summary

The preceding study of the Delaware MBO cases shows that the standards governing MBOs evolved through the incremental description of good and bad performances by managers. The overall doctrinal structure was unchanged throughout: From the beginning to the end, cases were analyzed either under the rubric of the "business judgment rule" or the "entire fairness standard," with an occasional reference to the intermediate *Unocal* test. At no point does the court ever say: "This is how you must do MBOs." Nor does the court ever say, "If you do MBOs this way, then we will leave you alone."

It is arguable that this fact-intensive, heavily normative narrative style is characteristic of all common law adjudication. It is likewise arguable that this style is, at least, characteristic of all standards. At the least, this seems to be the characteristic style of Delaware fiduciary duty case law.

This descriptive claim raises further questions. First, how do the narratives reach their ultimate audience, and in what form do they do so? This is the subject of the next Part. Second, if I am right as a descriptive matter, what are the implications for corporate law? That is the subject of Part IV.

II. Traces of the Transmission of Norms: The Case of MBOs

The central hypothesis of this Article is that a large part of what the Delaware courts do is tell stories as a way of articulating and expressing norms, as a way of giving content to the amorphous and highly contextual concepts of "good faith," "independence," "due care," and "fair dealing." If this is correct, then one would predict that these stories would make their way out into the relevant community. There are two primary hypotheses for how the norms might be transmitted. First, the stories themselves

might be transmitted directly to the target audience (directors and officers), either in detail or in summary form. Second, the stories may be digested by an intermediary, Delaware corporate lawyers, who then apply the norms without actually telling the stories to the clients.[136] In this Part, I examine some of the evidence of the public and semipublic manifestations of the transmissions of norms. I find some evidence of both sorts of mechanisms at work. This evidence is drawn from a number of genres, including the community's newspapers, the *Wall Street Journal* and the *New York Law Journal*, Delaware judges' extrajudicial speeches and articles, and finally a popular but little studied genre of legal literature, the "memoranda to our clients" sent by leading law firms to their clients.

A. Newspaper Accounts

As one would expect, Delaware cases are covered by the major business press. With regard to the MBO cases, one finds that although the early and minor cases receive no more than passing mention,[137] the major, high-profile cases generate substantial coverage that focuses on what one would expect a priori, the dramatic clash of egos and the emergence of heroes and especially villains.[138] In these articles, one finds the broadcasting of the stories told by the Delaware opinions, pitched at a somewhat higher rhetorical level and with supplemental reporting.

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136. A failure to discover any evidence of transmission of these stories is therefore ambiguous. One explanation of such a lack of evidence would be that, while my hypothesis might be correct as a description of what the Delaware courts do, there has been a breakdown in communication that results in the stories not being transmitted to their intended audience. Secondly, it could be that counsel digests the stories and transmits advice, but not the stories. Finally, my hypotheses for how Delaware corporate law works may be incorrect.

137. *See, e.g.*, *Formica Corp.*, WALL ST. J., Apr. 14, 1989, at C15; *Formica Corp.: Data Has Been Received by 15 Interested Parties*, WALL ST. J., Mar. 16, 1989, at C13; *Formica Corp. Enters Confidentiality Pacts with Third Parties*, WALL ST. J., Feb. 23, 1989, at A6; *Formica Corp.: Potential Bidders Total 70; 7 Sign Confidentiality Pacts*, WALL ST. J., Feb. 27, 1989, at A4; *ServiceMaster L.P.*, WALL ST. J., Apr. 25, 1989, at B4.

138. *See, e.g.*, Crossen & Blumenthal, *An Anti-Takeover Arsenal*, *supra* note 101, at B1; John Helyar & Bryan Burrough, *The RJR Nabisco Takeover—Buy-Out Bluff: How Underdog KKR Won RJR Nabisco Without Highest Bid*, WALL ST. J., Dec. 2, 1988, at A1; Hilder, *supra* note 101, at C1.

1. The Early Cases

Of the early cases, the two that received the most attention were *Becor Western*[139] and *J.P. Stevens*.[140] In *Becor Western*, management's MBO bid was reported on February 18, 1987, putting the world on notice that Becor was in play.[141] By June 1987, the *Journal* reported that "[i]n the past five months, no fewer than five bids have been made for Becor."[142] Management's bid, according to analysts quoted in the article, "was generally perceived to be low."[143] And, according to an arbitrager quoted, "Management was trying to steal the company for bottom dollar, and with the amount of exposure these deals have caused, they won't be able to."[144] Subsequent coverage by the *Journal* showed the board acting as an auctioneer,[145] and ultimately accepting management's bid.[146] The only significant mention of the Delaware courts came in the report of the completion of the takeover by the management bid, which was conditioned on the settlement of the class action shareholder suit in the Delaware Chancery Court.[147]

The battle for J.P. Stevens, which involved an active bidding contest for a larger, better-known company with prices escalating sharply, com-

139. Shingala v. Becor Western Inc., No. CIV.A.8858, 1988 WL 7390 (Del. Ch. Feb. 3, 1988).

140. *In re* J.P. Stevens Shareholder Litig., 542 A.2d 770 (Del. Ch. 1988). *National Medical Care* and *Shoe-Town* were also covered. *See National Medical Care Holder Sues to Block Company's Purchase*, WALL ST. J., Aug. 22, 1984, at 33; *Shoe-Town Inc.: Court Declines to Block Acquisition by Managers*, WALL ST. J., Jan. 20, 1988, at 7.

141. Alex Kotlowitz, *Becor Western Buyout to Total $238.1 Million*, WALL ST. J., Feb. 18, 1987, at 16.

142. Michael J. McCarthy, *Becor Western's Cash Stockpile Helps Lure Would-Be Acquirers Offering Creative Deals*, WALL ST. J., June 26, 1987, at 45.

143. *Id.*

144. *Id.*

145. *See, e.g.*, *Becor Slates July 9 as Bid Deadline, Sets Valuation Guidelines*, WALL ST. J., June 29, 1987, at 10; *Becor Western Board to Study Latest Bids at Meeting Thursday*, WALL ST. J., July 13, 1987, at 12.

146. *See Becor Western Inc. Accepts Bid by Group Led by Management*, WALL ST. J., July 20, 1987, at 9.

147. *B-E Holdings Buys Concern*, WALL ST. J., Feb. 5, 1988, *available in* 1988 WL 481176.

manded more attention. But again the proceedings in the Delaware courts did not figure prominently in the press reports. There was passing mention of the litigation accusing the directors of breaching their fiduciary duties (in agreeing to sell the company to Odyssey Partners) and seeking to block the merger and force the company to turn over confidential information to other bidders.[148] Such references, however, were vastly overshadowed by the corporate maneuvering.

2. The Formative Cases

By contrast, the opinions of the Delaware courts figure much more prominently in the formative cases of *Macmillan*, *Fort Howard*, and *RJR Nabisco*.

a. *Macmillan*

Here, not only did the *Journal* report the scheduling of potentially determinative hearings,[149] the *Journal* also found Vice Chancellor Jacob's view of the actors' behavior to be newsworthy:

> In granting the restraining order, Judge Jacobs bluntly described the impact the plan could have on shareholders. If the plan were found to be a breach of directors' fiduciary duty, it would cause "irreparable damage to Macmillan shareholders," he said. Not only would the restructuring change the company's capital and corporate structure, he wrote, it "would adversely affect the quality of the shareholders' investment and prevent or drastically reduce (their) opportunity to realize greater value for their shares than is being afforded by the restructuring . . . ." Noting the judge's terms, two persons in the Macmillan camp were downbeat. Said one: "The flavor of the order was more negative than we would have liked."[150]

But still the account pays little attention to the details of the story Jacobs told, as opposed to the effect and tone of his decision.[151]

148. *See, e.g.*, Ed Bean, *Pepperell Lifts Bid for Stevens to $1.14 Billion*, WALL ST. J., Mar. 25, 1988, at 4; *Pepperell Begins $1.11 Billion Offer For J.P. Stevens*, WALL ST. J., Mar. 28, 1988, at 20.

149. *See, e.g.*, *Hearing to Reopen Today on Macmillan Revamping*, WALL ST. J., June 10, 1988, at 29 ("A vice chancellor in the Delaware Chancery Court will reconvene a hearing at 10 a.m. EDT today to decide whether Macmillan Inc.'s restructuring should be halted.").

150. Johnnie L. Roberts, *Macmillan's Bid to Restructure is Dealt Setback*, WALL ST. J., June 13, 1988, at 22.

151. *See* Crossen & Blumenthal, *Macmillan, Inc.*, *supra* note 101, at 20 ("[i]n a sometimes harshly worded decision").

It was only after the shooting was over that a more detailed account was presented of the Macmillan story. Thus, in the wake of the Delaware Supreme Court's opinions that invalidated the board's attempt to favor the management group, the *Journal* gave a fuller account of the whole story, tracking the narrative given by the Delaware courts.[152] The *Journal*, like the courts, vilified "Edward P. Evans, Macmillan's proud and stubborn chairman and chief executive officer."[153]

The Delaware courts' criticism of Bruce Wasserstein, management's investment banker, likewise found its way into a front page article.[154] Here, the reporters focused on both the courts' criticism of the opinion Wasserstein gave that Maxwell's bid was inadequate,[155] and Wasserstein's handling of the final bidding contest in which Evans tipped KKR.

b. *RJR Nabisco*

The battle for RJR Nabisco—the biggest LBO of all time—of course received the most press attention, yielding countless articles and a book. But in these accounts, the focus shifted to the special committee's striking independence from the management group.[156] This same perspective was also reflected in the book that the *Journal* reporters subsequently wrote.[157]

3. Summary

The *Wall Street Journal* accounts, then, focus primarily on those few, high-profile deals that are newsworthy. Moreover, the *Journal* seems to play a prominent role in broadcasting the stories only in those few cases when a judge actually stops a deal or threatens to stop it. The nuances of critical judicial commentary unaccompanied by an injunction are lost. But when the *Journal* does get interested, as in the *Macmillan* or *RJR Nabisco* cases, its prominence and additional reporting amplify the volume of criticism from the Delaware court. As one experienced Wall Street transactional lawyer

152. *See, e.g.*, Crossen & Blumenthal, *An Anti-Takeover Arsenal*, *supra* note 101, at B1.

153. *Id.* Indeed, Evans is allowed to hang himself: "[Evans] contends that the maneuvers were meant only to protect shareholders. He also maintains that he has been more a hapless victim than an active player in the struggle. 'I didn't mean to do it,' he says. 'It was more or less done to me.'" *Id.*

154. *See* Hilder, *supra* note 101, at C1.

155. "The valuations were 'obviously intended to accord with management's restructuring,' the court said." *Id.*

156. *See, e.g.*, Helyar & Burrough, *supra* note 138, at A1.

157. BURROUGH & HELYAR, *supra* note 111.

put it in private conversation, "We're not afraid of what the Delaware courts say. We're afraid of what the press says."

B. Extrajudicial Utterances

Some Delaware judges give speeches and appear on panels. This provides an additional platform from which to summarize and promulgate standards of conduct for members of the corporate bar and their clients. A good example of this, in the context of MBOs, is Chancellor William T. Allen's *Business Lawyer* article, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, a slight revision of a speech previously delivered at the University of California, San Diego, Seventeenth Annual Securities Regulation Institute.[158]

The tone of the article is captured by an early paragraph:

> I remain open to the possibility that [special] committees can be employed effectively to protect corporate and shareholder interests. But I must confess a painful awareness of the ways in which the device may be subverted and rendered less than useful. I conclude, as well, that it is the lawyers and the investment bankers who in many cases hold the key to the effectiveness of the special committee.[159]

To elaborate this view, Allen relied on a contrast between those committees that performed badly, such as in *Macmillan* (quoting the "torpid, if not supine" phrase from the Delaware Supreme Court opinion and the "little more than a charade" language from the chancery court opinion), and those that performed well, citing *RJR Nabisco* as well as *Restaurant Associates*.[160] And, moreover, in focusing on these cases, with which many in his audience (both in San Diego and those reading the article) were familiar, he recalled, in summary form, the critical details.

If it is possible that special committees can perform well, what, asked Allen, distinguishes those that act well from those that act badly?[161]

158. William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055 (1990).
159. *Id.* at 2056.
160. *Id.* at 2059–60.
161. *Id.* at 2060.

Here, in what can be read as an attempt to exhort the corporate bar to counsel virtue, Allen argued that the duties of members of the special committee in these transactions were radically transformed, and that

> [w]hen special committees have appeared to push and resist their colleagues, it has been . . . because the men and women who comprised the committee have understood that as a result of accepting this special assignment, they have a new duty and stand in a new and different relationship to the firm's management or its controlling shareholder.[162]

The lawyers and investment bankers, Allen argued, hold the key to establishing the integrity of the process.

Just so the audience would not miss the message, Allen made clear that

> much, of course, will turn on the court's evaluation of the integrity of the special committee's process. In reaching that evaluation, the court will be mindful—and the lawyers advising the committee need to be mindful as well—that the committee, if respected, holds the shareholders' welfare in its hands; the court will be mindful that claims of so-called structural bias in the process are plausible; and, that the court's own power of perception is limited.[163]

Moreover,

> this is not a call to pay even greater attention to appearances; it is advice to abandon the theatrical and to accept and to implement the substance of an arm's-length process. To do this, the lawyers and the bankers must be independent of management. They must accept in their hearts that in the MBO or the auction context, their client is the committee and not management. They must clearly and emphatically remind their client that, at this juncture, the CEO and his associates are to be treated at arm's-length. And the lawyers and bankers must act on that view. That means that from the outset, the advisors must be prepared to forego future business. It comes to that.[164]

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162. *Id.* at 2061.
163. *Id.* at 2062.
164. *Id.*

Here, then, is a relatively explicit attempt—delivered from the podium rather than the bench—to induce better behavior by managers.[165] On this view, to be a moral director is to walk with the shareholders.

C. "A Memorandum to Our Clients"

If my hypothesis is correct, one would predict that the stories of the Delaware courts would find their way into the communications between lawyers and their clients. The best evidence of this would be the actual advice that lawyers give their clients, but such evidence is generally not available.[166]

An indirect record of such communication is the relatively well-known, but little-studied legal genre, the "memorandum to our clients," that prominent firms use to keep their clients apprised of changes in the law (and, of course, to market their services). In connection with this project, I have collected such materials from the relevant time period (1980–1990) from Wachtell, Lipton, Rosen and Katz, Sullivan and Cromwell, and Skadden, Arps, Slate, Meagher and Flom, three firms that had active takeover practices during that period. Only the Wachtell Lipton memoranda provide any detailed discussion of the duty of independent directors in an MBO transaction. Why neither of the other firms seems to have summarized and distributed such advice widely awaits further research.

The materials from Wachtell Lipton are consistent with my hypothesis but provide relatively little direct support. In the course of the 1980s, as MBOs became more prominent and as more cases on MBOs arose, one finds two types of memoranda in the files. One such memorandum is "The LBO White Knight,"[167] in which Martin Lipton addresses MBOs briefly in the course of a discussion of the suggestion that directors must conduct an auction once a company is for sale. Lipton argues that auctions are often not the best way to maximize shareholder value, and therefore it

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165. Delaware judges also, of course, address other issues when making public addresses. Thus, Justice Andrew G.T. Moore II, in *The 1980s—Did We Save the Stockholders While the Corporation Burned?*, 70 WASH. U. L.Q. 277 (1992), looked back on the takeover decade with a mixture of skepticism with regard to the economic benefits, and with pride with respect to the role the Delaware Supreme Court played in constraining what he viewed as abusive behavior.

166. It is not available—in part because it is protected by the attorney-client privilege, and in part because the parties generally have additional reasons for not disclosing it. But that is not to say that it is totally inaccessible. In a companion project, still in its preliminary stages, Michael Useem and I will try to gather more direct evidence through structured interviews with lawyers and directors. *See supra* note 19.

167. Martin Lipton, *In Defense of White Knight LBOs*, LEGAL TIMES, Aug. 18, 1986, at 1.

would be foolish to mandate them. He notes that the decisions he discusses—*Revlon*, *Hanson*, and *Fruehauf*—may have been "influenced by the fact that management of the target had an equity participation in the LBO."[168] But, he argues, this is true with respect to almost every LBO, and management's equity participation should not create a special standard for LBOs. Instead,

> [w]hile one must recognize the skepticism of the courts with respect to lock-up of an LBO that management *originates* and participates in, those doubts should not exist where the LBO is in *response* to an unsolicited bid. . . . Any possible detriment to shareholders arising from management participation is overwhelmingly counterbalanced by the benefit of a higher bid.[169]

In contrast to Lipton's short, policy-oriented discussion of LBOs, Wachtell Lipton also prepared and circulated a much longer, much more complete treatment, which was eventually published in various PLI volumes. Barry Bryer and Craig Wasserman, two partners at Wachtell Lipton, prepared a long memo originally entitled "Representing a Public Company in a Leveraged Buyout Transaction: An Update,"[170] and eventually evolving to "Management Buyouts and the Duties of Independent Directors."[171]

Thus, in their early memo, written before many of the MBO cases were decided, and relying on extensions from the cases governing parent-subsidiary freeze-out mergers, Bryer and Wasserman provided a long and detailed discussion of *Weinberger v. UOP, Inc.*,[172] including concise summaries of the court's narrative, as well as similar discussions of other freeze-out cases. They then turned to the then existing major MBO cases: *Revlon*, from Delaware, *SCM*, from the Second Circuit, and *Fruehauf*, from the Sixth Circuit. In the later memos, the earlier treatments were largely preserved, but supplemented with fairly complete accounts of the cases directly addressing MBOs. The result is a memo that is sixty-six pages long, single spaced.

From an academic perspective, reading these memos is very hard going. Although the discussions of legal doctrine are extremely sophisti-

168. *Id.* at 9.
169. *Id.* at 10–11.
170. Barry A. Bryer & Craig M. Wasserman, Representing a Public Company in a Leveraged Buyout Transaction: An Update (Dec. 9, 1986) (on file with author).
171. BARRY A. BRYER ET AL., MANAGEMENT BUYOUTS AND THE DUTIES OF INDEPENDENT DIRECTORS (1989).
172. 457 A.2d 701 (Del. 1983).

cated, the memoranda are filled with enormous factual detail about the cases. Compared to more academic discussions,[173] the case discussions seem only partly digested: one finds only summaries of the factual background without the synthesis that makes such case-by-case presentation unnecessary.

But the fact that the most sophisticated practitioners writing for sophisticated clients and practitioners present Delaware law in this way reflects a recognition—intuitively obvious to practicing lawyers, perhaps less obvious to those of us who spend our time responding to student requests for the "rule"—that the guidance resides in those specific factual accounts, and that summarizing the factual discussion is close to the limit of how far one can go to reduce the cases to a "rule." Clients are no less insistent than students in demanding clarity. The difference is that practitioners suffer a greater penalty than academics for giving in to the desire to provide clarity at the sacrifice of accuracy.

III. SOME IMPLICATIONS OF A NORMATIVE/NARRATIVE THEORY

A. Missing the Point of Delaware "Law": *Viacom v. QVC*

What difference does it make if you think of Delaware law as a set of instructive tales of good and bad managers, as opposed to a set of substantive rules? The answer is that it can make all the difference in the world. A comparison of the *Time-Warner*[174] and *Paramount/Viacom v. QVC*[175] cases provides striking evidence for the generality of my normative/narrative view of Delaware fiduciary duty law. At the same time, this comparison provides an interesting example of the intersection of law office practice, commentary in the trade press, and judicial opinions, similar to what occurred in the development of the standards governing MBOs.

During the takeover battles of the 1980s, a hotly contested question arose whether a corporation faced with an all-cash, all-share tender offer could refuse to withdraw a poison pill and "just say no" to the bidder. In the *Interco* case,[176] Chancellor Allen, applying the *Unocal* standard,

173. *See, e.g.*, Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After* QVC *and* Technicolor: *A Unified Standard (and the End of* Revlon *Duties?)*, 49 BUS. LAW. 1593 (1994); Gilson & Kraakman, *supra* note 22.

174. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

175. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

176. City Capital Assocs. L.P. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988). The factual account is drawn from the Delaware Chancery Court opinion. *See id.* at 791–94.

ordered the removal of a "poison pill" preferred rights plan. Allen held that when the only "threat" facing shareholders came from a noncoercive (all-cash, all-share) tender offer, the board could not leave the pill in place to force shareholders to accept an alternative management-recommended restructuring of approximately the same value, even if one assumed that the board believed in good faith and after prudent investigation that the management-sponsored restructuring was superior. Many read *Interco* as casting doubt on the "just-say-no" defense.[177] That case, which became moot after the Delaware Supreme Court had accepted an interlocutory appeal,[178] provoked a substantial amount of criticism.[179] As of 1989, the supreme court had not addressed the question.

Then, in 1989, Time Inc. and Warner Communications announced a stock-for-stock merger.[180] Soon, however, the Time-Warner merger faced a "threat." Two weeks before the annual shareholders' meeting at which the Time shareholders would vote on the merger, Paramount announced a $175 per share all-cash all-share tender offer for Time, a substantial premium over both the market price of $103–$113 prior to the announcement of the proposed Time-Warner merger and the post-announcement market price of $105–$122. Paramount's bid was conditioned on, inter alia, the termination of the Time-Warner merger agreement, financing, and the removal of Time's poison pill, as well as a number of other "defensive" measures.[181]

In response to Paramount's offer, Time and Warner, obviously worried that Paramount's bid would lead Time shareholders to reject the Time-Warner merger in order to be able to accept Paramount's offer, renegotiated the transaction and replaced the merger with a debt-financed cash tender offer by Time for the shares of Warner. Because bidding firm shareholders have no right or occasion to vote on a tender offer, this restructuring elimi-

177. *See, e.g.*, Theodore N. Mirvis, *'Time/Warner': Delaware Supreme Court Speaks*, N.Y.L.J., Mar. 29, 1990, at 5, 6.

178. Interco Inc. v. City Capital Assocs. L.P., 556 A.2d 1070 (Del. Ch. 1988) (unpublished table decision).

179. *See, e.g.*, Laurie P. Cohen, *Lipton Tells Clients That Delaware May Not Be a Place to Incorporate*, WALL ST. J., Nov. 11, 1988, at B7 (discussing Martin Lipton's memorandum to clients recommending reincorporation in other states if the *Interco* decision was not reversed).

180. Under the original plan, Warner shareholders would end up with about 62% of the common stock of the merged entity, with the Time shareholders receiving the remainder. In terms of market capitalization and 1988 net income, Warner was the larger of the two companies.

181. The factual account is taken from the chancery court opinion, *see* Paramount Communications Inc. v. Time Inc., No. CIV.A.10866, 1989 WL 79880, at *2–*17 (Del. Ch. July 14, 1989), and the Delaware Supreme Court opinion, *see* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1143–49 (Del. 1990). *See also* Mirvis, *supra* note 177.

nated the problematic vote by Time's shareholders. Paramount and Time shareholders sought an injunction restraining Time from purchasing Warner shares pursuant to its tender offer.

In the chancery court, Chancellor Allen denied the plaintiffs' motion for a preliminary injunction.[182] Plaintiffs appealed to the Delaware Supreme Court, which affirmed the chancellor's holding but on broader grounds. According to Justice Horsey, plaintiffs' "*Revlon* claim" fails because of "the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or breakup of the corporate entity inevitable, as was the case in *Revlon*."[183] According to Horsey, "*Revlon* duties" are only triggered when "a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. . . . Revlon duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company."[184] Thus, because the Time board's reaction to the Paramount bid was only a defensive response and "not an abandonment

182. The chancellor rejected plaintiffs' claim that the original merger agreement, that, plaintiffs claimed, would transfer control of Time to Warner's shareholders, put Time into a "*Revlon* mode" with the obligation to maximize present share value. *Time Inc.*, 1989 WL 79880, at *24. The chancellor held that when, as in the case of Time and Warner, both companies were widely held public corporations, a stock-for-stock merger left corporate control unaffected: "Control of both remained in a large, fluid, changeable and changing market." *Id.* at *55.

The chancellor also rejected plaintiffs' argument that the Time board had a duty to give shareholders a choice with respect to whether the corporation should be sold. First, the chancellor held that recasting the transaction to avoid a shareholder vote breached no duties because Delaware law did not afford a shareholder vote in the original transaction. Because the original Time-Warner merger was a triangular merger in which Warner and a wholly owned subsidiary of Time would merge, the Delaware General Corporation Law, section 251, did not grant the shareholders of Time a vote; only the shareholders of the Time subsidiary were required to approve the merger, but, as those votes were held by Time, Time's board had the right to vote them. Time shareholders' right to vote on the original transaction arose only because of a New York Stock Exchange rule. Finally, interpreting *Unocal*, the chancellor rejected plaintiffs' claim that the Warner tender offer was a disproportionate response to a noncoercive Paramount offer that did not threaten a cognizable injury to Time or its shareholders. Rather, although the restructuring of the transaction was "reactive in important respects (and thus must withstand a *Unocal* analysis)," *id.* at *68, the Chancellor held that the restructuring was a reasonable response to the threat posed by the Paramount bid to the realization of Time's major strategic plan.

183. Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1990). Like the chancery court opinion, the supreme court's opinion opened with a long account of the Time board's behavior in planning and executing the merger with Warner. Justice Horsey then rejected Chancellor Allen's formulation of the *Revlon* question as a choice between short-term and long-term strategy, and rejected his reliance on the fact that control, both before and after the merger, remained in the market. *Id.* at 1150–51.

184. *Id.* at 1150.

of the corporation's continued existence, *Revlon* duties are not triggered, though *Unocal* duties attach."[185]

With respect to the analysis under *Unocal*, Justice Horsey held that the first part of the *Unocal* test—the requirement that "reasonable grounds for believing that a danger to corporate policy and effectiveness existed"—was satisfied by the directors' showing of good faith and reasonable investigation.[186] But Justice Horsey went somewhat farther, emphasizing that "we have repeatedly stated that the refusal to entertain an offer may comport with a valid exercise of a board's business judgment."[187] Justice Horsey then reached out to reject Chancellor Allen's suggestion in *Interco* that an all-cash, all-shares offer, falling within a range of values that a shareholder might reasonably prefer, "cannot constitute a legally recognized 'threat' to shareholder interests sufficient to withstand a *Unocal* analysis."[188] In contrast to the chancellor's opinion, Justice Horsey construed the threat of the Paramount offer more broadly, noting that Time shareholders might be confused by the Paramount offer or might not fully understand the impact of Paramount's conditions, and that the timing of the Paramount offer to follow issuance of Time's proxy notice could reasonably be viewed to upset, if not confuse, the Time stockholders' vote.[189]

The Delaware Supreme Court's decision in *Time-Warner* was widely viewed as the complete undermining of *Revlon* and as an endorsement of the "just-say-no" defense. In an early article in the *National Law Journal*, Robert Todd Lang, co-managing partner of New York's Weil, Gotshal and Manges, which represented a Warner investment banker, was quoted as saying that "'Although the Supreme Court still hasn't given corporate boards the unlimited right to 'just say no' to hostile bidders, the opinion gives boards the power to say 'no' if they have good business reasons for refusing to negotiate or to consider an unsolicited offer.'"[190]

In an article also published in the *National Law Journal*, leading takeover lawyers at the Skadden, Arps, Slate, Meagher and Flom firm, James C. Freund and Rodman Ward, Jr., read *Time-Warner* broadly. According to their analysis, *Time-Warner*'s narrow interpretation of *Revlon* rendered the doctrine almost irrelevant:

185. *Id.* at 1150–51.
186. *Id.* at 1152.
187. *Id.*
188. *Id.*
189. *Id.* at 1153.
190. Sherry R. Sontag, *Time May Create Broad Takeover Defense*, NAT'L L.J., Mar. 12, 1990, at 14.

> *Time* slips a safety latch onto the *Revlon* trigger. According to the court, corporate reorganizations that don't bust up the company don't give rise to *Revlon* duties to maximize immediate shareholder value. Such duties arise only with "an active bidding process seeking to sell" the company or an effort "to effect a business reorganization involving a clear break-up of the company."
>
> The company most likely to end up in the *Revlon* soup is one which, like Revlon itself, would "abandon its long-term strategy and seek an alternative transaction . . . involving the break-up of the company"—a course of action which is so far "out" as to be barely discernible on the horizon, because it may be just about the only thing that could involuntarily trigger an auction.[191]

With respect to the just-say-no defense, Freund and Ward state:

> The "just say no" defense is definitely looking better and better. While not explicitly endorsing the tactic (which wasn't at issue in the case), the *Time* court's strong support of the business-judgment rule and its reluctance to intervene in the board's management of the company provide genuine muscle to directors' efforts in resisting a takeover. After all, the Supreme Court came right out and said that, "absent a limited set of circumstances as defined under *Revlon*, a board of directors . . . is not under any per se duty to maximize shareholder value in the short term, even in the context of a takeover."[192]

Similarly, Theodore Mirvis, a partner at Wachtell, Lipton, Rosen & Katz who writes often in the *New York Law Journal*, read the Delaware Supreme Court's decision as "an undeniable endorsement of 'Just Say No' where the decision not to redeem the pill is made in good faith and on an informed basis."[193] The supreme court's rejection of the chancery court's decisions in *Interco* and *Pillsbury*, "which cast doubt on a board of directors' right to 'Just Say No' by refusing to redeem a poison pill rights plan in the face of an all-cash, all-shares premium tender offer," was, for Mirvis, a strong endorsement of the defense.[194] Mirvis read the court as holding that directors need not abandon corporate business plans when a bid is

191. James C. Freund & Rodman Ward, Jr., *What's 'In,' 'Out' in Takeovers in Wake of* Paramount v. Time, NAT'L L.J., Mar. 26, 1990, at 22, 23.

192. *Id.* at 25.

193. Mirvis, *supra* note 177, at 6.

194. *Id.* at 5.

received "'unless there is clearly no basis to sustain the corporate strategy.'"[195] The message for directors, according to Mirvis, is that

> [d]irectors' identification of threats will be upheld provided only that the board identifies the threat in good faith and with reasonable investigation; the risk that the stockholders will mistakenly not appreciate the company's long-term value is an approved form of threat, and the directors do not have to negotiate with a bidder before acting on the basis that the bid is too low.
>
> Directors' responses will not be held to be unreasonable even though they preclude stockholder choice and an immediate control premium. Defense can be effective.[196]

Moreover, as Mirvis pointed out, the Delaware Supreme Court seemed to reject explicitly the notion that a firm could unwittingly find itself in "*Revlon*-land."[197] Rather, the *Revlon* duty to maximize current shareholder value is implicated only when a corporation itself initiates a bidding process seeking to sell itself or to effect a reorganization involving a clear breakup of the company, or when a corporation, acting in response to a bid, abandons its long-term strategy and pursues an alternative involving the breakup of the company.[198]

Finally, in extrajudicial statements, Justice Andrew Moore, a justice of the Delaware Supreme Court and a member of the panel that decided *Time-Warner*, seemed to state explicitly that *Time-Warner* validated the just-say-no defense.[199]

Thus, post–*Time-Warner*, one could be excused for concluding that the "rule" in Delaware was that a board of directors could "just say no" to an unwelcome tender offer, and that *Revlon*, once a major feature of the doctrinal landscape, was now confined to its facts and need never apply unless the target board chose to trigger it.

But as Paramount, the loser in the *Time-Warner* case, was to discover to its surprise, reading Delaware cases as establishing "rules" is a deeply misleading and dangerous approach. Beginning in 1983, Paramount (then known as Gulf & Western) began to transform itself from a diffuse con-

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195. *Id.* at 6.
196. *Id.* at 7.
197. *Id.* at 6.
198. *Id.*
199. *'Just Say No' May Be Viable Defense, but Not Carte Blanche, Panelists Say*, 21 Sec. Reg. & L. Rep. (BNA) 1832 (Dec. 15, 1989) ("Although the Delaware Supreme Court has not yet tackled the 'just say no' defense head on, Justice Andrew G.T. Moore II of that court told a Dec. 8 conference that case law indicates that it may be a viable defense to hostile takeovers.").

glomerate into an entertainment and publishing company.[200] Its unsuccessful attempt to acquire Time in 1989 was one stage along this road. Beginning in 1990, Paramount began to consider a merger with Viacom. Preliminary negotiations were unproductive. Throughout this period, Paramount's board of directors devoted substantial attention to Paramount's strategic goals and the steps taken by management to achieve those objectives.

In the spring of 1993, negotiations became more serious. Vigorous, arms-length negotiations over price and terms of a merger were conducted throughout the spring and summer of 1993, finally resulting in an agreement in mid-September. The merger agreement provided for the conversion of Paramount shares into Viacom shares and cash, with a total value of around $69 per share. In addition, Paramount's board agreed not to shop the company, unless counsel determined that it had a fiduciary obligation to do so, and to pay Viacom a termination fee of $100 million, payable if Paramount terminated the merger agreement as the result of a competing transaction, if shareholders rejected the merger, or if the board recommended a competing transaction. Finally, Viacom was granted a "lockup" stock option. In announcing the merger, Redstone and Davis issued a joint press release stating that the proposed merger offered the "greatest long term benefits to stockholders and audiences around the world" and that no other company could provide Paramount and Viacom what they could offer each other.

But, just as Paramount tried to barge its way into the Time-Warner merger, so QVC tried to derail the Viacom-Paramount merger. A week after the Paramount board approved the Viacom-Paramount merger, QVC proposed an acquisition of Paramount by QVC at approximately $80 per share in cash and securities. Paramount, after extensive board meetings, documentation, and reports by consultants, rejected QVC's offer, adhering to its original plan to merge with Viacom, albeit now at a higher price, as Viacom had raised its offer in response to QVC's bid. Over the ensuing weeks, as the QVC offer became more definite and less contingent, Paramount adhered to its intention to merge with Viacom.

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200. This account is drawn from the Delaware Chancery and Supreme Court opinions. *See* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

If one read *Time-Warner* as validating the just-say-no defense, then one might reasonably conclude that the Paramount board could "just say no" to QVC. After all, they had a long-term plan to expand as a communications and entertainment company. They—like Time and Warner—had looked carefully at potential merger partners and had concluded that the fit with Viacom was best. The directors had reviewed a detailed analysis prepared by the management consultants Booz Allen that indicated that the merger with Viacom would "create over $3BN [billion] more incremental shareholder value than a merger with QVC."[201] This situation, Paramount could and did argue, was unlike *Smith v. Van Gorkom*[202]

> because the directors were at all times fully informed and attentive to their duties. And [the facts] are not controlled by *Revlon*, because Paramount did not put itself up for sale, initiate an active bidding process, or abandon a long-term business strategy by seeking or effecting a reorganization or other transaction involving the breakup of the company.[203]

Rather, said Paramount, this case was just like *Time-Warner*: a corporation, pursuing a well-thought-out long-term plan that the board believed "[would] afford higher long term value to shareholders and [would] be in the corporation's best long-run interests,"[204] rejected a last minute attempt to scuttle it.

But it turns out that such a reading was badly mistaken. Paramount lost in both the Delaware Chancery and Supreme Courts, just as it had lost in the *Time-Warner* case. Both courts enjoined the selective removal of the poison pill and the stock lockup, both of which were designed to facilitate the Viacom transaction. Why?

One can tell a doctrinal story distinguishing *Time-Warner*, as both the chancery and supreme courts did. In the chancery court, Vice Chancellor Jacobs, after noting the arguments that *Time-Warner* significantly reformu-

201. QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1255 (Del. Ch. 1993) (citation omitted).

202. 488 A.2d 858 (Del. 1985) (holding that directors in a takeover situation breached their duty of care).

203. *QVC*, 635 A.2d at 1263–64.

204. *Id.* at 1263.

lated the circumstances triggering *Revlon*, avoided the general doctrinal issue. Rather, according to Jacobs, the critical circumstance is that "the Paramount board has committed the company to a transaction that will shift majority voting control from Paramount's public shareholders to Mr. Redstone."[205]

The Delaware Supreme Court told a similar doctrinal story. Chief Justice Veasey, with Justices Moore and Holland (both of whom were on the panel that decided the *Time-Warner* case), affirmed, likewise finding the change of control to Redstone critical in distinguishing *Time-Warner*. Contrary to Paramount's argument, the Delaware Supreme Court argued:

> [O]ur decision in *Time-Warner* expressly states that the two general scenarios [when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company] are not the only instances where "*Revlon* duties" may be implicated. The Paramount defendants' argument totally ignores the phrase "without excluding other possibilities." Moreover, the instant case is clearly within the first general scenario set forth in *Time-Warner*. The Paramount Board, albeit unintentionally, had "initiate[d] an active bidding process seeking to sell itself" by agreeing to sell control of the corporation to Viacom in circumstances where another potential acquiror (QVC) was equally interested in being a bidder.[206]

Time-Warner and *Viacom* are two different cases. As a technical matter, the cases—like all cases—are distinguishable. But the doctrinal arguments are not particularly persuasive: The Delaware Supreme Court in *Time-Warner* had expressly refused to adopt the chancery court's attempt to distinguish *Revlon* on the basis of whether a change of control was present. Similarly, the notion that a firm could "unintentionally" put itself up for sale was likewise rejected in *Time-Warner*. After all, if it could be said that the Paramount board had (albeit unintentionally) initiated an active bidding process seeking to sell itself, the same could have been said of the Time board. The music in the two opinions is unmistakably different. Is there another basis on which the two cases are more consistent?

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205. *Id.* at 1265.
206. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 47 (Del. 1994).

If it is the factual narratives that constitute the standard in Delaware fiduciary duty cases, as I argue, the cases are far more consistent. In *Time-Warner*, fully informed directors acted deliberately pursuant to a well-thought-out long-term plan. Along comes Paramount, which tries to stop the Time board. In response, the directors reject Paramount's efforts and determine to continue their long-term plan. In *Viacom*, a strong-willed CEO misleads the board, keeps crucial information from them, prevents them from discussing the terms of the bid with Barry Diller, and structures the transaction so that QVC is at a serious disadvantage because of personal antipathy for Diller. From this perspective, the cases are completely consistent with Delaware norms. Strong-willed CEOs who dominate directors are disfavored.[207] Allowing personal antipathy for a bidder to interfere with the board's serious consideration of the bid is wrong.[208] Tilting the playing field towards management's preferred bidder immediately raises questions.[209]

In this regard, consider the chancery court's opinion. In detailing the various rounds and the eventual terms of the deal, Vice Chancellor Jacobs emphasized that no matter how the merger was structured, Redstone, the controlling shareholder of Viacom, would end up as controlling shareholder of the combined enterprise.[210]

The opinion then continues, describing QVC's feared and unwelcome acquisition proposal and Paramount's response: delay, delay, delay. Throughout, management gave very negative assessments of QVC's offers, claiming that they were subject to numerous conditions and uncertainties. One director testified that management's summary

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207. *Cf.* Cede & Co. v. Technicolor, Inc., 636 A.2d 956 (Del. 1994); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Guth v. Loft, 5 A.2d 503 (Del. 1939).

208. See, for example, Michel Bergerac's "strong personal antipathy" for Ronald Perelman in *Revlon*, 506 A.2d at 176.

209. See, for example, the behavior of Macmillan's Chairman and Chief Executive Officer Evans and its President and Chief Operating Officer Reilly in *Macmillan I*, 552 A.2d 1227 (Del. Ch. 1988).

210. QVC Network, Inc. v. Paramount Communications Inc., 635 A.2d 1245, 1250 (Del. Ch. 1993). The style of Jacobs' opinion is particularly noteworthy from the standpoint of this Article. It self-consciously follows the dramatic form. For example, part I.C. of the opinion is headed "Enter QVC," with the first subheading, "Bidders Beware." *Id.* at 1252. Subsequent sections read as if they are describing subsequent scenes, as indeed they are. The whole "fact section" of the opinion reads like a drama.

> created a negative impression of the QVC offer from the outset of the meeting: "My reaction was that this was not what I consider a live offer. It was full of contingencies and I would consider holes in it and I was very—by the time I got through reading this, I was very negative on the whole subject."[211]

Here we get to the board's crucial failures. Although it appears that the board focused its attention on the contingencies of the QVC offer rather than the comparative economic merits of both offers,

> [n]o director suggested that inquiries be made to QVC to ascertain whether its financing conditions could be resolved, and no director asked Lazard to discuss whether the QVC offer was financeable . . . .
>
> In sum, although financing concerns were central to the board's rejection of the QVC proposal, the board did not request that management obtain more information from QVC regarding financing as it did at its September 27 meeting. Instead, and with this limited data regarding the conditions of QVC's offer, the board simply followed management's lead in rejecting the unwelcome offer.[212]

These findings echo *Macmillan I*, with the CEO's description of Bass as a "greenmailer" serving more to propagandize than to inform the board.

At the crucial moment—the November 15 board meeting, by which point it was clear that QVC's bid offered a higher present value to shareholders—management and the board failed to fulfill their duties to the shareholders:

> The defendants make much of the "conditions" to QVC's tender offer and of that offer's supposedly illusory nature. The board is, of course, entitled to take such conditions into account in evaluating the QVC bid. But, the board's position might be more persuasive had management or the board first chosen to discuss those conditions with QVC, to ascertain which of them would likely be fulfilled or waived, before concluding *a priori* that the conditions were fatal and dismissing them out of hand. It is commonplace for tender

211. *Id.* at 1257.
212. *Id.* at 1258 (citations omitted).

> offers to have conditions of some kind. That, however, does not render them "illusory." If the mere existence of conditions permitted a board to ignore a higher competing bid for control on that basis alone, *Revlon* and *Unocal* would have little meaning. In this case, discussions with QVC would have revealed (for example) that QVC's financing commitments would soon be in hand. Here, the board did not even ask QVC on November 15 (as it had in September) to produce evidence of its financing. A discussion with QVC would also have revealed that QVC had received (or would imminently receive) Hart-Scott-Rodino antitrust clearance. But meeting with QVC was the last thing management wanted to do, and by skillful advocacy, management persuaded the board that no exploration was required.[213]

The board's failure even to talk with QVC is the crucial finding. In doctrinal terms, this is translated into a finding that the board was not adequately informed. In substantive terms, this is a fact-specific finding of the board's lack of good faith. The board went through the steps they thought *Time-Warner* required—they had a long-term plan—but they evidently did not do so with the proper intentions. They did not do so in good faith.

In the Delaware Supreme Court opinion affirming Vice Chancellor Jacobs' opinion, the same facts are emphasized and the same themes sounded:

> When the Paramount directors met on November 15 to consider QVC's increased tender offer, they remained prisoners of their own misconceptions and missed opportunities to eliminate the restrictions they had imposed on themselves. Yet, it was not "too late" to reconsider negotiating with QVC. . . . Nevertheless, the Paramount directors remained paralyzed by their uninformed belief that the QVC offer was "illusory." This final opportunity to negotiate on the stockholders' behalf and to fulfill their obligation to seek the best value reasonably available was thereby squandered.[214]

213. *Id.* at 1269.
214. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 50 (Del. 1994).

Subsequently, the Court concludes:

> The directors' initial hope and expectation for a strategic alliance with Viacom was allowed to dominate their decisionmaking process to the point where the arsenal of defensive measures established at the outset was perpetuated (not modified or eliminated) when the situation was dramatically altered. QVC's unsolicited bid presented the opportunity for significantly greater value for the stockholders and enhanced negotiating leverage for the directors. Rather than seizing those opportunities, the Paramount directors chose to wall themselves off from material information which was reasonably available and to hide behind the defensive measures as a rationalization for refusing to negotiate with QVC or seeking other alternatives. Their view of the strategic alliance likewise became an empty rationalization as the opportunities for higher value for the stockholders continued to develop.[215]

And then, in a peculiarly apologetic and defensive final paragraph, Chief Justice Veasey responds to those who would accuse him of inconsistency with the *Time-Warner* case:

> It is the nature of the judicial process that we decide only the case before us—a case which, on its facts, is clearly controlled by established Delaware law. Here, the proposed change of control and the implications thereof were crystal clear. In other cases they may be less clear. The holding of this case on its facts, coupled with the holdings of the principal cases discussed herein where the issue of sale of control is implicated, should provide a workable precedent against which to measure future cases.[216]

In an illustration of how corporate law norms are disseminated, at least in the high-profile cases, a contemporaneous *Wall Street Journal* article sent out the message conveyed by the Delaware courts, and supplemented it with independent research of its own.[217] The article detailed Davis's

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215. *Id.* at 51.

216. *Id.* Finally, and consistent with my overall view of Delaware law as a critical part of a system of norms of behavior, the opinion contains an addendum in which the Delaware Supreme Court castigates the Texas lawyer defending the deposition of one of the Paramount directors for his abusive and unprofessional conduct. *Id.* at 51–56.

For an attempt to provide an internally consistent theory that reconciles these cases, see Kahan, *supra* note 10.

217. The *Journal* story amplifies the court's opinion:

> In a stuffy, windowless conference room on a bleak November afternoon, Paramount Communications Inc.'s board of directors found itself in the dark—again.

domineering personality,[218] and his attempts to drive away Malone and Diller. It also describes a passive board with personal loyalty to Davis.[219]

Casts off and ties loosened, directors had gathered at this hastily convened meeting at Paramount headquarters to evaluate competing bids for the company. They knew full well that their strong-willed chairman, Martin S. Davis, was determined to go with a friendly Viacom Inc. offer, even though home-shopping giant QVC Network Inc. had just sweetened a hostile bid that now was valued at $1.2 billion more.

Mincing no words, Mr. Davis attacked the QVC bid as containing too many conditions. Then Paramount's investment advisers from Lazard Freres & Co. weighed in with their written opinion that Viacom's $85-a-share offer was fair.

Director George Weissman . . . raised his hand. Why, he asked, hadn't Lazard evaluated QVC's $90-a-share bid, too? Lazard's Felix Rohatyn, according to court records, had this reply: "We haven't been asked."

And with that, the board promptly dropped the issue. QVC's bid wasn't to be taken seriously.

The November incident wasn't the only time during the continuing $10 billion takeover fight that Paramount directors weren't given the full story. In memos and statements filed in a suit QVC brought against Paramount in Delaware Chancery Court, a picture emerges of a chief executive so determined to ward off QVC's overtures that he sometimes withheld crucial information. On numerous occasions, the board wasn't given a chance to weigh information that would have put preferred suitor Viacom in an unflattering light—or made archfoe QVC's bid look more attractive.

Mr. Davis had a willing partner in this exercise in denial: The board itself, which, as Mr. Davis himself put it at one point, followed him "in lockstep" toward the Viacom deal. For the most part, directors didn't question Mr. Davis's rejection of the higher QVC bid, court papers and interviews show; and indeed, some legal experts say the board had reason to believe it was on solid ground. Though several of the directors—including Lazard partner Lester Pollack as well as one of Mr. Davis's top lieutenants, Donald Oresman—had reservations about excluding QVC, they rarely if ever voiced their concerns to fellow board members.

The extent of the board's complacency, and Mr. Davis's willingness to exploit it, caught up with Paramount last week. Delaware's Supreme Court upheld an earlier ruling forcing Paramount to consider both bids equally, effectively throwing the bidding for Paramount wide open. The lower-court ruling it upheld had lashed out harshly against Mr. Davis and his passive board. "By skillful advocacy," Vice Chancellor Jack B. Jacobs of the Delaware Chancery Court wrote in his opinion, "management persuaded the board that no exploration [of QVC's offer] was required."

Johnnie L. Roberts & Randall Smith, *The Plot Thickens: Who Gets the Blame for Paramount Gaffes? Big Cast of Characters*, WALL ST. J., Feb. 13, 1993, at A1.

218. "[H]e is characterized even by his fans as a bully who berates his closest allies with the slightest provocation." *Id.*

219. As the *Journal* told it: "Several were appointed by his late predecessor, Charles Bludhorn, at a time when Mr. Davis was in charge of director relations. He courted them so assiduously—mixing a flattering deferential attitude with favors like tickets to movie premieres and Knicks games—that they remain loyalists to this day." *Id.* at A6.

In an interesting part of the article that does not track the Delaware opinions, the *Journal* confirms the concern that players have with how they are portrayed by the Delaware courts:

Paramount's own investment advisers at Lazard had also asked whether the company should go into an "auction mode." The bankers, led by mergers heavyweight Mr. Rohatyn, 65, and Steven Rattner, 41, a boyish former newspaper reporter who is a rising

Although doctrinally the fit between *Time-Warner* and *QVC* is questionable, if not implausible, from the internal perspective of Delaware fiduciary duty cases, the fit is in fact much closer. The principal difference between the two cases is that the managers and board behaved well in *Time-Warner* and badly in *QVC*.[220]

And one can see how Paramount went astray. If one thought that *Time-Warner* stood for the proposition that a board need not depart from a long-term strategic plan simply because another bidder showed up—a perfectly reasonable reading of the opinion in *Time-Warner*—then one can understand why Martin Davis and Donald Oresman, having concluded that they were following a long-term strategic plan in the interests of Paramount, felt reasonable in giving Diller the brush-off.

But that is to misunderstand what the Delaware courts are up to. If one instead reads *Time-Warner* as yet another example of a case in which the courts approve directorial conduct because they are convinced that the directors behaved in *good faith* and with *due care*, then one would never advise a client to give Barry Diller the brush-off on the grounds that *Time-Warner* authorized just that action. And, indeed, I would be willing to bet that Paramount's Delaware corporate lawyers (either those practicing in Delaware or the experienced outside counsel practicing Delaware law in New York) advised against this course of action.

The test of my claim is a counterfactual one: Suppose that rather than giving Diller the brush-off, Davis and Paramount had sat down with him early and often, had given him a full opportunity to present his proposal, to discuss and describe his financing, to discuss his plans for the future of the company, and so forth. And suppose that after these extensive discussions, the Paramount board, after long and careful consideration, had decided that

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star at the firm, were growing worried. They had their reputations to consider, and didn't want to be pilloried if Mr. Davis was criticized for proceeding improperly.

Id.

220. The epilogue to the decision is interesting. After the Delaware Chancery Court's opinion, and its affirmance by the supreme court by order, the bidding between QVC and Viacom continued, see-sawing back and forth. Ultimately, Viacom prevailed with a $10 billion offer ($107 per share in cash for 50.1% of Paramount stock, and securities for the remaining shares). Randall Smith, *Wall Street's Final Analysis: Might Made Right*, WALL ST. J., Feb. 16, 1994, at B1. This represented an increase of $38 per share over the original deal that Viacom struck with Paramount at $69 per share, an increase of around $2 billion, and a much larger percentage of cash. *Id.*

a merger with Viacom was in the long-term interests of Paramount because Viacom offered a much better fit. Would the case have come out the other way? No one, of course, knows, but I have no doubt that Paramount would have vastly increased its chances of success had it done so.

Finally, one cannot say that *QVC* overrules *Time-Warner* in any straightforward way. In an interesting attempt to put a spin on the *QVC* case in the *New York Law Journal*, Martin Lipton and Theodore Mirvis, of Wachtell Lipton, who (somewhat ironically) represented QVC, wrote "*10 Questions and Answers Raised by Delaware 'Paramount' Decision.*"[221] Recall that it was Mirvis who argued after the *Time-Warner* case that the case represented an acceptance of the just-say-no defense.[222] Now, post-*QVC*, Lipton and Mirvis adhere to this view, despite the fact that they had just convinced the Delaware courts not to let Paramount "just say no" to QVC's bid. The question, as always, is all in how you say it:

> The Paramount decision expressly states that it does not apply to a situation where a company is following its own strategic plan and has not initiated a takeover situation. Where the target of a hostile bid wishes to consider rejecting the bid and remaining independent it is critical that the board of directors follows the correct process and have the advice of an experienced investment banker and legal counsel.[223]

Despite the mildly self-serving quality of the advice, Lipton and Mirvis are clearly right. Indeed, if one looks back at their reading of *Time-Warner*, it is consistent. Mirvis earlier argued that *Time-Warner* was "an undeniable endorsement of 'Just Say No' *when the decision not to redeem the pill is made in good faith and on an informed business basis.*"[224] What Lipton and Mirvis understood, and what someone on the Paramount side did not, is that in Delaware, the qualification "in good faith and on an informed basis" is not an empty formula but in fact is nearly the whole show.

Indeed, *QVC* makes clear that going through the motions without the right intention is legally risky in Delaware. Paramount did meet with

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221. Martin Lipton & Theodore Mirvis, *10 Questions and Answers Raised by Delaware 'Paramount' Decision*, N.Y.L.J., Feb. 10, 1994, at 1.

222. *See* Mirvis, *supra* note 177.

223. Lipton & Mirvis, *supra* note 221, at 5.

224. Mirvis, *supra* note 177, at 6 (emphasis added).

Diller. They did "consider" his offer. But they did everything grudgingly, as if they were simply going through the motions, having previously decided the outcome. And note something else: A reliable way of compiling a compelling record of good faith and reasonable inquiry is for lawyers to counsel their clients to act in good faith and to inquire diligently, guiding them through the steps that this requires. This is what the Delaware courts are, on my view, seeking to insure, first and foremost.

B. Shareholder Litigation

Shareholder litigation has come under mounting criticism of late. The conflicts of interest inherent in the relationship between class counsel and shareholder plaintiffs have been analyzed in detail.[225] More recently, Kraakman, Park, and Shavell have looked carefully at the relationship between shareholders' incentives to sue and corporate value, finding that shareholders incentives may be either excessive or insufficient relative to a goal of maximizing corporate value.[226]

Roberta Romano, in the most careful empirical study to date, could find little direct benefit to shareholders from shareholder litigation.[227] Plaintiffs had abysmal success in litigated cases. In her sample, plaintiffs won no judgments for damages or equitable relief. Of the two-thirds of the cases that settled, only half involved a monetary recovery, while attorneys received fees far more frequently. In addition, the settlements are highly skewed, which, suggests Romano, is consistent with either of two troubling

225. *See* John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987); Coffee, *supra* note 116; John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, LAW & CONTEMP. PROBS., Summer 1985, at 5; *see also* Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

226. Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L.J. 1733 (1994).

227. Romano, *supra* note 10; *see also* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986).

hypotheses: that most fiduciary breaches involve only minor harm to shareholders, or that most shareholder suits are without merit.[228]

Romano finds this "gloomy assessment of the value of shareholder litigation . . . cross-validated by examining the market's evaluation of lawsuits."[229] Specifically, standard event study methodology fails to reveal any benefit to shareholders from litigation. Similarly, Romano finds little evidence of specific deterrence.[230]

Other recent work has been consistent with Romano's "gloomy assessment." Janet Cooper Alexander's study of a small set of securities class actions concluded that the merits did not matter, that is, that the merits of the individual cases had no bearing on the settlement amount.[231] This finding, which has been strongly criticized from a variety of directions,[232] is consistent with a view that class actions are nothing more than a tax on public offerings, failing to distinguish between prohibited and permitted behavior.

But the preceding case study of the elaboration of norms governing MBOs places the role of shareholder litigation in a different light and raises significant questions regarding both the current wisdom regarding the excessive quantity of shareholder litigation as well as the measurement of the benefits conferred by such litigation. Two features emerge from the study of the MBO cases and will be presented in more detail below. First, and perhaps most striking, there are very few of these cases. During a period when MBOs were one of the hottest deal vehicles around, they only yielded fifteen Delaware cases, with twenty-one opinions, over the period 1980–1990. Further, these opinions came extremely late in the day. By the time the norms were fully elaborated, MBOs' day had nearly passed.

Second, the previous discussion of the MBO cases illustrates the role that shareholder litigation plays in the elaboration of corporate norms, a

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228. Romano, *supra* note 227, at 60–61.

229. *Id.* at 65.

230. *Id.* at 84.

231. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497 (1991).

232. For a summary of the criticism, see John C. Coffee, Jr., *The 'New Learning' on Securities Litigation*, N.Y.L.J., Mar. 25, 1993, at 5.

role sometimes mentioned but not often documented.[233] This benefit—a public good—is separate from and in addition to compensation, specific deterrence, and general deterrence, the three factors normally considered.

1. The Strange Paucity of Cases

Management buyouts were one of the hottest transactions during the 1980s. Moreover, the received wisdom is that lawsuits are filed in almost every transaction. Therefore, the fact that there were only fifteen MBOs that yielded published or unpublished Delaware opinions in the 1980s is surprising and significant.

Getting a handle on the actual number of MBOs of publicly held companies is not easy. First, there is the definitional problem: How large a stake, or how early an involvement in a transaction, must management have before it is categorized as a "management buyout"? Second, one wants to distinguish between management buyouts of publicly held companies and leveraged buyouts more generally and, in particular, leveraged buyouts of divisions or privately held companies, both of which pose much less severe conflicts of interest. Because management is so often involved in LBOs of publicly held companies, often as part of one of the bidding groups, or at least as a post-deal equity participant, the frequency and size of leveraged buyouts of publicly held companies gives an approximation of the number of MBOs.

Table I, drawn from figures in *Mergers & Acquisitions*,[234] lists the number and value of LBOs of publicly held companies from 1981, when *Mergers & Acquisitions* began collecting figures on such transactions, until 1990, by which time the Delaware jurisprudence was well developed and LBOs began to go into at least a temporary decline.

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233. *See, e.g.*, Donald E. Schwartz, *In Praise of Derivative Suits: A Commentary on the Paper of Professors Fischel and Bradley*, 71 CORNELL L. REV. 322 (1986).

234. *See Leveraged Buyout Trends*, *supra* note 30.

TABLE I: LEVERAGED BUYOUTS OF PUBLICLY HELD COMPANIES 1981–1990[235]

Year	No. of Deals	Value ($ billion)
1981	17	2.16
1982	27	2.46
1983	26	1.79
1984	60	13.18
1985	41	10.38
1986	43	24.91
1987	32	22.43
1988	74	26.54
1989	59	50.03
1990	25	8.14
Total	404	$162.02

By contrast, consider the number and timing of the MBO cases from Delaware. Table II is a listing of all Delaware MBO cases that yielded opinions that were reported on Lexis or Westlaw, cross-checked by inquiries and examination in the Delaware Chancery Court. As I discuss further below, there are substantial reasons to conclude that this is close to the complete universe of MBO cases filed in Delaware during the relevant time period.

235. *LBO Signposts*, *supra* note 30, at 60; *Leveraged Buyout Trends*, *supra* note 30, at 81.

TABLE II: DELAWARE MBO CASES 1980–1990

Case	Form	Outcome			Attorney Fee	
		Motion	Final	Recovery to Class	Req'd	Granted
1. EAC (op: 8/85)	Individual	Plaintiff	NA	NA	NA	NA
2. *Nat'l Medical Care* (op: 6/86)	Class	Plaintiff	Dismissed w/o Prejudice	$0	$0	$0
3. *Restaurant Assocs.* (op: 10/87, 9/90)	Class	Defendant	Settled	$2.5M	$750K	$750K
4. *Shoe-Town* (op: 1/88, 2/90)	Class	Defendant Plaintiff	Settled	$2.15M	$525K	$525K
5. *Becor* (op: 2/88)	Class	Settlement Approved	Settled	Benefit Conferred	$350K	NA
6. *J.P. Stevens* (op: 4/88)	Class & Bidder	Defendant	Settled	Benefit Conferred	$950K	$950K
7. *Macmillan* (op: 7/88, 10/88, 5/89)	Class & Bidder	Plaintiff	Settled	Benefit Conferred	$18M	$2M

1. EAC: Plaintiff's motion for preliminary injunction granted; defendants criticized.
2. *National Medical Care*: Defendants' motion to dismiss denied; defendants criticized.
3. *Restaurant Associates*: Plaintiffs' motion for preliminary injunction denied; defendants praised.
4. *Shoe-Town*: Plaintiffs' motion for preliminary injunction denied; defendants criticized; defendants' motion to dismiss denied.
5. *Becor*: Settlement approved.
6. *J.P. Stevens*: Plaintiffs' motion for preliminary injunction denied; defendants criticized.
7. *Macmillan*: Plaintiffs' motions for preliminary injunction granted (twice); defendants criticized.

TABLE II: DELAWARE MBO CASES 1980–1990 (continued)

Case	Form	Outcome			Attorney Fee	
		Motion	Final	Recovery to Class	Req'd	Granted
8. *Fort Howard* (op: 8/88)	Class	Defendant	Settled	$13.4M	$3M	$3M
9. *Amsted* (op: 8/88)	Class	Settlement Approved	Settled	Benefit Conferred	$300K	$300K*
10. *KDI* (op: 11/88, 12/90)	Class	Defendant	Dismissed	$0	$0	$0
11. *RJR Nabisco* (op: 1/89)	Class & Bidder	Defendant	Settled	$57M	$9M	$9M
12. *Formica* (op: 3/89)	Class	Defendant	Settled	Additional Disclosure	$250K	$175K
13. *American Home Shield* (op: 10/89, 1/91)	Class	Defendant Plaintiff	Settled	$2.7M	$800K	$800K
14. *Young's Market* (op: 12/89)	Class	Defendant	Settled	$1.45M	$500K	NA
15. *General Instruments* (op: 8/90)	Class	Defendant	Dismissed	$0	$0	$0

8. *Fort Howard*: Plaintiffs' motion for preliminary injunction denied; defendants criticized.
9. *Amsted*: Settlement approved; court ordered that $75,000 of the $300,000 attorney fee be awarded to counsel for the objector (*).
10. *KDI*: Plaintiffs' motion for preliminary injunction denied; defendants' motion for summary judgment granted.
11. *RJR Nabisco*: Plaintiffs' motion for preliminary injunction denied; defendants praised.
12. *Formica*: Plaintiffs' motion for preliminary injunction denied; mild criticism of defendants.
13. *American Home Shield*: Plaintiffs' motion for preliminary injunction denied; defendants criticized; defendants' motion to dismiss denied.
14. *Young's Market*: Plaintiffs' motion for preliminary injunction denied.
15. *General Instruments*: Plaintiffs' motion for preliminary injunction denied.

When Tables I and II are compared, the disproportion between the number of reported cases and the number of deals is staggering. Between 1980 and 1990, there were approximately 400 LBOs of public companies in the United States, many of which involved management in some form or other. By contrast, there were only fifteen litigated MBO deals in the Delaware courts, yielding twenty-one opinions.[236]

The gigantic gap raises several possibilities. First, it is possible that the accepted wisdom that litigation is brought in every deal is simply an overstatement.

Second, it could be that suits were filed in Delaware in many of the other deals but that they were settled or dismissed without order or opinion and therefore do not show up on Lexis or Westlaw. This, however, seems not to be the case because all of these cases are filed as class actions and therefore need judicial approval before being dismissed. In addition, officials of the Delaware Chancery Court do not know of any such MBO cases.

A third possibility—consistent with the received wisdom—is that there are lots of other cases filed, but they are not filed in Delaware. In other words, most of the cases that arise out of these deals arise either under the law of other states (for non-Delaware corporations)[237] or under the federal securities laws, with state claims added, if at all, as pendent state law claims. If correct, this is important: Although there were some important early MBO cases outside of Delaware,[238] no significant jurisprudence of MBOs developed in any other state. There seems to be a minimum number of cases required to generate a reasonably well-specified jurisprudence, and only Delaware seems to have passed this threshold.

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236. The question of how often suits are filed in management buyout cases during the relevant period is complicated and unclear. In a recent study, *see* Easterwood et al., *supra* note 30, the authors studied 214 buyout targets between 1978–1988. According to the authors, shareholders filed suit in 83 of the transactions (38.8%). In only five instances were there court decisions.

Because the authors do not distinguish between cases filed in Delaware versus cases filed in other states, or between cases filed under state law and cases raising federal causes of action, their findings do not cast much light on what happened to the 78 cases that did not result in a court decision.

237. *See* Easterwood et al., *supra* note 30 (of the 218 sample suits, only 102 involved Delaware corporations).

238. *See, e.g.*, Edelman v. Freuhauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

2. The Time Lag

The second feature that leaps out from the comparison of Tables I and II is the timing of the Delaware cases: They come very late in the deal cycle. Although MBOs of significant publicly held companies, as a transactional form, got going seriously around 1981, the cases came so slowly that the defining trilogy of *Macmillan*, *Fort Howard*, and *RJR Nabisco*[239] was not written until 1988 and 1989.[240]

This lag, which is endemic to law but which is exacerbated by rapidly developing transactional forms,[241] had several consequences. First, it interfered with attempts by the Delaware courts to articulate standards in "real time." This is a problem that all courts interpreting standards face: Ex post decision making restricts courts to what comes before them. To the extent that standards only emerge over time as narratives accumulate, the process of norm articulation will lag behind deals.

This reactive stance, combined with what I claim to be a fairly self-conscious attempt by the courts to shape the standards of conduct in a rapidly developing transactional form, may be the driving force behind judicial attempts to surpass it. Thus, the "preachiness" of Delaware MBO opinions, the pattern of criticizing conduct even when no injunction is issued, and judges' extrajudicial utterances can all be read as attempts to be heard on a critical matter in the absence of a case raising just the right issue and in the absence of the articulation (or articulability) of a governing rule. Such utterances are, in a literal sense, advisory opinions.

As such, these judicial comments share both the vices and virtues of advisory opinions. They are useful insofar as they help lawyers and parties plan transactions. They are problematic, however, precisely when they are

239. *See supra* Part I.B.5.

240. A complementary explanation for the timing of the cases was suggested to me by Lawrence Hammermesh in a personal conversation. As Hammermesh points out, the *Revlon* case, which raised plaintiffs' hopes of prevailing in challenges to board action in takeovers, was decided in 1985, and may well have triggered the increase in challenges to MBO transactions. That *Revlon* had such an effect is almost certainly true. But, strikingly, even in the post–*Revlon* enthusiasm, the number of challenges to MBOs as a percentage of the number of deals was small.

241. *See generally* Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993); Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of the Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989).

"issued" without a full factual record. Given the fact-specific quality of Delaware opinions, this may make them particularly problematic. At the same time, the disproportion between the number of cases and transactions may make them especially necessary.

The lack of law also pushes transactional lawyers into a central and critical position. The MBO cases show that in a world of vaguely defined norms and rapidly evolving transactional forms, what the business lawyer tells the client—rather than what the judge announces to the world—is the "law." We see traces in the "memoranda to our clients" genre, but the core of this body of law resides in the firms and in the advice given to clients in confidence. This advice necessarily is given in the shadow of ex post judicial review, with, as we have seen in the Delaware cases, the possibility, albeit somewhat remote, of upsetting the deal. In only two of the cases, *EAC*[242] and *Macmillan I*,[243] did the court enjoin a transaction, the ultimate failure for a business lawyer. Although in other cases criticism may have signaled a refusal to grant a defendant's motion to dismiss, and may have led to a subsequent monetary settlement, such settlements can be budgeted for and do not destroy a deal.

One particularly striking manifestation of the tension in the production of law between the judges and the lawyers can be found in the competing attempts to put a "spin" on new opinions. If, for example, one compares Chancellor Allen's takeover opinions with, for example, Theodore Mirvis' columns in the *New York Law Journal*, one immediately feels that tension.[244] In part, one observes competing attempts to convince the Delaware Supreme Court. But one also observes attempts to shape accepted practice in the transactional community.

MBOs again provide a good illustration. A per se ban on MBOs is conceivable. Serious and important commentators made just that argument in the 1970s.[245] When MBOs started to arrive in significant numbers in the early 1980s, the law was clearly unsettled. Lawyers did these deals and, by the time the Delaware courts had an opportunity to articulate standards, that is, by the latter half of the 1980s, hundreds of deals had already been

242. EAC Indus., Inc. v. Frantz Mfg. Co., No. CIV.A.8003, 1985 WL 3200 (Del. Ch. June 28, 1985), *aff'd*, 501 A.2d 401 (Del. 1985).

243. Robert M. Bass Group, Inc. v. Evans (*In re* Macmillan, Inc. Shareholders Litig.), 552 A.2d 1227 (Del. Ch. 1988).

244. Theodore N. Mirvis, *What Triggers* 'Revlon'? *Some New Answers*, N.Y.L.J., Dec. 3, 1990, at 5 ("Just when you thought it was safe to go back in the water . . . . along comes the decision by the Delaware court of Chancery in Roberts v. General Instrument."); *see also* Lipton & Mirvis, *supra* note 221, at 1.

245. *See, e.g.*, Brudney & Chirelstein, *supra* note 26.

done. It was too late in the day to hold MBOs illegal per se. By doing these sorts of deals, in the absence of controlling case law, law office practice at least influenced and probably constrained judicial decisionmaking.

3. Case Law as a Public Good

In the closing paragraph of her article, Roberta Romano notes:

> [O]ne potential social benefit from a shareholder suit that is ancillary to its role as a governance device has not been discussed: legal rules are public goods. All firms benefit from a judicial decision clarifying the scope of permissible conduct. The benefit of clarification is not simply deterrence of future managerial misconduct, but rather, given the contractual setting of the corporation, identification of a rule around which the parties (managers and shareholders) can transact.[246]

But Romano seems skeptical of such benefits:

> As few suits produce a legal rule (only two in this sample), this explanation of lawsuit efficacy turns on the need for a large number of lawsuits in order to obtain a ruling. There is no reason to believe that the current level of litigation is optimal in relation to any public good benefits, but I leave that cost-benefit calculation for another study.[247]

Note how the rule-centered view of corporate law, which forms a basis of Romano's skepticism of the efficacy of shareholder lawsuits, understates the public good aspect of shareholder litigation. If I am correct that fiduciary duty law evolves primarily at the level of norms rather than the level of rules, then to focus on the number of cases that "produce a legal rule"—only two in Romano's sample—is to miss a significant part of the benefit. In the MBO cases, it would be a fair reading of the cases to say that none of the cases individually "produces a legal rule." In none of the cases does the court overrule any prior cases or explicitly adopt any legal rule at all. Instead, all the discussions are couched as elaborations of the duty of care and the duty of loyalty. Indeed, one does not find any new legal "rule" even looking back on the cases as a group. Rather, what we see is the elaboration of the norms of conduct appropriate to management buyouts (all under the guise of applying the standard analysis of the duties

246. Romano, *supra* note 10, at 85.
247. *Id.*

of loyalty and care). From this perspective, each of the cases individually told something significant about legal norms governing management buyouts.

In this context, note the ambiguity in Romano's comment: She allows for the possibility that a large number of cases is needed to produce a legal rule. This either means that you need a large number of lawsuits to yield a lawsuit that changes a legal rule (her actual meaning, I believe), or that a legal "rule" or "standard" only emerges out of a large number of cases. This second possibility seems to characterize Delaware fiduciary duty law most accurately. Moreover, as my earlier discussion suggests, the problem seems to be a paucity of cases, not an excess. None of the other states had enough cases to generate a standard of conduct.

This finding has implications for the awarding of attorneys' fees. First, because even defense victories, such as *RJR Nabisco*,[248] are valuable in describing appropriate norms of conduct, fees for plaintiff victories must be sufficiently generous to make it worthwhile to bring cases that the plaintiff may end up losing.[249]

This likewise raises the issue of the definition of success and failure in shareholder litigation. Recall Romano's finding that plaintiffs' success rate in shareholder litigation was abysmal. Should *Fort Howard*[250] be defined as a plaintiff defeat or victory? From one perspective, the defendants won: The motion for a preliminary injunction was denied and the deal went through. But although plaintiffs' preliminary injunction motion was obviously denied, the court's criticism foreshadowed or perhaps caused the subsequent settlement.

Cases such as *Fort Howard* that fall into the middle category are most appropriately considered partial plaintiff victories. The criticism is a clear signal (confirmed in the cases) that a defendants' motion for dismissal or summary judgment will likely be denied, with the consequence that most such cases will settle. In such cases, plaintiffs' counsel will receive a fee and will be paid for the efforts expended and benefits provided by the case as a whole, including unsuccessful motions along the way. Thus, if one

248. *In re* RJR Nabisco, Inc. Shareholders Litig., No. CIV.A.10389, 1989 Del. Ch. LEXIS 9 (Feb. 14, 1989).

249. An alternative solution would be to provide fees to plaintiffs' counsel even when they lose, but the distorted incentives that such a proposal would create make it impossible.

250. *In re* Fort Howard Corp. Shareholders Litig., No. CIV.A.9991, 1988 WL 83147 (Del. Ch. Aug. 8, 1988).

looks again at the list of cases in Table II, one sees that in each of the major cases in which the court criticized defendants' behavior without enjoining the transaction, plaintiffs' attorneys received fees.[251] That said, it is likewise true that even in cases in which the court approved or even applauded defendants' conduct, plaintiffs' counsel usually still received a fee, although typically a far smaller one.[252]

Finally, comparing Tables I and II provides a rough, back-of-the-envelope estimate of the out-of-pocket cost of developing the specific norms of conduct for MBOs: Plaintiffs' attorneys were awarded a total of $17.2 million in fees in the fifteen Delaware MBO cases. In the same time period, approximately $160 billion was spent on LBOs.

C. The Delaware Way: Could It Be Efficient?

The earlier case study of the Delaware MBO cases provides a picture of the Delaware approach as regulating at least one difficult problem of managerial conduct. In this section, I speculate on how the system might work. Because of competition from the various markets (product market competition and interstate competition for charters, principally), there are reasons to believe that the system that has emerged in Delaware is a reasonably efficient system of corporate governance.[253] For present purposes, it is useful to assume that the Delaware system is pretty good and to ask, speculatively, how might such a system, which may seem rather odd and fuzzy, both in comparison to other areas of U.S. law and in comparison to the corporate law of other advanced industrial economies, end up working reasonably well?

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251. I cannot discover whether plaintiffs' attorneys received fees in the first two cases, *EAC* and *National Medical Care*. But plaintiffs' attorneys received fees in *Shoe Town*, *J.P. Stevens*, *Macmillan*, *Fort Howard*, *Formica*, and *American Home Shield*.

252. The major exception to this finding is the *RJR Nabisco* case in which the court applauded the performance of the special committee, yet still awarded plaintiffs' counsel an enormous fee, finding that their watchdog function benefited the class. Even when a bidder is also suing, (and taking the lead role ahead of the shareholder plaintiffs), Delaware courts have found that class counsel has an important role to play as a watchdog, standing by to take over if the bidder should strike a deal or lose interest or change its position. *See, e.g.*, *In re Macmillan*, Nos. CIV.A.9953, 9909, 1989 WL 137936 (Del. Ch. Nov. 16, 1989). It is interesting to note that parallel federal class actions resulted in a recovery to shareholders of $72.5 million and a fee to class counsel of $17.7 million. *RJR Nabisco*, 1992 U.S. Dist. LEXIS 12702 (S.D.N.Y. 1992).

253. *See generally* ROMANO, *supra* note 9. It could be that this is simply wrong, that Delaware's system survives despite substantial inefficiency because of network externalities or market failure or something else. Whether or not this is true is a separate debate.

The Delaware MBO cases display a number of features. As already discussed, there were relatively few decisions in relation to the number of deals, and these decisions came relatively late in the deal cycle. Second, most of the opinions were written in the context of motions for preliminary injunction, and almost all such motions were denied. Third, despite the fact that most such motions were denied, the judicial opinions were often very critical of defendants' conduct. Fourth, the opinions themselves are fact-intensive, process-oriented, and deeply and persistently judgmental of managerial conduct. Although the individual opinions are highly fact specific, over time certain features of transactions assume prominence. Thus, in the case of MBOs, the independence and activism of the special committee and its investment banker, as well as the extent to which alternative bids were sought, all feature prominently in the narratives. Finally, the opinions—even those in which the motion for preliminary injunction is denied—seem to shape conduct.

These features raise several questions. First, why might such a system be superior to potential alternatives, such as a system in which the courts (or the legislature) articulate rules ex ante that make it clearer what sort of transactions are permitted and what sort of transactions are forbidden?

Second, if I am right that the system seems to rely on the possibility of public shaming to constrain behavior, how is it that such a system works? One might suspect, ex ante, "that being a successful businessman requires having a very thick skin, even enjoying the reputation of someone who skates close to the edge, even being something of an outlaw."[254] How is it that such a person would be deterred by the possibility of being criticized by a Delaware civil servant who wears black robes, much less incorporate such criticism into his or her personal code of conduct? Third, might there be an alternative explanation for the distinctive Delaware style?

I will try to address these questions separately.

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254. Letter from Eric Posner (Aug. 23, 1995) (on file with author).

1. The Mushiness of Delaware Fiduciary Duty Case Law

Why might it be that Delaware corporate law shies away from using "laws" to deter bad behavior and leans, instead, towards morality tales?[255] One can try to answer this question from several directions.

From an historical perspective, one could tell a story (as has already been told)[256] of the historical differences between law and equity, of equity's greater concern with "equity," and of the survival of the division between courts of law and courts of equity in a few U.S. jurisdictions (most prominently New Jersey and Delaware). The problem with this sort of account is that it does not tell us very much about why the equity style survived in corporate law, or what functions that style serves.

One can gain somewhat more insight from a comparative perspective. Corporate law can be divided into two alternative and rather incompatible models. On one side there is the civil code, Germanic approach which, with some significant parody, can be described as "anything not explicitly permitted is prohibited." The second approach is the "enabling" approach that characterizes Delaware law: Anything not explicitly prohibited is permitted, and the law mainly serves to save transaction costs by providing low-cost standard form contracts. Tracking this difference in character is a difference in judicial role: In Germany, the free-ranging, fact-specific, fiduciary duty analysis of Delaware is absent and utterly foreign to the corporate law sensibility.

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255. Because the Delaware legislature is responsive to pressures from Delaware-chartered corporations, (see, for example, the adoption of Delaware General Corporation Law section 102(b)(6) in the wake of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)), the persistence of the Delaware style requires the acquiescence of the relevant players: the courts, the bar, the legislature, and Delaware-chartered corporations.

256. William T. Allen, *Speculations on the Bicentennial: What Is Distinctive About Our Court of Chancery*, *in* COURT OF CHANCERY OF THE STATE OF DELAWARE 1792–1992, at 13 (1992); William T. Quillen, *Constitutional Equity and the Innovative Tradition*, LAW & CONTEMP. PROBS., Summer 1993, at 29.

These contrasts in national styles suggest that the peculiar quality of Delaware cases may be linked to, and is perhaps a necessary consequence of or supplement to, the open-textured quality of the law. The virtues of the enabling approach to corporate law have been celebrated.[257] But because the possibilities are (intentionally) open-ended, the Delaware legislature and courts cannot promulgate ex ante the standards to govern new situations until they see a variety of cases and figure out how well or badly people behaved.[258] To put it differently, in an open-textured regulatory structure, many important norms can only be generated ex post, and with endless possibilities, safe harbors are particularly risky.[259]

Because of the enormous discretion exercised by Delaware Chancery and Supreme Court judges, the personnel are critical. If one is to depend on the courts to fill out the details of proper behavior in the corporate community, the judges must be respected by the community. Delaware accomplishes this in two ways. First, a substantial number of the judges are drawn from the very world at issue, that is, they are experienced and respected practitioners of Delaware corporate law. Second, the Delaware courts have traditionally been characterized by a very high degree of collegiality among the judges, so that even those judges who did not practice in the area are socialized into the peculiar practices after joining the court.

But, if most law-following is self-induced, then a system of enabling rules with ex post judicial review, like Delaware's, faces an additional problem: It is notably lacking in mandatory rules that themselves provide the guidance that individual law followers need to follow the rules. Moreover, in such a system, the type of law-following required goes more to process and motive than to substantive outcome. In such circumstances, the articulation of substantive rules does not provide the sort of guidance required. On the contrary, the particular sort of guidance demanded seems to be better provided by narrative than by rule. Martha Nussbaum has argued

257. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991); ROMANO, *supra* note 9; Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

258. Alternatively stated, it is too expensive to figure out ex ante the appropriate response to the uncountable number of cases that could arise under the open-textured Delaware provisions. *See* Kaplow, *supra* note 10, at 568–86.

259. Note that on this view, the Delaware system requires a functioning court system. In economies in which this feature is absent—Russia, for example—this particular combination of flexibility and constraint is unavailable, leading one generally to prefer a system of greater mandatory rules. *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

that narratives, especially moralistic novels like those of Henry James, provide the kind of moral guidance one needs to be a moral person, and, in their thick descriptions, provide a better guide—that is, more useful, relevant, and interesting—than the kind of principles discussed in traditional moral theory.[260] The suggestion here is similar.

2. But How Could Shame Constrain the Shameless?

It is fine to claim that Delaware fiduciary duty law relies, in large measure, on the possibility of public shaming or praise to constrain managers, but, as was pointed out before, would one not expect that successful businessmen might have sufficiently thick skins to be immune to such influence?

Here, it seems to me, the answers are particularly interesting. The short answer is "yes," one would expect some particularly successful businessmen to be immune to such influence, and here the effect of Delaware corporate law seems particularly subtle.

Consider what I have claimed is a characteristic style of Delaware law: The denial of a preliminary injunction motion coupled with strong criticism. In the next deal, the "thick-skinned" businessman wants to skate close to the edge. Will he be constrained by the possibility that he will go down in history as a villain of Delaware corporate law? Probably not. But his lawyer is likely to advise him that such behavior will make it more likely that the deal will be enjoined, or that he will be left unprotected against maneuvers by his opponents. In other words, even the corporate actor who is immune to the social sanctions of Delaware corporate law will be constrained to some degree by Delaware "law." In this regard, it is worth recalling T. Boone Pickens, a corporate actor who fits the mold of the outsider unlikely to be constrained by Delaware norms. Although it is possible that a negative portrayal in Delaware opinions meant little to him and other outsiders, it is likely also that the principle of Delaware law that eventually emerged—that Pickens always loses—meant more.[261]

And what about the others? Will the nonlegal sanctions have bite, separate from the possibility that the deal might not go through? To put it

260. NUSSBAUM, *supra* note 13, at 125–47. I owe this point, and cite, to Eric Posner.

261. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *see also* Dale Arthur Oesterle, *Delaware's Takeover Statute of Chills, Pills, Standstills and Who Gets Iced*, 13 DEL. J. CORP. L. 879, 923 n.171 (1988).

differently, under what circumstances are Delaware norms likely to be internalized?

Here we come to what one might call the silver lining in the agency cost cloud. The prototypical Delaware corporation is a large, publicly held corporation in which ownership is separated from control. In such corporations, the principal actors are agents. For them, the financial gains from allowing the corporations they manage to skate close to the edge are likely to be small. Moreover, the culture of such an organization is typically more bureaucratic than entrepreneurial, with directors of such corporations serving as much a ritual function as a managerial function. A system that relies on public shaming is perfectly suited to such contexts: The cost to the actor—the disdain in the eyes of one's acquaintances, the loss of directorships, the harm to one's reputation—may often be sufficiently great to deter behavior, even without anything more.

Consider how this dynamic played out in the MBO context. MBOs, overnight, provided the opportunity for the senior managers to become very rich, to go from being bureaucrats to entrepreneurs. Under such circumstances, one can expect that some managers might rather quickly become indifferent to the criticism of the judges. The possibility of becoming seriously rich sometimes has that effect.

How did the courts respond? In the MBO cases, one sees a subtle shift of attention from the managers to the special committee. Although the potential gains to managers in MBOs might lead them to develop resistance to the deterrent effect of public shaming, the members of the special committee had no such prospects. They were not getting rich. They were simply trying to do their best as outside directors. One would predict that such actors are likely to be far more susceptible to the kind of influence that Delaware opinions exert than the managers. The Delaware courts, perhaps sensing this, focused much of their attention—both in the opinions and in extrajudicial utterances—on influencing the conduct of the special committees.

Note, now, a surprising implication of this analysis. If the success of Delaware's method for constraining or encouraging managers to act on behalf of shareholders depends critically on a separation of ownership and control, with the greater susceptibility to reputational effects that agents have in comparison to principals, then the system is likely to be less suitable for corporations not characterized by this separation, such as closely held corporations. The Delaware style may well have evolved in response to the particular needs and properties of the large, publicly held corporation. The same mixture of flexibility and court scrutiny may be less effective when the objects are less susceptible to shaming.

3. A Complementary Explanation of the Delaware Style

To this point, I have largely described the Delaware judicial style as one well suited to the articulation and expression of standards of managerial conduct. But might there be a different, politically driven explanation?

Delaware is a small state. It is, in part because of historical accident, the state of incorporation for some of the largest and most powerful corporations in the country and the world. Delaware law governs the internal affairs of corporations because of the internal affairs doctrine, a doctrine that is in tension with the approaches to choice of law and conflict of law dominant in the United States.[262] Within Delaware, five appointed judges on the chancery court and five appointed judges on the supreme court interpret and apply Delaware corporate law, with the nominal power to stop the largest business transactions in the country. Billions of dollars ride on these deals, with millions of dollars in fees involved. In a word, the Delaware courts may be, or at least may feel themselves to be, politically vulnerable.

How could actors in such an institution be expected to justify their decisions? One method of increasing the political legitimacy of wielding such extraordinary judicial power will be to demonstrate that the objects of such power, the directors and managers of particular companies, have behaved very badly. On this analysis, the style of Delaware opinions can be understood as deriving from political considerations.

If we assume that this explanation is true, how does it affect the rest of my analysis? First, even if true, judges may be acting from mixed motives: a desire to defend the political legitimacy of their power; and, likewise, a desire to shame, praise, or influence the behavior of the relevant actors. Indeed, to the extent that the judges' efforts are successful in constraining the relevant actors, their political legitimacy may be increased. Thus, the spectacle of important Delaware Supreme Court arguments being broadcast live on CNN with leading corporate law academics as "color commentators" may bolster the legitimacy of the Delaware courts by showing graphically how, through the existing system, even the most powerful actors in the economy are held accountable. On this account, the "morality play" aspect may serve both functions simultaneously. It may promulgate community standards for the community of senior managers at the same time that it justifies the exercise of extraordinary power by unelected judges of the second smallest state.

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262. *See generally* P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1.

CONCLUSION

This Article proposes a theory of how corporate law works, of the mechanisms that link what the Delaware courts do with the behavior of members of the governed community, the managers and directors of Delaware corporations. The core of my claim is that we should understand Delaware fiduciary duty law as a set of parables or folktales of good and bad managers and directors, tales that collectively describe their normative role.[263] The evolution during the 1980s of the norms of managerial and directorial conduct in management buyouts provides a case study in which we can trace out this process in sufficient detail to begin to understand some of its subtlety and complexity.

The evidence I gather leaves unsettled the important question of how the norms are transmitted. In particular, it is still unclear how (and whether) the parables make their way to their audience. There is evidence that some of the most important and dramatic tales are transmitted fairly directly, while others are mediated by corporate lawyers who digest them, transmitting the lessons through the exercise of judgment and through the ways in which they structure the board's deliberations. The mechanism by which Delaware opinions influence conduct is ultimately an empirical question, the full description of which awaits further research.

An appreciation of how Delaware law works has implications, first, for how lawyers advise their clients. Second, it affects our view of the role of shareholder litigation in the Delaware courts, finding greater benefits than the current skepticism recognizes. Such a system, which has at least withstood the pressures of interstate competition for corporate charters, may have developed as an efficient response to Delaware's unique corporate environment.

The fiduciary duty cases of the Delaware courts form an important part of U.S. corporate law. We know, or at least have good grounds to believe,

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263. Robert Cover argued that the "folktales" of jurisdiction in which judges assert authority to judge kings serve important inspirational and aspirational functions, that they inspire judges to resist "[p]rudential deference . . . the great temptation, and the final sin of judging." Cover, *Folktales*, *supra* note 15, at 190. This aspirational function is closely related to their mythical character:

> [W]ere the gesture and aspiration of resistance not the principal motif of these stories, *we* would have no reason to remember them or to make them our own. We would need no myth to prepare us to cave in before violence and defer to the powerful. We must get the relative roles of myth and history straight. Myth is the part of reality we create and choose to remember in order to *reenact*.

Id. One claim of this Article is that Delaware folktales of fiduciary duty have similar ambitions and serve similar purposes.

that U.S. corporate law works reasonably well. But we know extremely little about how that system works, about the connections between corporate law and corporate managers. This Article is an attempt to begin to answer this central, but largely unasked, question of corporate law.