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Unstable Coalitions: Corporate Governance as a Multi-Player Game

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ARTICLES

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I. INTRODUCTION

This is an article written in honor of Professor Donald Schwartz, a leading figure in academic corporate law for over two decades, but also a man nearly unique in his willingness to move beyond corporate law to the general study of corporate behavior. In this light, this article will not explore the latest wrinkle in the law—the most recent case, latest SEC ruling, or newest take-over defense tactic—but will instead ask if there are new ways in which we should try to talk about corporate law and corporate behavior. These were questions that Don Schwartz repeatedly asked himself and others, and this article is a modest attempt to respond by suggesting a different framework within which we can better understand institutional bargaining inside the corporation.

Let me begin by describing the prevailing orthodoxy. Scholars of both law and economics have tended to view corporate governance as largely a principal/agent relationship.[1] Under this view, shareholders are the principals; management, the agents. While standard economic theory today describes the corporation as a "series of bargains" or "nexus of contracts" in which additional interest groups—creditors, employees, suppliers, etc.—also participate,[2] it still assumes that these other actors will not seek to participate in

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1. I do not mean to suggest that economists view the firm strictly in terms of the principal/agent relationship. Indeed, the earliest economic theorists viewed the firm as a production function, and proponents of more recent "transaction cost" models have theorized about the boundaries of the firm. For an overview of all these theories, see Hart, *An Economist's Perspective On The Theory Of The Firm*, 89 COLUM. L. REV. 1757 (1989). My point is rather that the problem of internal governance has been viewed by economists largely as a principal/agent problem. *See, e.g., id.* at 1758-60; Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979). Such theories tend to overlook the degree to which other actors can influence or form alliances with the agent.

2. For standard accounts, see Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

governance decisions. Under the neoclassical view, efficiency dictates that only the firm's residual claimants—its shareholders—should have voting rights.[3] As a result, corporate governance (although not the broader topic of corporate contracting) essentially boils down to the principal/agent relationship between shareholders and managers. So viewed, the law's role becomes that of reducing the "agency costs" that shareholders must incur to hold management faithful to their interests.

The thesis of this article is that this bilateral model of corporate governance oversimplifies, basically because it leaves out an essential third player: stakeholders. Although stakeholders have not in the past sought to participate in corporate governance, this pattern is changing—only recently, to be sure, but very rapidly in some sectors of the economy. In some cases, the motor force driving this change may be the failure of an earlier system of implicit contracting; in other cases, it may be an exogenous change (such as the development of junk bonds) that revealed the inadequacy of existing contractual protections and left stakeholders exposed to new risks. In response, new contractual protections have been designed to protect some stakeholders, but other stakeholders have sought instead to participate in governance decisions. The key transition, however, is the formation of coalitions—sometimes between management and stakeholders to resist shareholder pressures and sometimes between stakeholders and shareholders to oust management. The central concern of this article will be where this transition is leading. Arguably, the public corporation should be viewed less as a "series of bargains" than as a "series of coalitions." Compared to bargains, coalitions are less stable, less enforceable, and less predictable. While the "nexus of contracts" paradigm conveys, at least rhetorically, the view that the relationships among those interacting within the corporation are fixed and enforceable, the reality may be that these relationships are more fluid and transitional, with outcomes determined less on the basis of legal rights than through coalition politics.

Because coalitions tend to be short-lived, one implication of this view is that the locus of power and authority within the corporation is less certain, and control shifts more predictable, than traditional theory implies. Some instability is inherent because *ex post* enforcement is seldom possible, and hence alliances last only as long as it is in the parties' mutual self-interest to remain allied. Once we recognize that there are at least three essential players in the game of corporate governance—management, shareholders, and stakeholders—it follows that the simple principal/agent model of corporate governance no longer represents an adequate descriptive or "positive" model.

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3. *See* Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 403-06 (1983) (arguing on grounds of efficiency that because only residual equity owners have an overall interest in a firm's profitability, only they should possess voting rights).

Put simply, once stakeholders are introduced into the game as a third player, management, although nominally an "agent" of the shareholders, may find ways to avoid being accountable to its principal by entering into contractual arrangements with stakeholders that effectively shelter management. Sometimes such arrangements may represent simple collusion by which management bribes the stakeholders (with the shareholders' funds) to support it against its principal. Other times they may represent an efficient, if implicit, system for protecting stakeholders against risks when contracting is too costly.[4] In any event, what is clear is that in a three-sided game, any two players can form a coalition against the third, and outcomes thus become indeterminate.[5]

So what? The conclusion that outcomes are often indeterminate may seem remarkably weak, but it leads to a methodological critique of some importance. Neoclassical economists have tended to view the corporation as an equilibrium position; that is, from the standard "nexus of contracts" perspective, the corporation is not an entity but rather the residue of a series of bargains in the relevant financial and managerial markets among those supplying the factors of production.[6] This perspective ignores the possibility of continuing, or at least recurring, disequilibrium. In contrast, from a game theory perspective, one can describe conditions under which such disequilibrium is predictable. A purpose of this article is to explore this game theory perspective as it could apply to bargaining among internal corporate constituencies. Unfortunately, the problem with game theory as an analytic tool is that those using it have sometimes tended to abstract the issues under consideration to a level of generality at which all sight is lost of relevant institutional detail. As a result, this article will first focus on the new character of the bargaining within the firm and only later suggest a theory of when and why such bargaining may fail.

A game theory approach to corporate governance will sound fanciful to

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4. Under this view, the board (management) is not an agent, but a neutral referee that balances the interests of different constituencies within the corporation. For a consideration of this view, which probably is consistent with directors' own perceptions of their roles but which raises serious issues of accountability, see Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 81-86 (1986).

5. I recognize that there are also persons external to the corporate "nexus of contracts" with whom management may collude, such as the proverbial "white knight" or "white squire." For example, one arguably can view the recent battle among Time, Warner, and Paramount as a case that at bottom involved a conflict between Time's shareholders, who wished to accept a takeover premium, and its management who wished to avoid ouster. From this perspective, one can view Time's top dollar offer for Warner plus its more than generous employment arrangements with Warner's senior executives as collusion between management and an external ally. *See* Hilder, *Warner Employees to Get Record Total Of $677 Million if Time Deal is Approved,* Wall St. J., July 24, 1989, at A4, col. 2.

6. *See* Jensen & Meckling, *supra* note 2, at 311.

some.[7] As recently as a decade ago, actual examples of coalitional bargaining would have been difficult to find. Yet, two developments make its focus on flux, rather than equilibrium, increasingly important. First, the magnitude of the collective action problems that historically have kept shareholders from uniting to engage in negotiations with management has shrunk dramatically with the rise of institutional share ownership.[8] As a result, bargaining between shareholders and other groups (management, unions, creditors, etc.) is now more feasible, even if still unusual. Second, stakeholders have new reason to bargain, because they have found themselves exposed to adverse wealth transfers caused by takeovers and leveraged buyouts (LBOs). Put simply, at least some of the gains received by target shareholders in takeovers have come at the expense of creditors and employees.[9] The extent of such wealth transfers is in serious dispute, and most doubt that they account for the greater part of the target shareholders' gains.[10] Still, the critical point is that as the takeover market has changed, stakeholders have begun to participate in corporate control contests, and they seem likely to do so with even greater frequency in the future.

The organizational form of the public corporation has experienced new stresses as the result of developments in the takeover market, and some have even predicted its demise.[11] Like reports of Mark Twain's death, such predictions seem premature, but as some of the contracting parties experience recurrent losses, they will predictably search for new contractual or institutional protections. Evidence of such a search is abundant. Over the last three years, new forms of bargaining and new institutional arrangements have become visible: LBOs, employee stock ownership plans (ESOPs), poison puts, and union-led takeovers are all examples. This article will consider the different ways in which this bargaining could play out.

An assessment of the judicial role is necessarily involved in this evaluation.

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7. Nonetheless, respected economists have used it to analyze other kinds of bargaining within the firm. *See* M. AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM (1984); Leibenstein, *The Prisoner's Dilemma in the Invisible Hand: An Analysis of Intrafirm Productivity*, 72 AM. ECON. REV. 92 (Papers & Proceedings, May 1982).

8. See *infra* notes 180-182 and accompanying text.

9. *See, e.g.*, Coffee, *supra* note 4, at 68-71; Shleifer & Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (A. Auerbach ed. 1988). Recent evidence on bondholders' losses in takeovers provides some additional support for this wealth transfer hypothesis. *See infra* notes 70-80 and accompanying text.

10. *See* Lehn & Poulsen, *Leveraged Buyouts: Wealth Created or Wealth Redistributed?*, in PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 46 (M. Weidenbaum & K. Chilton ed. 1988) (arguing that wealth transfers from creditors and preferred shareholders to common shareholders is not great enough to require a public policy remedy). For an estimate that shareholder gains from takeovers and restructurings between 1981 and 1986 amounted to $162 billion, see Black & Grundfest, *Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986: $162 Billion Is A Lot of Money*, 1 J. APPLIED CORP. FIN. 5 (1988).

11. *See* Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.- Oct. 1989, at 61.

To what extent are courts competent to resolve or monitor these disputes? What new problems will they face? One should not assume, however, that legal forces will be decisive. Courts are not necessarily at stage center in this process, and legal rules that attempt to preclude collusion may only complicate the bargaining process by locking the parties into a familiar problem known to game theorists as the "Prisoner's Dilemma."[12] New market forces and mechanisms are emerging, and the growing "institutionalization" of the stock market may prove to be the force that most profoundly changes the nature of the bargaining within the firm. In assessing the interplay of these forces, this article will seek more to provide a positive account than a normative critique of the firm. Nevertheless, the recognition that changes are occurring in what *is* happening inevitably sets the stage to reconsider what *ought* to happen, and a preliminary normative evaluation will be offered in the concluding section.

II. INTERNAL CONTRACTING AND THE MODERN HISTORY OF THE FIRM

Before proceeding further, some terms need to be defined. "Stakeholder" is a deliberately ambiguous term, which includes a variety of subgroups whose interests can often conflict.[13] The two largest constituents in this amorphous category are creditors and employees. Their relative exposure to loss and ability to bargain collectively with management differ greatly, but one factor that unites them is a long-term interest in the firm's solvency. This implies a preference that the firm retain or reinvest much of its "free cash flow." Free cash flow is a term coined by Professor Michael Jensen to refer to those discretionary cash flows that remain once the firm makes the required payments to creditors and other fixed-interest claimants.[14] In contrast to stakeholders, shareholders tend to regard free cash flow as suboptimally invested capital, which they wish to have returned to them. This is exactly what restructurings, leveraged buyouts, and bust-up takeovers do, thus explaining why stakeholders and shareholders view such transactions from opposing perspectives.

Jensen's focus on free cash flow and his concomitant recognition that a significant conflict of interest could arise between shareholders and managers over its use is a significant concession that shows a new consensus developing among theorists of the firm. In a sense, it brings us full circle. For a genera-

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12. The Prisoner's Dilemma game and its application to corporate coalitions is discussed more fully *infra* at Part V.

13. The possibility—indeed probability—of conflict among the stakeholders is examined *infra* at Part V. In the interim, this article will use the heroically simplifying assumption that stakeholders have relatively homogenous preferences vis-a-vis management.

14. *See* Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (Papers & Proceedings, May 1986).

tion, a number of economic and business scholars—including William Baumol, Robin Marris, Oliver Williamson, and Merritt Fox—have expressed the view that management has an innate preference for empire building, asset retention, and cash hoarding.[15] These writers, often called the "Managerialists," have tended to disagree with more neoclassical economists, who believed that either the market or internal contracting within the firm would suffice to discipline any such frolics and detours by management. Free cash flow theory also disagrees with the neoclassical theory in hypothesizing that management tends to hoard discretionary (or "free") cash flows, reinvesting them in unprofitable acquisitions or internal expansion instead of paying them out to shareholders in the form of dividends or other distributions.[16] In this light, the free cash flow theory is only a reinterpretation of the Managerialists' original view that corporate managements are biased toward empire building; as a theory, it at once concedes the accuracy of the Managerialists' diagnosis but pronounces the problem largely solved by the advent of the bust-up, or financially motivated, takeover.[17]

Still, the free cash flow theory never answers the key question: why is management so biased toward inefficient growth and retention of cash flows? Originally, the Managerialists focused on the psychic income and security that growth and large size afforded management.[18] Professor Williamson also theorized that management had an "expense preference."[19] More re-

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15. For some of the better known works in this vein, see W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1959); M. FOX, FINANCE AND INDUSTRIAL PERFORMANCE IN A DYNAMIC ECONOMY: THEORY, PRACTICE, AND POLICY (1987); R. MARRIS, THE ECONOMIC THEORY OF 'MANAGERIAL' CAPITALISM (1964); Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032 (1963). For an overview of this tradition, see Coffee, *supra* note 4, at 20-21, 28-31.

16. *See* Jensen, *supra* note 14, at 323.

17. A "bust-up" takeover involves the acquisition of a corporation for purposes of liquidation. The acquiror hopes to realize a premium in the spread between the liquidation value and acquisition price. *See* Coffee, *supra* note 4, at 2-4.

Today, virtually all close observers of the takeover scene recognize that takeovers have spurred a massive "deconglomeration" movement that is pruning overgrown corporate empires and reshaping the size and scope of the American industrial corporation. The appearance of the bust-up takeover in the 1980s has demonstrated that many, if not most, publicly held firms trade in the stock market at a significant discount off their liquidation values. In effect, bust-up takeovers arbitrage this spread between stock market and liquidation values. *See id.* at 3-5. What explains the spread between these two values? For an overview of the various theories that seek to explain the motives for takeovers, see Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 892-901 (1988). Today, almost no theorists continue to subscribe to "information" theories under which the target company is seen as undervalued by the market. *Id.* at 898-901.

18. *See, e.g.*, R. GORDON, BUSINESS LEADERSHIP IN THE LARGE CORPORATION 305-06, 311 (1945); R. MARRIS, *supra note 15, at 61-66.*

19. *See* Williamson, *supra* note 15, at 1034-36 (management prefers certain costs that generate value above productivity, including costs for staff expenditures, special managerial salaries, and funds for discretionary investment).

cently, Professor Jensen may have come closer to the mark by focusing on problems in executive compensation that may give executives inadequate incentive to accept risk or maximize the return on assets (instead of seeking to maximize corporate size).[20] Yet neither hypothesis explains why the discount between going-concern and bust-up values can reach the magnitude sufficient to justify takeover premiums that now average nearly fifty percent.

Thus, let me introduce a third possibility: the much discussed managerial preference for earnings retention and growth may be partially explained as the product of an implicit bargain with stakeholders. Just as aberrations in the planetary orbit of a distant planet may be explained by the weak gravitational force of an even more remote, hidden planet, so may the seeming infidelity of management to the goal of shareholder wealth maximization be explained to some degree by the hidden pull of stakeholders. To be sure, stakeholders may not have approved of the waste and expense preference behavior that the Managerialists saw during the pretakeover era, but they did support management's policy of earnings reinvestment. Directors, in turn, defined their role as that of balancing the interests of these different constituencies, and so they became the force that, prior at least to the dominance of the hostile takeover, held the implicit bargain in place.[21]

Why were stakeholders this interested in free cash flow? Creditors and employees have common reasons to resist the shareholders' desire to drain the firm of its free cash flow. Employees have "firm specific" human capital invested in the firm, and a policy of expansion through acquisitions and internal growth (even if inefficient) increases their opportunities for promotion and advancement within the firm. For long-term creditors, any increase in the firm's debt/equity ratio reduces their security. Acquisitions, in contrast, may have a co-insurance effect that decreases the variability of the firm's cash

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20. *See* Baker, Jensen & Murphy, *Compensation and Incentives: Practice vs. Theory*, 43 J. FIN. 593, 600-09 (1988); M. JENSEN & K. MURPHY, PERFORMANCE PAY AND TOP MANAGEMENT INCENTIVES, (Harvard Business School Working Paper No. 88-059, 1988); *see also* Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1155-60 (1985) (by G. Rehnert) (arguing in favor of executive compensation based upon "relative market price" or value of firm's shares directly attributable to CEO's performance).

21. Some decisions have in fact defined the board's fiduciary responsibility to be to "deal fairly and even-handedly with both the protection of investors, on the one hand, and the legitimate concerns and interests of employees and management of a corporation who service the interests of investors, on the other [hand]." GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1020 (S.D.N.Y. 1985). *But see* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182-84 (Del. 1986) (rejecting view that board should consider interests of non-shareholder constituencies when sale of corporation is inevitable). In this article's terminology, the *Revlon* view that the board may not protect the interests of these other constituencies may have left boards exposed to unanticipated risks and hence eager to develop coalitions. For the empirical observation that senior management sees its chief loyalty to be to employees, not shareholders, see G. DONALDSON, MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM 155-56 (1984).

flow and thereby creates value for bondholders, even if the acquisition is debt-financed.[22]

This story of a happy collusion between stakeholders and target management to retain free cash flow in the firm came to an abrupt halt in the early 1980s with the dawn of bust-up takeovers. Target managements suddenly faced a choice between increasing leverage or becoming vulnerable to a hostile takeover. Bondholders, who had grown accustomed to a managerial distaste for leverage, were suddenly surprised by a change in managerial preferences that left them exposed and unprotected. Yet, before this story can supply a normative argument that justifies judicial protection for bondholders, one must explain why stakeholders did not protect themselves contractually. In theory, employees could have negotiated employment contracts (or "golden parachutes") that promised them employment security; similarly, creditors could have negotiated negative covenants in their loan agreements that restricted the firm's ability to increase leverage through acquisitions, financial restructuring, or large scale dividends.

Different explanations can be given for why stakeholders failed to secure these contractual protections. Neoclassical financial economists have a simple answer to this question: stakeholders in effect accepted the risk in exchange for a higher return. In the case of creditors, for example, they argue that bondholders, being rational actors, discounted the risk of expropriation through wealth-transferring restructurings and accepted a higher interest rate to compensate them for bearing this risk. Hence, this argument concludes, bondholders cannot complain of unfairness when a firm subsequently restructures in a manner that adversely affects them, because this right to issue additional debt was bargained for by the shareholders through their agents, the management. Although courts have not yet faced hard cases in which management has used a discretionary power opportunistically, they have to date uniformly ruled against bondholders in circumstances in which the indenture did not restrict the issuance of additional debt.[23]

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22. For a discussion of this point, see D. COOK & J. MARTIN, THE CO-INSURANCE AND LEVERAGE EFFECTS ON TARGET-FIRM BONDHOLDER WEALTH (Working Paper, Nov. 1988) (copy on file at *The Georgetown Law Journal*).

23. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1507-08 (S.D.N.Y. 1989) (rejecting claim by large bondholder that leveraged buyout of issuer breached either fiduciary duty of good faith or fair dealing); Hartford Fire Ins. Co. v. Federated Dep't Stores, Inc., 723 F. Supp. 976, 990-93 (S.D.N.Y. 1989) (finding, in part, no breach of good faith or fair dealing when merger devalued debentures issued before transaction because indenture explicitly permitted merger and assumption of additional debt); *cf.* Harris Trust & Sav. Bank v. E-II Holdings, Inc., No. 89-C203 (N.D. Ill. Dec. 13, 1989) (LEXIS, Genfed. library, Dist file) (upholding dismissal of trustee's request for declaration of its rights to information from defendant on whether acquisitions and transactions were within terms of Note Indenture and Trust Act of 1939). For the general view of the Delaware courts that issuers do not owe bondholders a fiduciary duty, see Simons v. Cogan, 549 A.2d 300, 303-04 (Del. 1988) (corporate directors do not owe fiduciary duty to holders of converti-

Nonetheless, the claim that what was not prohibited was therefore permitted is too neat, tidy, and simplistic. The major puzzle is why rational investors would purchase investment grade debt, and thereby accept the interest rate penalty applicable to such supposedly secure obligations, when this would leave them seriously exposed to risks in the control of an adverse party (i.e., the debtor). Although it is certainly conceivable that some investors would take this risk (for example, junk bond investors), the curious irony is that the class of bondholders who have suffered the most from LBOs and bond rating downgradings has been those who are the most risk averse—namely, the purchasers of senior investment grade bonds.[24] Why is it that those most likely to have feared the risk have suffered most from it?

Possible answers include: (1) that the risk was so unexpected or of such a low probability that it was impossible or too costly to protect against (much as it makes little sense to buy earthquake insurance in Florida); (2) that the risk was one that stakeholders believed the law already protected them against; and (3) that, although they understood they were legally exposed, stakeholders relied either on an implicit bargain that management would not exploit such loopholes or, more generally, on management's reputation for acting in good faith and in accordance with prevailing business standards and expectations. The second possibility that stakeholders mistakenly assumed they were protected (much as homeowners may misinterpret their insurance policies) deserves special attention because it raises the possibility of informational or market failure.

A. LEGAL PROTECTIONS FOR INCOMPLETE CONTRACTS

In overview, there are at least three theories potentially available to bondholders when the indenture does not clearly permit the issuance of additional debt: (1) they can claim that there is an omission in the contract that the court should fill in by determining what rational parties would have intended;[25] (2) they can assert that the issuer breached a duty of good faith, which is a mandatory term in all contracts;[26] or (3) they can argue that the

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ble debentures because such holders have no equitable interest in the corporation and are protected by terms of the indenture). For a further discussion of these cases, see *infra* text accompanying notes 38-48.

24. For such a finding, see A. Warga & I. Welch, Bondholder Losses in Leveraged Buyouts 13 (tent. draft Dec. 1989) (revised draft released May 1990) (copy on file at *The Georgetown Law Journal*).

25. *See generally* Farnsworth, *Disputes Over Omissions In Contracts*, 68 COLUM. L. REV. 860 (1968).

26. The duty of good faith is a universal, nonwaivable element of contract law, which applies equally to bond indentures and to other contracts. *See* Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 369 (1980). For cases in which courts have refused to let issuers exploit bondholders even though the issuer's conduct conformed to the literal language of the bond indenture, see Sharon Steel Corp. v. Chase Manhattan Bank, N.A., 691

court should read into the contract an implied term restricting debt issuances, possibly based on extrinsic evidence as to the parties' intent. The first and third approaches arguably merge, because the terms that a court will infer are basically those that it believes rational parties would want.

The problem of contractual omissions and/or implied terms is at the heart of the modern law and economics approach to contract law.[27] Proponents of this approach agree that the court should allocate unanticipated risks by attempting to recreate the bargain that rational parties would have reached had they focused on the omission. But what rules would rational parties agree upon under conditions of hypothetical bargaining? According to the Easterbrook and Fischel view, courts should adopt whatever default rule maximizes aggregate value, regardless of its distribution among the parties.[28] Conversely, Professors Ayres and Gertner have argued that courts should apply a "penalty" default rule under which any party possessing private information would be forced to reveal it to the other or have the court adopt a presumption unfavorable to it.[29] The premise of this latter approach is that it is "information revealing" and thus ensures that the contracting process results in a more complete agreement in which the parties bargain on the basis of equal knowledge. Although a penalty default rule will not maximize value *ex post,* its *ex ante* effect is to create an incentive for the parties to reveal their future intentions and to contract for explicit permission, because otherwise the court will construe ambiguous terms or the duty of good faith

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F.2d 1039, 1051-52 (2d Cir. 1982); Van Gemert v. Boeing Co., 553 F.2d 812, 815 (2d Cir. 1977), *aff'd,* 444 U.S. 472 (1980); *cf.* Pittsburgh Terminal Corp. v. Baltimore & O.R. Co., 680 F.2d 933, 942-43 (3d Cir.), *cert. denied,* 459 U.S. 1056 (1982). For an excellent review of the law in this area, see Bratton, *The Economics and Jurisprudence of Convertible Bonds,* 1984 WIS. L. REV. 667.

27. For a description of the "hypothetical bargaining" approach under which a court faced with an omission asks itself what term rational actors would have agreed upon, see R. POSNER, ECONOMIC ANALYSIS OF LAW 79-85 (3d ed. 1986). *See also* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 435-39 (7th Cir. 1987) (although not within the employment contract, employer owed fiduciary duty to disclose impending merger to shareholder/employee planning to resign who upon resignation was required to sell shares back to the employer at book value). Other theorists have suggested that courts should sometimes use a "penalty" default rule that deliberately does not represent the bargain the parties would have struck but instead induces the contracting party possessing private information to reveal private information it possesses by construing ambiguous terms against it. The premise to this approach is that it is "information revealing" because it induces the party possessing asymmetric information, with the result that the other contracting party can then better price the rights and risks of the transaction. *See* Ayres & Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 YALE L.J. 87, 97-101 (1989).

Besides the Posnerian approach, which looks for the result that would maximize aggregate wealth regardless of its distribution, and the "penalty" approach of Ayres and Gertner, *supra,* still other approaches exist. Professor Bratton, for instance, has argued that the "burden of specificity [should be] on the party who seeks to disrupt settled expectations." Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring,* 1989 DUKE L.J. 92, 148-49. Under this approach, the burden might be on the corporate issuer to justify a sharp increase in leverage.

28. *See* Easterbrook & Fischel, *Corporate Control Transactions,* 91 YALE L.J. 698, 700-04 (1982).

29. *See* Ayres & Gertner, *supra* note 27, at 95-107.

to prevent the party possessing private information from using it opportunistically.

Obviously, these two approaches to gap-filling in incomplete contracts can lead to very different outcomes in bondholder suits of the type under discussion. If one believes the parties' dominant concern would be value maximization, then because virtually every commentator has found that stockholders' gains have exceeded bondholders' losses, bondholders would lose their suit. If, however, one prefers a "penalty" default rule because of the likelihood of asymmetrical information, then bondholders may have a much stronger case—at least when management anticipated, but did not reveal, the prospect of a restructuring or other measure that increased firm-specific risk. It is not self-evident which rule is superior, and even proponents of the former approach sometimes reveal a sympathy for elements of the latter. Thus, even a judge as conservatively focused on wealth maximization as Judge Easterbrook has assumed that all contracts contain an implied term that neither side will behave "opportunistically."[30]

Still, a preliminary question must be answered before either approach becomes applicable: is there a gap in the contract at all? On a theoretical level, one can make a persuasive case that gaps are inevitable because long-term relational contracts are necessarily incomplete.[31] "Bounded rationality" is a fact of life, which economics cannot ignore, and it implies that parties do not anticipate all future contingencies. This is particularly so in long-term contracting, because there are inevitable cognitive limitations on the human mind's information processing capacity.[32]

Yet, even if some gaps are inevitable, it does not follow that the parties would leave the most important terms and contingencies in the contract open. In this light, one can ask whether a rational creditor would have ignored a contingency as important as a limitation on debt incurrences. Arguably, such an omission amounts to a consent. Yet, the problem of gap definition is more complicated, as a brief historical survey may help reveal.

B. THE DISAPPEARANCE OF FINANCIAL COVENANTS

Prior to 1985, the financial marketplace had not seen firms suddenly restructure themselves in the aggressively leveraged manner that Unocal and Phillips Petroleum both did in that year. These transactions each resulted in

30. *See* Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 438 (7th Cir. 1987) (Easterbrook, J.) ("One term implied in every written contract and therefore, we suppose, every unwritten one, is that neither party will try to take opportunistic advantage of the other.").

31. For a good statement of this position, see Goetz & Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1092 (1981).

32. This concept, which originated with Herbert Simon, has been most fully articulated by Oliver Williamson. *See* Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233 (1979).

the companies' debt ratings falling from AA to BB—a level below investment grade.[33] Nor are these cases simply isolated events. By 1986, the pattern had become prevalent; debt downgradings by Standard & Poor's in that year exceeded upgradings by a two-to-one margin.[34]

Yet, even if bondholders did not have actual precedents to rely on prior to 1985, one can argue that the risk that management would restructure so as to "leverage the firm up to the eyeballs" was obvious. One answer may be that while creditors recognized this possibility, they also perceived no managerial incentive to engage in such conduct. During the halcyon days of the 1970s, creditors learned, based on their experience with the conglomerate acquisition waves of the 1950s and 1960s, that they need no longer fear managerial discretion in the large publicly held corporation. Even when conglomerate acquisitions increased leverage significantly, debt investors may have found that this impact was typically offset by a co-insurance effect, at least if the combining firms' cash flows were partially covariant. In addition, creditors observed over time that management had its own incentives to pursue growth and expansion, and to avoid excess leverage. Thus, to the extent that stability and the avoidance of risk appeared to be the common goals of management and bondholders during this era, most bond covenants restricting extreme leverage seemed superfluous (or at least not worth the interest rate penalty that the issuer might demand). Moreover, management often had legitimate reasons to seek the elimination of negative covenants that restricted additional debt or limited such issuance to a percentage of net worth. For example, management would often issue such debt to acquire assets that could not be valued on the firm's balance sheet at a value equal to the securities issued in exchange for it.[35] In practice, such issuances might reduce firm-specific risk and thereby benefit both managers and bondholders. As a result, bondholders and managers had common interests with which negative covenants could sometimes interfere.[36]

From a historical perspective, the 1985 Unocal and Phillips Petroleum restructurings, which were undertaken as novel takeover defenses, occurred in a watershed year. 1985 was also the year in which management perfected

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33. For the view that these two transactions represented a watershed, see Bratton, *supra* note 27, at 137.

34. *Id.* at 138 (footnote omitted).

35. This would be the case, for example, when goodwill had to be created as a balance sheet entry or when the acquired firm was otherwise purchased on the basis of its expected future earnings, rather than on the market value of its physical assets.

36. Negative covenants could also give rise to holdout problems if some, but not all, bondholders were willing to waive them. Legal restrictions exist on the ability of bondholders to grant a waiver in the case of publicly held debt. *See* Roe, *The Voting Prohibition in Bond Workouts*, 97 YALE L.J. 232, 250-51 (1987) (Trust Indenture Act prohibits majority modification of indenture core terms including price and maturity).

the poison pill and the Delaware courts upheld it.[37] In this light, the explanation given by the bondholder plaintiffs in the *RJR Nabisco*[38] litigation has some plausibility: they did not seek negative covenants on additional debt issuances because they assumed that debt would be issued only for "business purposes."[39] At the time, the risk that debt would be issued essentially to fund distributions to shareholders seemed nonexistent in the case of a "world class," publicly held corporate issuer.

The explanation that bondholders failed to understand the changing nature of the credit markets in which they participated has, however, an important flaw: internal documents discovered by the defendant in the *RJR Nabisco* litigation seem to show that the plaintiff creditor, Metropolitan Life, was well aware of the "event risk" posed by LBOs at the time it lent to RJR Nabisco.[40] Metropolitan Life did nothing, apparently because it was concerned that its competitive position vis-a-vis other lenders would be injured if it began to demand new covenants.[41]

Does this mean that Metropolitan Life accepted the risk? Met Life's answer is that the risk it accepted was that RJR Nabisco would issue additional debt, not that it would "deliberately liquidate its shareholders' equity after selling the bonds expressly on that assumption."[42] That is, had debt been issued for a productive business purpose, Met Life acknowledged that it could have raised no objection, but the issuance of debt to eliminate the "huge base of shareholders' equity [that] was a principal underpinning of the 'investment grade' ratings from Standard & Poor's and Moody's that were solicited by RJR to sell the bonds" constituted, in its judgment, a violation of an implied covenant.[43] In this view, the implied covenant was not a debt limitation, but rather a distribution restriction, and the amendments of the indenture to remove negative covenants did not affect it.

This argument may, however, involve too fine a distinction. Clearly,

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37. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356-57 (Del. 1985) (upholding "flip-over" poison pill defense whereby target shareholders receive rights to purchase the bidder's stock at a discount if the bidder merges with the target or consolidates with it through some equivalent transaction); *see also* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 958 (Del. 1985) (upholding discriminatory corporate repurchase of shares as a takeover defense tactic).

38. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989).

39. *Id.* at 1516.

40. Defendants pointed out that the indenture had twice been amended, in 1983 and 1985, to eliminate negative covenants that would have prohibited the RJR Nabisco leveraged buyout and that internal documents of the chief creditor showed that it was fully conscious of this risk. *Id.* at 1510-11.

41. *Id.* at 1513.

42. *See* Letter from Philip K. Howard, Counsel for Metropolitan Life in the *RJR Nabisco* case, to Professor E. Allan Farnsworth, Columbia University School of Law 1 (Jan. 10, 1990) (commenting on an earlier draft of this article and stating the theory of plaintiff's case) (copy on file at *The Georgetown Law Journal*).

43. *Id.* at 1.

Judge Walker at the District Court level thought so in dismissing Met Life's suit, but an appeal is pending before the Second Circuit. Whatever the outcome of the case, this distinction seemingly goes to the heart of the question of what kinds of behavior are "opportunistic": borrowing money need not be opportunistic, but distributing the equity easily can be. Yet, is the distinction manageable? What if only half the borrowed funds were paid out as a dividend? Is any material increase in dividends above the corporation's historic rate "opportunistic" if it is based on borrowed funds? Not only is it difficult to define opportunism in this context, but a judicial power to distinguish "good" borrowings from "bad" borrowings, or "good" mergers from "bad" mergers, creates great uncertainty in the capital markets.[44] At this point, the court would simply be adding a new substantive term to the agreement, rather than simply forbidding one party from undercutting rights that the other party bargained for. In terms of precedent, courts have not filled this large a gap with an implied term. In the District Court's view, the omission at issue in *RJR Nabisco*—the failure to limit subsequent debt issues—involved too central and prominent a term in the contract to expect a court to discover, on these facts alone, an omission that it could fill or an implied condition that protected the bondholders.[45] Arguably, the absence of a restriction on additional debt is less a gap than a triumphal arch through which bondholders invited the issuer to proceed, even if in theory an analytic distinction can be drawn between debt issuances for "business purposes" and those to fund distributions to shareholders.

Doctrinally, the problem with Met Life's attempt to rely on the duty of good faith to prevent all forms of opportunism is that the role of this duty has traditionally been more to constrain the exercise of a discretionary power possessed by one party in an ongoing contractual relationship than to trump

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44. In Hartford Fire Ins. v. Federated Dep't Stores, 723 F. Supp. 976 (S.D.N.Y. 1989), plaintiffs argued that although the bond indenture neither restricted additional indebtedness nor barred a merger, it intended only to authorize "traditional" mergers and borrowings in the ordinary course of business. The court rejected this claim squarely:

> [N]othing in the Indenture supports this distinction between 'good' and 'bad' mergers or 'ordinary' and 'extraordinary' debt. Moreover, permitting courts to weigh the virtues of such transactions on a case-by-case basis threatens to inject an impermissible degree of uncertainty into the bond market.

Id. at 992.

45. 716 F. Supp. at 1519. As the *RJR Nabisco* court said, "the implied covenant will only aid and further the explicit terms of the agreement and will never impose an obligation 'which would be inconsistent with other terms of the contractual relationship.'" *Id.* at 1517 (quoting Sabetay v. Sterling Drug, Inc., 69 N.Y.2d 329, 335, 506 N.E.2d 919, 922, 514 N.Y.S.2d 209, 212 (citation omitted)). Although additional facts, such as the issuer's efforts to obtain an investment grade debt rating, may justify judicial relief by suggesting an implied representation, the district court in the *RJR Nabisco* case assumed that the issuer had intentionally sought an investment grade debt rating and still granted summary judgment for the corporate issuer. *See id.* at 1514, 1526.

express terms in the contract or to substitute implied terms for terms that were removed from the contract by express amendment.[46] Courts may disregard an express term only when they find that the term is "unconscionable." Yet, it is usually the creditor, not the debtor, whose behavior is alleged to be unconscionable. Given the relative equality of the parties' bargaining power,[47] it seems unlikely that the debtor's failure to bind its own hands and preclude additional debt issuances could ever be described as "unconscionable." If so, absent fraud or a breach of representation by the issuer, the bondholders would appear to lose.[48]

C. THE DECLINE OF IMPLICIT CONTRACTING

This conclusion that the law provides few remedies for those who do not contract for protection leads us back to our earlier puzzle: what explains the mysterious failure of bondholders who purchased investment grade debt to negotiate for contractual provisions? If Met Life should not have believed that the law protected it, what other explanations are possible? Of course, there is always the possibility that Met Life simply blundered, that it made a unique mistake which other institutional investors avoided. This seems unlikely, because other institutions have either made similar mistakes or have also recently sued or vehemently protested.[49] Two other explanations seem more promising. First, one possibility is that inadequate information caused a market failure. Evidence of this theory may lie in the failure of the bond rating agencies to downgrade the debt securities of issuers such as RJR

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46. *See, e.g.*, Broad v. Rockwell Int'l Corp., 642 F.2d 929, 957-58 (5th Cir. 1981) (en banc) (directors did not breach fiduciary duty to debenture holders in approving merger that negatively affected debenture values because debenture holders assumed risk); Gardner & Florence Call Cowles Found. v. Empire, Inc., 589 F. Supp. 669, 673-74 (S.D.N.Y. 1984) (state contract law requirement of good faith not breached when merger did not deprive debenture holders of rights explicitly granted in contract); *see also* Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate Over Corporate Bondholder Rights*, 1989 COLUM. BUS. L. REV. 1, 123-33 (improper for courts to apply implied duty of good faith to create substantive protection for bondholders when inconsistent with express terms of bond contract).

47. *See RJR Nabisco*, 716 F. Supp. at 1521 (citing Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1982)).

48. One other theory remains for plaintiffs: breach of representation. In fact, Metropolitan Life raised a potentially meritorious breach of representation argument, claiming that RJR Nabisco's active solicitation of an investment grade bond rating amounted to a representation that it would not take voluntary action to undercut that rating. The court noted this argument in *RJR Nabisco*, 716 F. Supp. at 1514 & n.18, but never satisfactorily addressed it in the decision. Yet, even if this is deemed an implied representation, there remains the puzzling question of how long the representation survives. Does the issuer's solicitation of an investment grade rating really bind it to maintain that rating for the life of the bonds? Such a claim seems heroically overstated.

49. According to one recent study prepared by security analysts at Salomon Brothers, of a total of $147 billion of bonds vulnerable to "event risk," $54 billion of them were affected, "causing direct losses to investors of nearly $3 billion between 1986 and 1989." *See* Henriques, *End of the "Event Risk" Nightmare?*, N.Y. Times, Mar. 11, 1990, Bus. at 15, col. 4.

Nabisco. Met Life did not stand alone in its failure to respond to the risk if these rating agencies continued RJR Nabisco's rating at investment grade, even in the absence of negative covenants. A final possibility is that institutional investors relied on an implicit contract to protect them—that is, they believed that their long-term relationship with the corporate issuer would deter the latter from seeking to exploit short-term advantages. Under this story, implicit contracting broke down under the pressure of hostile takeovers.

The first theory of market failure must explain why information that sophisticated investors would have wanted did not reach them. At least with respect to traders in the secondary market, it is arguable that information about negative covenants is not available within the limited time available for making trading decisions.[50] Until recently, the screen trader buying debt securities in the secondary market often had little understanding about, or access to, information concerning the negative covenants applicable to the security. Even when the terms of the covenants were available, the trader may have still been uncertain about their efficacy. Although these traders' Quotran screens could tell them the security's interest rate and the issuer's credit rating, information about ambiguities in the indenture's covenants does not reduce well to the kind of symbols that can appear on a computer screen. Ultimately, this simply may be another example of information technology's tendency to squeeze out the softer variables in favor of those more easily quantified.

One difficulty with this argument, however, is that in principle, financial intermediaries—here, the credit rating agencies—should have been able to overcome the information cost problem inherent in gathering data about negative covenants. Still, until recently, the evidence indicates that they made little attempt to deal with the special problem of event risk.[51] As a result,

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50. This argument does not apply, however, to institutions such as Met Life that negotiated these covenants or at least bought the securities from the issuer in the primary market.

51. One recent study finds that Standard & Poor's changed its bond rating on average only 4.9 months after an LBO announcement; and Moody's, after only 4.7 months. This slow pace hardly suggests a diligent effort to present relevant information to consumers. *See* A. Warga & I. Welch, *supra* note 24, at 9. Even more pervasive problems exist with the market for information. Bond rating agencies are paid a modest amount by the issuer to review the issuer's securities, and typically the review process is cursory. Only the ratings of two agencies—Moody's and Standard & Poor's—truly count, and such an oligopolistic market structure falls far short of perfect competition. In particular, bond rating agencies are thought to be slow in responding to new information and in changing ratings. Often, a rating change is an event that follows, rather than precedes, the market's adverse reaction to a change in the company's financial position. *See* Hettenhouse & Sartoris, *An Analysis of the Information Value of Bond-Rating Changes,* 16 Q. REV. ECON. & BUS. 65, 76 (1976) (rating changes have little value because market price sufficiently reflects changed circumstances); Tauke, *supra* note 46, at 37-40 (failure of many bonds to decrease in market price after downgrading by rating agency probably reflects that bond market is only efficient for well-known, heavily traded debt instruments). Such delayed rating changes are of more interest to his-

"contract term" information may not have been priced as efficiently as information about interest rates or firm creditworthiness. In addition, the value of a negative covenant cannot always be reliably evaluated until it is tested under circumstances in which the issuer would like to escape its restrictions.[52] Therefore, traders may initially place insufficient value on "strong" negative covenants or an excessive premium on "weak" ones. If the market cannot distinguish "strong" indentures from "weak" ones at relatively low cost, then it may treat all issuers alike, and as a result, management will get little in return for binding its own hands effectively. Under these circumstances, a classic "market for lemons" could develop.[53]

Market failures are easier to predict than prove. What evidence then supports this claim that the market for information about bonds malfunctioned? First, one could cite the extraordinary increase in the information now provided by bond rating agencies about event risk. An entirely new rating system was put into effect in 1989 specifically to address this problem.[54] Yet, an increase in the information provided does not alone prove a market failure;

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torians than security analysts and explain the popular phrase in the industry that bond ratings are "rear-view mirrors." Finally, the reviewers who rate bonds at these agencies are usually modestly paid clerks, who seldom have the skills of highly trained and compensated corporate attorneys. For critiques of the performance of bond rating agencies, see J. PETERSEN, THE RATING GAME: A REPORT TO THE TWENTIETH CENTURY FUND TASK FORCE ON MUNICIPAL BOND RATINGS (1974); Coffee, *Market Failure and the Economic Case for A Mandatory Disclosure System*, 70 VA. L. REV. 717, 745-46 (1984). Still, the bond rating process is changing, albeit slowly, in response to the demand for new types of information. *See infra* note 54.

52. The first "poison put" debt covenants proved to be ineffective because they applied only to "hostile" transactions and could be evaded if the transaction at the last minute went "friendly." Other loopholes have been detected in more recent poison puts. *See* Steinwutzel & Gardner, *Super Poison Puts As a Protection Against Event Risk,* INSIGHTS Oct. 1989, at 3-6 (surveying various triggering events for "poison puts" and concluding that they are not panaceas for bondholder protection).

53. Such a development is possible when a firm cannot credibly signal that its covenants are effective restraints. Under such conditions, attempts to outperform the market average are futile and wasteful. For the standard account of this phenomenon, see Akerlof, *The Market For "Lemons": Quality Uncertainty And The Market Mechanism*, 84 Q.J. ECON. 488 (1970). To the extent that issuers cannot convince the market that their covenants are more effective than the "weak" covenants of other issuers, it becomes inefficient to include truly restrictive covenants in the trust indenture. Further, if as a result of the securitization of debt offerings, the issuer need not negotiate its debt covenants with sophisticated purchasers and also cannot easily distinguish its covenants from those of other issuers, these linked developments may imply that less incentive will exist to write meaningful, individually tailored debt restrictions—at least as long as the issuer receives little in return for doing so. Of course, this state of affairs may be a temporary, even fleeting phenomenon, and it seems unlikely to arise in private placement transactions in which issuer and institutional investor can bargain at length.

54. Standard & Poor's Corp. announced in July 1989 that it would start a new rating service to evaluate takeover protection that issues offered debt investors. The resulting five-tier rating system (called "Event Risk Covenant Rankings") has been applied to 14 issues containing poison puts. Interestingly, only one security of the 14 so rated was given the highest rating of E-1; this suggests that poison put provisions may sometimes be ambiguous or illusory. *See* Gilpin, *S & P to Rate Protection on Takeovers,* N.Y. Times, July 22, 1989, at 31, col. 6.

rather, it could simply indicate an increase in the demand for information as investors became aware of new risks and, in turn, became willing to invest greater amounts in securities research. Still, two other items of evidence supply important corroborating evidence of market failure. First, a study by Professors Asquith and Wizman has found an extraordinary amount of error and inconsistency in the information published by bond rating agencies.[55] Comparing the information in Moody's *Industrial Manual* with the actual prospectuses for the bonds, they found the Moody's description to be incorrect in 36 out of 171 cases studied (or 21%).[56] Another study by Professors Warga and Welch shows that bond rating agencies respond even to publicly disclosed events at a dilatory pace.[57] On average, they found that Moody's delayed 4.7 months after the LBO announcement before lowering its rating; and Standard and Poor's, 4.9 months.[58] These findings are consistent with earlier studies that have found the market generally not to react to ratings changes, apparently because the market had already anticipated the ratings decline.[59] In this light, rating agencies seem to have functioned more as "rear view mirrors," reporting assessments already reached by the market, than as purveyors of new information. To be sure, the limited role played by bond rating agencies does not alone prove that the bond market was inefficient, but it does negate the possibility that informational intermediaries were the mechanism that made the market efficient. Absent some institution to reduce and spread the costs of obtaining highly technical information, fragmented investors will not incur these costs on an individual basis and the level of information in the market will be suboptimal.

Fairness, however, also requires the recognition that these inefficiencies in the secondary trading market cannot account for the failure of institutional investors to insist upon strong negative covenants in the primary market (where transactions are negotiated on a face-to-face basis). Nor was any of these informational problems insurmountable, as the bond market's shocked reaction to the RJR Nabisco LBO transaction showed. In the aftermath of RJR Nabisco, suddenly virtually all bond offerings came to contain a new contractual protection—the "poison put."[60] A fuller explanation therefore requires that we examine the position of the investor's principal agent: the

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55. *See* P. Asquith & T. Wizman, Event Risk, Wealth Redistribution and the Return to Existing Bondholders in Corporate Buyouts 11 (Feb. 1990) (unpublished manuscript) (copy on file at *The Georgetown Law Journal*).

56. *Id.*

57. A. Warga & I. Welch, *supra* note 24, at 9.

58. *Id.*

59. *See, e.g.*, Grier & Katz, *The Differential Effects of Bond Rating Changes Among Industrial and Public Utility Bonds by Maturity*, 49 J. BUS. 226 (1976); Hettenhouse & Sartoris, *supra* note 51, at 65.

60. *See infra* notes 83-89 and accompanying text.

bond underwriter. Why did it not do a better job of negotiating adequate covenants or other protections for its customers? Why did bond underwriters ignore the problem of event risk for so long?

The best way to approach an explanation of the bond underwriter's arguably compromised position is to begin with the curious disappearance of negative covenants from bond indentures during the 1970s and early 1980s.[61] While financial economists have given little attention to this transition, the contrast over a decade is striking. A well-known study by Smith and Warner, which examined eighty-seven public issues between 1974 and 1975, found that over ninety percent contained a negative covenant restricting the issuance of additional debt.[62] Yet, examining ninety-two companies in the 1980s, McDaniel found that only twenty-eight percent of issues then included a similar covenant (and only sixteen percent of newer issues did).[63] Reflecting this shift, the American Bar Association adopted a new streamlined model indenture in the early 1980s that largely dispensed with business covenants on the assumption that investors did not care about them.[64] Interestingly, the disappearance of negative covenants was not limited to publicly issued debt. A 1987 study of leveraged buyouts by Marais, Schipper, and Smith[65] found that "more than 80 percent of [the] private long-term debt" in their sample lacked "covenants restricting the issuance of additional debt of equal or higher seniority."[66] Moreover, they found that private debt represented the largest single category of nonequity security in their survey.[67] Thus, even in the private placement context, in which it is far easier to tailor special debt covenants (and in which fewer issuers have very strong credit

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61. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413, 425-26 (1986) (reporting survey of Fortune 100 corporations and finding that few had negative covenants in their indentures). Of course, negative covenants remain common in bank loan agreements, but these are easily renegotiated and banks can be more easily compensated on an *ex post* basis for accepting additional risk. Still common in bond indentures is the negative pledge clause and certain prohibitions on sale and leaseback transactions, but all other "business covenants" appear to be vanishing. *Id.* at 426.

62. Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 123 (1979).

63. McDaniel, *supra* note 61, at 425-26. For a more recent discussion of this transition, see Bratton, *supra* note 27, at 139-42.

64. A.B.A. Section of Corp., Banking & Bus. Law, *Model Simplified Indenture*, 38 BUS. LAW. 741, 743 (1983).

65. Marais, Schipper & Smith, *Wealth Effects Of Going Private For Senior Securities*, 23 J. FIN. ECON. 155 (1989).

66. *Id.* at 161, 164. This finding that privately placed debt also lacked such business covenants contradicts the traditional view, as set forth in Smith & Warner, *supra* note 62, at 150-51, that purchasers of privately placed debt, being riskier, demanded such covenants while purchasers of much less risky publicly held debt were willing to dispense with them as superfluous. Apparently, the disappearance of these covenants was an across-the-board phenomenon that did not relate closely to the risk level of the debt.

67. Marais, Schipper & Smith, *supra* note 65, at 161.

ratings), debt covenants restricting subsequent debt issuances seem to have largely disappeared.

What explains this pattern? One can describe bondholders in the early 1980s as either exhibiting an unjustified complacency or as relying on an implicit contract, but either description is very different from asserting that they had knowingly accepted the risk that LBOs would come to pose. Put simply, bondholders had learned to trust management, but management had not acknowledged any reciprocating legal duties to bondholders. Because bondholders relied on custom, rather than on contracting, management may be said to have breached their trust, but not the contract.

Still, even if bondholders were complacent or overly trusting, why did not their agents—the underwriters—protect them? Typically, underwriters negotiate with the issuer the terms of the bond indenture as the advance agent of the bond purchasers. In this capacity, underwriters seem to have abandoned a long standard covenant that restricted subsequent debt issues. The reason for their puzzling passivity may lie in another transition that occurred in the early 1980s: the balance of power between the corporate issuer and its underwriters shifted sharply in the direction of the former. With the introduction of expedited short-form registration on Form S-3 and later shelf registration under rule 415,[68] the SEC introduced a new degree of competition into debt underwriting. This competition chiefly benefitted the issuer, which was now free to pick and choose among underwriters competing for its business. In such an environment, it would not be surprising that underwriters, anxious to hold and obtain new business, began to represent their customers' interests less zealously. This story that underwriters were compromised as the investors' agents by the institutional fact that the corporate issuer hires them does not deny that there may be some reputational loss from failing to represent the customer faithfully, but it responds that this potential loss was outweighed by the revenues otherwise clearly at risk.

While this capsule history is undoubtedly incomplete, it sets the stage for the major changes in the early 1980s. With little warning, takeovers went

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68. Form S-3 was adopted in 1981 as part of an effort to streamline the registration process and permit corporations already subject to the continuous reporting system of the Securities Exchange Act of 1934 to utilize filings made under that Act for purposes of satisfying their disclosure obligations under the Securities Act of 1933. *See* Exchange Act Release Nos. 6331-6338 (Aug. 6, 1981), *reprinted in* R. JENNINGS & H. MARSH, SECURITIES REGULATION 115-19 (6th ed. 1987). Essentially, Form S-3 permits qualified issuers to incorporate by reference material filed (or subsequently filed) under the Securities Exchange Act. R. JENNINGS & H. MARSH, *supra*, at 117. Rule 415, adopted in 1983, permits the registration of securities for a delayed or continuous offering. *See* Exchange Act Release No. 6499 (Jan. 17, 1983), *reprinted in* R. JENNINGS & H. MARSH, *supra*, at 199-209. Its adoption greatly telescoped the period between when an issuer decided to make an offering of securities and when that offering could be actually brought to market. Thus, it effectively fostered a competitive auction for the issuer's business, and this increased the issuer's negotiating leverage with underwriters.

from a force that produced expansion in firm size to one that, at least frequently, produced contraction. With the appearance of "junk bond" financing, takeovers became a disciplinary force that contributed to the downsizing of the conglomerate form of business organization. Diversification became a vice, not a virtue, and a host of corporations in the early 1980s undertook voluntary divestiture programs under the threat of a hostile takeover.[69] Spin-offs, restructurings, and assets sales also became commonplace. Finally, as private markets developed in which corporate acquisitions could be quickly financed, the LBO matured into a force by which virtually any corporate management could take virtually any company private. The symbolically culminating event in this transition was, of course, the 1988 RJR Nabisco leveraged buyout. In short, having convinced bondholders to delete most negative covenants for reasons that seem plausibly in their mutual self-interest, managements have exploited that trust when faced with shareholder pressures that might otherwise result in their ouster. In the terminology that this article will later use, this is not a story of coalition formation, but of coalition defection.

It now seems self-evident that bondholders were surprised both by the extent of their own exposure and by the unwillingness of courts to recognize any remedy applicable to them. But what does their surprise teach us? Perhaps it suggests that institutional learning occurs slowly and that even sophisticated investors can lull themselves into a false sense of security. These investors did not heed factors whose significance should have been recognized earlier until a vivid case dramatized their vulnerability. Thereafter, the markets were shocked temporarily, but in time new contractual devices and information systems emerged. Clearly, the message of the RJR Nabisco debacle for bondholders was that during an unsettled time, investors must contract with the issuer and not rely on past managerial practices or reputational capital. In time, as new contractual devices were developed, managements found ways to put these devices to their own use—to protect themselves from shareholders. This process by which contracting and coalition formation began to merge is the subject of Part III.

III. THE STAKEHOLDERS STRIKE BACK: NEW DEFENSES FOR THE CONTRACTUALLY EXPOSED

A. CREDITORS

1. The Extent of Bondholder Losses

As late as 1988, commentators rejected out-of-hand the possibility that stockholders' takeover gains came at the expense of bondholders:

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69. *See* Coffee, *supra* note 4, at 52-60.

> In sum, the evidence provides no support for the hypothesis that the supposed gains from acquisitions are actually transfers from the holders of senior securities to the holders of common stock.[70]

Early studies indeed showed that bondholders experienced only insignificant losses from takeovers and LBOs, but the data on which these findings were based were often quite thin. For example, a study by Lehn and Poulsen found only minimal price changes in the ten days before and after the announcement of the leveraged buyout, but this conclusion was based on a sample that consisted of the debt securities of only eight companies issuing publicly traded, nonconvertible bonds, and all their buyouts were in the period between 1980 and 1984.[71] A later study of price effects by Marais, Schipper, and Smith covered considerably more securities (fifty publicly traded, nonconvertible bonds issued by some thirty firms), but all the cases studied were before 1985.[72] Again, they found only minimal price effects on average, but they concluded that bondholders faced a maximum exposure of ten percent of the book value of their investment as a result of the buyout.[73] Such a loss by no means rivals the magnitude of shareholder gains, but it is hardly insignificant to most bondholders.

The Marais, Schipper, and Smith study is puzzling in that it found frequent bond rating downgradings and enormous increases in leverage,[74] but only modest price effects. However, when they focused on a subsample of firms experiencing buyouts in which (1) the buyout proposal resulted in either a downgrading in the Moody's debt rating of the security or a significant increase in leverage, and (2) the buyout was "nondefensive" and thus more likely to take the market by relative surprise, they found significant losses (at least when the increase in leverage was significant).[75] These results suggest that downgradings by bond rating agencies are in fact associated with real losses to bondholders, although the loss may typically precede the downgrading.

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70. *See* Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 57 (Winter 1988).

71. *See* Lehn & Poulson, *supra* note 10, at 51-52.

72. *See* Marais, Schipper & Smith, *supra* note 65, at 159.

73. *Id.* at 182.

74. In their sample of 113 buyouts, no firm had a debt/equity ratio exceeding .90 before the buyout (and only 22 had a ratio over .50), but afterwards 43 firms had a ratio over .90. *Id.* at 161. The median firm in their sample increased its debt/equity ratio by nearly .50, and over one-fifth of their sample increased leverage by over .70. *Id.* The median leverage ratio in their study shifted from .263 before the buyout to .845 afterwards. *Id.*.

In nearly all of the cases in their study, if there was a class of rated debt outstanding, its rating declined following a successful management buyout; in no case did it improve. *Id.* at 180-83. In 61% of these cases, the debt security had an investment grade rating before the buyout; in no case did an investment grade rating survive a successful buyout. *Id.* at 177-80. In short, leverage increases and rating declines went hand in hand and were widely prevalent.

75. *Id.*

Other studies examining data from the same period have similarly found significant wealth losses to bondholders, but only when the target firm's leverage increase was greater than fifty percent.[76] This point has significance because the most recent studies, all completed in late 1989 or early 1990, have uniformly found significant bondholder losses. Yet, in a sense, they are studying a different phenomenon, because, beginning around 1985, takeovers normally came to involve a very significant increase in leverage.

Studying successful leveraged buyouts in the 1985-1988 period, Warga and Welch found a significantly negative average return on outstanding publicly traded, nonconvertible bonds following the announcement of the LBO.[77] Moreover, they found that bondholder losses may be of the same order of magnitude as equityholder gains (although still smaller in absolute size). Why are their findings so divergent from earlier studies? Three reasons probably explain the discrepancy: (1) their data is post-1985, after which the size of leverage increases soared; (2) they used a much wider event window (four months before to four months after the announcement); and (3) they used trader-quoted prices rather than exchange-based prices. This third factor requires a special word of explanation because it casts considerable doubt on the accuracy of prior studies. Price quotes from the New York or American Bond Exchanges primarily reflect the odd-lot activities of individual investors; they cover only a limited number of issuers and a small portion of the overall trading. In the past, trader quotes have generally been unavailable to researchers, who have instead relied on "matrix prices." Matrix prices are supplied by various institutional reporting services but are actually based on formulas that simply estimate what bond prices should have been, based on the price of U.S. Treasury securities or an actively traded equity security of the same issuer. Employing actual trader quotes obtained from Shearson Lehman Hutton, Warga and Welch demonstrated wide divergences between trader quotes and matrix prices.

Although the Warga and Welch study found bondholder losses, it also tends to undercut the explanation that takeovers are motivated by a desire to exploit bondholders. Using cross-sectional data, they found that the amount of bondholder losses was not significantly related to the amount of shareholder gains.[78] In this light, the motive for LBOs does not appear to be the naked pursuit of wealth transfers from bondholders.

Two more recent studies confirm this picture. In the most detailed study yet completed, Professors Asquith and Wizman examined a sample of 215 bonds associated with 65 buyouts and found a statistically significant decline

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76. D. COOK & J. MARTIN, *supra* note 22, at 1, 13-16.

77. *See* A. Warga & I. Welch, *supra* note 24, at 20.

78. *Id.* ("Our regressions lead us to conclude that equity gains do not appear to be a significant predictor of bondholder losses in LBOs.").

of minus 2.6%.[79] In addition, they found that 68% of all bonds studied had a one month abnormal negative return around their event window; thus, one large transaction (such as an RJR Nabisco) cannot bias their findings. What is even more interesting about the Asquith and Wizman study is their next step: they subdivided the bonds in their sample into subclasses depending on the strength of their negative covenants. Having done so, they found that bonds with "strong" covenants rose 2.3% on the announcement of a buyout, while bonds with "weak" covenants fell 2.8% and those with no covenants sank 5.4%.[80] The gain on "strong" bonds apparently occurred because their owners recognized that these bonds would have to be redeemed in connection with the buyout since the corporation would otherwise be in default. Yet, as a result, gains on "strong" bonds masked steep declines on "weaker" ones.

Real as the bondholders' losses appear to be, the Asquith and Wizman study also presents data tending to refute the claim that bondholder exploitation is a significant motive for takeovers and LBOs. In the 49 successful buyouts in their sample, they found that bondholders experienced an aggregate abnormal loss of $708 million, but at the same time stockholders received abnormal gains of over $21 billion—in short, bondholder losses were only 3.3% of stockholder gains.[81] Thus, while there appear to be wealth transfers from bondholders to stockholders in takeovers, nothing suggests that this is the motor force behind the takeover phenomenon.

The final recent study, undertaken by two Salomon Brothers analysts, goes the furthest in terms of placing an aggregate price tag on the impact of "event risk" on bondholders.[82] Of a total of $147 billion in principal amount of bonds classified by them as vulnerable to "event risk," they found that $54 billion were affected, and direct losses of nearly $3 billion were experienced by investors between 1986 and 1989. In short, what could go wrong often did go wrong—but not so frequently as to suggest systematic exploitation.

Where then are we left? Real losses are apparently experienced, but these losses are only a modest fraction of the gains. Moreover, on a percentage basis, the losses are so small as to make it feasible for the law to require that

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79. *See* P. Asquith & T. Wizman, *supra* note 55, at 21.

80. *Id.* at 15.

81. *Id.* at 21. This figure rose from 3.3% to 7.22% if it is assumed that total debt, public and private, on the issuer's balance sheet "falls by an amount equal to the abnormal return of the public debtholders." *Id.* This seems an unlikely assumption, however, because short-term debt should logically be less affected by event risk than long-term debt. Still, the great unknown here is the amount of any loss on the part of employees. When added to that of the bondholders, it could represent a much greater percentage of the shareholders' gain and thereby give greater credence to the wealth transfer story.

82. *See* Henriques, *supra* note 49 (discussing study by Palermo, Skaperdas, and Weintraub).

bondholders be compensated, or even held harmless, without such a legal rule being likely to preclude takeovers.

2. Bondholder Responses

If the best evidence is now that bondholders do lose from LBOs, then we must recognize the period of 1985-1990 as one of profound disequilibrium for long-term creditors. But what happens next? Eventually, one would expect that sophisticated investors would protect themselves by developing new safeguards. Already, the pattern of these new contractual protections has crystallized and become known as the "poison put."

In brief, the poison put is a right given in the debt instrument to bondholders to demand repayment at their option of the full principal amount of the indebtedness (possibly plus a premium) in the event of certain occurrences such as a takeover, restructuring, recapitalization, or merger.[83] Between only January and June 1989, over fifty debt issues, totaling approximately $14 billion in principal amount, have contained such event risk protections.[84]

Poison put bonds first appeared in early 1986 (probably in direct response to the Revlon takeover the preceding fall).[85] However, the event that clearly traumatized bondholders was the RJR Nabisco buyout in 1988. Immediately, the popular financial press reported that the bond market had been seized by hysteria. Unable otherwise to offer long-term debt, several firms, including Harris Corp., Williams Cos.' Northwest Pipeline Unit, Becton,

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83. To date, poison puts have been used more to compensate bondholders against event risk than to deter hostile takeovers. Generally, poison puts (or "super poison puts" in the more extravagant language of the financial press) are triggered if a "designated event" (as defined) occurs and a specified decline also takes place in the debt's rating by either Standard & Poor's Corp. or Moody's Investors Services, Inc. Sometimes, a decline in the rating of both rating agencies is required. "Designated events" are typically defined as (1) a change in control, usually demonstrated by the acquisition of either 20% or 30% of the issuer's stock by a person or group; (2) a merger or acquisition of the issuer, including a sale of substantially all its assets; (3) a buy-back by the issuer of some percentage (usually 30%) of its stock within a defined period (usually a 365-day period); (4) a recapitalization that, either through repurchases or dividends, meets the 30% mark in a 365-day period; or sometimes (5) a change in continuing directors—that is, a failure of a majority of the directors to remain in office. *See* Heiberling, *Event Risk Provisions Protect Bondholders Against Takeovers,* Nat'l L.J., June 5, 1989, at 22, col. 1. Generally, these puts have had a five or ten year life, and thus do not last for the life of the bond. Sometimes, the issuer also has the option to override the put provision by increasing the interest rate to a level that in the judgment of a designated investment banking firm compensates the bondholders for the increase in event risk. For a more recent variant that gives event risk protection without being a takeover deterrent, see *infra* text accompanying note 89.

84. Steinwurtzel & Gardner, *supra* note 52, at 1; *see* Light, *Investors Are Developing a Taste for This Poison,* BUS. WEEK, July 10, 1989, at 78.

85. *See Poison Put Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy,* Wall St. J., Feb. 13, 1986, at 5, col. 1 (noting their use by W.R. Grace & Co. and Sperry Corp. in Jan. 1986). Moody's *Bond Survey* reported 46 related industrial downgradings for 1985, 1986, and 1987, which may also have spurred innovation in the bond market. *See* D. COOK & J. MARTIN, *supra* note 22, at 2.

Dickinson & Co., and Grumman Corp., adopted poison put provisions in 1988.[86] A typical poison put would entitle the holders of $50 million in face amount of debentures due in the year 2010 to be immediately paid this amount if a tender offer were made or if any person or group acquired more than twenty percent of the voting shares of the company. Particularly if interest rates had risen after the time of the debentures' issuance, the result could be a considerable windfall because debt securities trading in the market for, say, $45 million suddenly become worth $50 million on their tender to the issuer. In addition, an aggressive drafter could write the poison put to entitle the holders to a call premium of, say, ten percent (or $5 million more on these facts). The result then is twofold: (1) creditors are more than amply protected against event risk;[87] and (2) management has a new defensive weapon against takeovers, one which may be less vulnerable to judicial invalidation than the now familiar "poison pill."[88] Accordingly, the poison put represents an initial example of a coalitional strategy of the kind that this article suggests may become much more prevalent in future years. Here, bondholders and management link arms to reestablish their relative control over the firm's free cash flow, control that had been disrupted by the appearance of the bust-up takeover.

The defensive utility of the poison put as an antitakeover device is only marginal; it will not block those takeovers in which the bidder is willing to pay off the debt. Yet, its defensive impact is hardly accidental. This is clearer once one recognizes that the most obvious protection for bondholders from event risk is not a put, but an upward interest rate shift in the event of a rating downgrading. Given an active secondary market, such a provision adequately compensates diversified bondholders and permits nondiversified bondholders to sell into the market. Moreover, such contingent rate shifting bonds, which also first appeared in 1989, permit the issuer to reduce the interest rate slightly if the bond rating is upgraded.[89] Given this option and

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86. *See* Winkler & White, *Shock Still Clouds Blue-Chip Corporate Bond Market,* Wall St. J., Mar. 22, 1989, at C1, col. 3.

87. Indeed, the early evidence suggests that bond purchasers have placed a high premium on these new "put" provisions. For example, the Harris debenture issue, which was one of the first debenture issues to contain this provision, traded at 120 basis points over U.S. Treasury securities, instead of at the 160-190 basis points at which other debentures of similar risk levels were traded. *See* Heiberling, *supra* note 83, at 25, col. 4. In short, the market valued this poison put at from 40 to 70 basis points. In addition, the market estimated the value of the 10-year term of the Harris put (as compared to the more typical 5 year term) at 10-20 basis points. *Id.* However, there is also evidence that on close inspection, many of these puts are not as protective as they initially seem. So far, Standard & Poor's has given only one out of 14 issuers rated its highest "event protection" rating. *See supra* note 54.

88. *See infra* notes 122-136 and accompanying text for a discussion of why poison puts present greater difficulties for courts than poison pills.

89. In June 1989, Enrop Corp. of Houston issued the first of these bonds pegging the yield to the credit rating. Its bonds are rated BBB-, just above the floor in investment grade. Thus, investors

the fact that the issuer benefits under the shifting rate formula if there is a credit upgrading, the suspicion grows that those managements choosing to adopt the poison put format are utilizing the bondholders' anxiety for their own self-protective ends. In short, a coalition is formed between management and bondholders, and stockholders are the party left out.

B. EMPLOYEES

The status of employees has both important similarities with and differences from that of creditors. Employees have obvious reasons to fear that bust-up takeovers may result in staff reductions, pension plan terminations, and attempts by a new employer to breach prior implicit contracts and negotiate "give backs."[90] Although the actual extent of employee losses from takeovers is debatable,[91] the phenomenon of coalition formation with management to resist a takeover is more evident in this context than it is between creditors and management. Although there have been prior instances in which unions sought to influence control changes,[92] 1989 witnessed the first serious attempts at employee takeovers of solvent public corporations. This observation leads to a basic contrast between creditor and employee behavior in this area: employees have sought to rely more on governance protections than on contractual provisions.

Why? One reason may be that unions are greatly concerned with the identity and reputation of those seeking control but recognize that they cannot block all control changes. Another is that employees cannot "exit" the corporation as costlessly as can creditors (possibly because of firm specific capital) and so must negotiate for governance protections. To date, employee

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had special reason to fear a rating decline, and Enrop responded to this need. Under its indenture, if the credit rating is moved up to A-, the interest rate moves from 9.5% to 9.4%, but if the rating falls one notch (to below investment grade), the rate goes from 9.5% to 12%. *See* Light, *supra* note 84, at 78. Such two-sided adjustments protect both sides.

90. The evidence about the impact of takeovers on employment is in dispute. While takeovers are often followed by layoffs and plant closings, some studies find that in the majority of such cases, "the layoffs would probably have occurred without changes in control because of severe industry-wide competitive pressures." Bhide, *The Causes and Consequences Of Hostile Takeovers*, 2 J. APP. CORP. FIN. 36, 39 (1989). My claim here is only that from the perspective of unions and employees, the perceived impact of the takeover is clearly adverse to their interests.

91. Although the conventional wisdom is that takeovers cause significant reductions in employment within the target firm, empirical studies have not confirmed this view. *See* Lichtenberg & Siegel, *The Effect Of Control Changes On The Productivity Of U.S. Manufacturing Plants*, 2 J. APP. CORP. FIN. 60, 66 (1989) (finding principal impact of control changes to be on nonproduction and staff employees, with little impact on production employees).

92. For example, unions significantly influenced a contest for control of TWA in 1985 (in part by threatening to strike) to favor Carl Icahn over Frank Lorenzo. *See* Salpukas, *The Long Fight for TWA: Unions Decided the Winner*, N.Y. Times, Aug. 31, 1985, at 1, col. 5. Employees have also purchased control, typically through an ESOP, but these transactions have been both fully supported and largely structured by the incumbent management team.

takeovers—both actual and threatened—have chiefly focused on the airline industry, in which Northwest, United Airlines, TWA, and Eastern have all been the subject of such activity. The pattern has, however, varied. In the recent control contest over NWA, Inc. (the parent of Northwest Airlines), NWA's pilots' and machinists' unions initially asked for job protection covenants in their collective bargaining agreements that seemed intended to bar a hostile takeover by, or a sale of assets to, any person unacceptable to the unions.[93] When the pilots' collective bargaining agreement expired, press accounts suggested that the unresolved character of the collective bargaining agreement had an impact similar to that of a poison pill because management could agree to significant salary increases if a bidder bought control in a hostile raid;[94] in effect, the raid would trigger a windfall for stakeholders. Midway through this takeover battle, however, the union representing NWA's 20,000 machinists submitted its own recapitalization proposal to oppose bids submitted by Pan Am and Marvin Davis.[95] One bidder, Marvin Davis, entered into direct discussions with NWA's principal unions.[96] Alarmed at the prospect of a coalition forming between its unions and a hostile bidder, NWA's management obtained a temporary restraining order in federal court barring Davis and his representatives from communicating with NWA's unions.[97] In effect, management found an answer to the danger of coalition formation in this unique case by enjoining any such negotiations. Nonetheless, its victory proved short-lived, as another bidder (Alfred Checchi) eventually won control with union support.

In other recent instances, a coalition between unions and outside investors did form. In 1989, the unions at Eastern Airlines searched for a takeover bidder to wrest control from Frank Lorenzo and eventually formed an ultimately unsuccessful alliance with a Chicago commodities broker to structure

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93. *See* Valente, *NWA's Pilots and Machinists Indicate Willingness to Oppose a Hostile Bidder,* Wall St. J., May 8, 1989, at A4, col. 2.

94. Valente & Smith, *Northwest Pilots Emerge as Critical Force in Determining if NWA Gets Taken Over,* Wall St. J., Apr. 6, 1989, at A10, col. 1.

95. *See* Berg, *2 More Bidders Enter NWA Contest,* N.Y. Times, June 17, 1989, at 33, col. 3.

96. In NWA, Inc. v. Davis, No. 4-88-298 (D. Minn. Apr. 13, 1989), United States District Court Judge Harry H. MacLaughlin enjoined Marvin Davis and certain associates from engaging in "communications or other actions which interfere with or otherwise disrupt the current or prospective contractual relations between plaintiffs and the unions representing Northwest employees." *Id.* at 3. The court had first found that Mr. Davis or his representatives had "held discussions with representatives of Northwest's principal labor unions." *Id.* at 2.

97. *See id.* The basis for this seemingly unprecedented opinion appears to have been a theory of tortious interference with contractual rights. However, the court did not enjoin "nondisruptive communications between defendants and Northwest's unions." *Id.* The line seems hazy at best between "disruptive" and "nondisruptive" communications among a bidder and the target's unions. Still, the case shows that sometimes managers can secure legal relief against the prospect of coalition formation between stakeholders and shareholders.

a takeover deal.[98]

While airlines have been the principal targets of employee takeovers, other companies have also been the subject of employee buyout proposals. In 1989, the unions representing workers in the Chicago and Northwestern Rail System submitted a proposal for an employee buyout of the system's parent, CNW Corp.[99] Similarly, the Amalgamated Clothing and Textile Workers Union proposed employee buyouts in 1989 for both Cluett Peabody & Co. and Health-tex.[100] What distinguished the airline takeover attempts was the industry-wide effort of employers to negotiate "give backs" and benefit reductions. As a result of deregulation, new entrants to the airline industry had challenged mature firms, in part by hiring nonunionized labor at substantial savings. Faced with this competitive challenge, older firms had responded by seeking to negotiate wage reductions. Interestingly, the backdrop to the modern history of employee takeovers is not the prospect of job loss, but rather the threat to an above-market wage structure.

By far the most publicized transaction involving unions in 1989 was the abortive effort by UAL's pilots' union to structure a $6.75 billion leveraged buyout of UAL.[101] The UAL buyout attempt had a long history, as the pilots' union had played a central role in a loose coalition with several large investors that succeeded in ousting UAL's chief executive officer, Richard J. Ferris, in 1987.[102] At one point, the union, assisted by an investment banking firm acting as an adviser, had considered and almost made a hostile tender offer. Its efforts were thwarted, however, in large part because of the constant and bitter opposition of UAL's other principal union—the machinists' union—which negotiated a labor contract with management that effectively blocked the pilots' proposed buyout through an ESOP.[103] Nonetheless, following a hostile bid by Marvin Davis for UAL in 1989,

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98. *See* Salpukas, *Eastern Union Set Back As Bid for Takeover Fails,* N.Y. Times, June 6, 1989, at D1, col. 1.

99. *See* Marsh, *CNW Unions Submit Offer to Buy Stake,* Wall St. J., June 5, 1989, at A4, col. 4.

100. *See, e.g.,* Trachtenberg, *Clothing Union to Make Offer for Health-tex,* Wall St. J., June 13, 1989, at A6, col. 1 [hereinafter Trachtenberg, *Clothing Union Offer*]; Trachtenberg, *Textile Union Discloses Hays as Partner In Its Attempts to Acquire Cluett Peabody,* Wall St. J., June 6, 1989, at A6, col. 1.

101. *See* Salpukas, *Out of Disorder, a Deal: 5 Weeks of UAL Talks,* N.Y. Times, Sept. 19, 1989, at D1, col. 2. In April 1990, a revised and reduced buyout for $4.38 billion was made by all three of UAL's principal unions and was accepted in principle by UAL's board of directors. *See* Salpukas, *Owner Backs Sale Of United Airlines To Worker Group,* N.Y. Times, Apr. 7, 1990, at 1, col. 3.

102. For a detailed account of the origins of this buyout attempt in 1987, see Hyde & Livingston, *Employee Takeovers,* 41 RUTGERS L. J. 1131, 1154-63 (1989). The pilots' union was chiefly dissatisfied with UAL's diversification into the hotel and car rental businesses, which UAL left after Ferris' ouster.

103. For history of this dispute, see Airline Pilots Ass'n Int'l v. UAL Corp., 699 F. Supp. 1309 (N.D. Ill. 1988), *aff'd in part, rev'd in part,* 874 F.2d 439 (7th Cir.), *on remand,* 717 F. Supp. 575 (N.D. Ill. 1989).

UAL's management quickly switched sides and formed an alliance with the pilots' union to propose a leveraged buyout under which employees would acquire seventy-five percent of UAL (with the remaining equity being divided between management and a third party investor, British Airways). The corporate governance provisions negotiated to hold together this shotgun marriage of labor and management were specially tailored and appear to be unprecedented. Although the unions were to have only three seats on a fifteen-member board (with eight seats held by independent directors), two out of the three labor directors' votes would be necessary to approve any major decision.[104] This insistence by the pilots' union on a special veto power over important decisions seemingly reflected a distrust of UAL's management and a fear that management would otherwise be in a position to breach its implicit deal once the transaction was complete. For their interests to be protected, the union's representatives felt it necessary to insist on a veto power over any major divestiture or acquisition of assets or any move toward diversification.[105] In short, contractual provisions were not enough; governance had to be shared—possibly so that free cash flow would be kept locked in the core business.

The UAL story does not end, however, with a happy marriage of labor and management. The machinists' union remained bitterly opposed to the buyout throughout 1989, and their hostility, according to press reports, caused the "unraveling [of] the deal by frightening potential lenders."[106] Following the inability of the original buyout proposal to obtain adequate financing, the UAL board withdrew its support for the buyout. Nonetheless, arbitrageurs, who had been left holding substantial blocks of UAL stock whose value had declined precipitously after the buyout's failure, began a consent solicitation to remove the board and approached the pilots' union for support.[107] Both the unions and shareholder groups showed that they could form a coalition against the board as well as with it.

Finally, in early 1990 the rival unions did form an alliance and formulated a buyout proposal based on the use of an ESOP that would give employees seventy-five percent ownership of UAL.[108] This proposal, however, excluded UAL's chief executive officer, Stephen Wolf, from any significant equity participation, and he apparently resisted it as a result. In effect, by early 1990

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104. *See* Salpukas, *supra* note 101, at D17, col. 1. In particular, any disposition of airline assets or any diversification into other businesses would require labor director approval. *Id.*

105. *Id.*

106. Miller & Smith, *UAL's Board May Be Pushing Buy-Out Effort,* Wall St. J., Nov. 13, 1989, at B2, col. 4.

107. *See* Salpukas, *New Move for Control of UAL,* N.Y. Times, Nov. 4, 1989, at 33, col. 4.

108. *See* Salpukas, *Unions Set To Make UAL Offer,* N.Y. Times, Jan. 25, 1990, at D1, col. 3; *see also* Salpukas, *Labor Overcame Differences to Hammer Out a UAL Bid,* N.Y. Times, Apr. 9, 1990, at D1, col. 1 (describing negotiations among unions and with Coniston Partners).

the unions had come full circle back to their original position in opposition to management. What is most striking about the UAL story is that over the course of an almost three-year period, every coalition that could be formed was formed: management allied with one union against another; the unions allied with each other and with management; and ultimately the unions allied with a powerful shareholder to outflank management. Machiavelli would have understood this world of alternating coalition formation and defection.

In overview, recent employee buyout proposals have generally been structured to include an outside partner. Typically, a union bidder will seek an alliance with an independent investor or another firm in the same industry (such as British Airways in the UAL deal or KLM in the Northwest Airlines transaction). In addition, both Eastern's unions and the Amalgamated Clothing and Textile Workers Union secured independent investors to serve as their partners. While this pattern can be explained as simply a search for equity capital, it may also be intended to demonstrate the unions' credibility as serious investors. The presence of an outside investor also distinguishes these transactions from simpler ESOP transactions, which are also often funded through wage concessions.[109] Even over the last year, the scale of the wage concessions that unions have offered has climbed rapidly. NWA's unions offered somewhat vague productivity savings as their *quid pro quo* for job protection.[110] Possibly more desperate, Eastern's unions appear to have engaged in more explicit bargaining, offering "to sacrifice as much [as] 35% of their wages to help [their preferred bidder] stem losses during a revamping of the airline."[111] Most recently, UAL's pilots offered $2 billion in wage concessions over a five-year period in return for most of the equity in the buyout.[112]

The more puzzling question is why unions believe a change in equity ownership matters to them. In terms of classical economic theory, businesses do not shut down as long as average variable costs are being recovered. Even if a new owner finds it expedient to sell divisions or liquidate the company, viable operations do not disappear into a black hole. A new owner may terminate losing operations, but in theory the former owner would do so also. Why then are the unions so concerned? The most plausible explanation is that unions perceive corporate control changes to pose a threat of involuntary wealth transfers from employees to shareholders. But how does this happen? One empirical fact may help clarify their fears: to date, unions

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109. For an example, *see infra* note 119.

110. *See* Valente & Carey, *NWA Union's Restructuring Proposal Would Include Payout, Employee Stake,* Wall St. J., June 2, 1989, at A4, col. 1.

111. Harlan, *Eastern's Creditors, Terming Ritchie Bid Unfeasible, to Renew Talks with Carrier,* Wall St. J., June 6, 1989, at A4, col. 2.

112. *See* Salpukas, *supra* note 108, at D1, col. 1, at D4, col. 1.

have become "players" in corporate control contests almost exclusively in the cases of financially troubled companies or companies whose managements were seeking "give backs" and salary reductions.[113] Jack Sheinkman, the president of the clothing union seeking to buy Health-tex, has been particularly candid: "We're doing this so that we'll have some say in the future outcome of the firm . . . . It's a very troubled company. If we're successful, we plan to bring in management."[114]

The unions' fear appears to be either (1) that new owners can exploit the uncertainty surrounding a financially distressed company to negotiate opportunistically for wage or other concessions that are not truly cost justified, or (2) that new owners will not observe prior implicit contracts that the unions had with the former owners.[115] If workers are risk averse, they may not be willing to call the new owner's bluff when it threatens to close or relocate plants or operations. Indeed, some evidence suggests that the unions which have made bids are precisely those most likely to be risk averse, because they have already suffered significant declines in membership and would not remain viable if such losses continued.[116]

Of course, it is not immediately apparent why the former owners could not also exploit these same fears or why a takeover is necessary before shareholders bring coercive pressure to bear. Two different hypotheses seem possible: (1) the former management recognized an implicit contract with the unions that protected the latter's job security, while the new bidder team would not respect this legally unenforceable understanding;[117] or (2) the shareholders, having been frozen out by a management-union coalition that formed to lock "free cash flow" into the firm, were eager to accept the overtures of any bidder who would break up this coalition and divide the free cash flow with them. In this latter view, the bidder and target shareholders represent a counter-coalition to that of the management and the unions.

Given these fears on the part of labor, what explains the difficulty (and indeed the marked antagonism) that unions have experienced when trying to cooperate with each other to effect a buyout? The bitter hostility between UAL's pilots' and machinists' unions is the most dramatic example of this

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113. UAL was probably the only financially healthy target of recent employee buyout proposals, and its management was seeking salary concessions. *See id.*

114. Trachtenberg, *Clothing Union Offer*, *supra* note 100, at A6, col. 2.

115. For an elaboration of this argument in traditional economic terms, see Schleifer & Summers, *supra* note 9, at 43-46. The old owner may be unwilling to behave opportunistically but has no qualms about selling at a premium to those who will. *Id.* at 41.

116. *See* Trachtenberg, *Clothing Union Enters the Buy-Out Fray,* Wall St. J., June 1, 1989, at B8, col. 5 (Amalgamated Clothing and Textile Workers Union declined from 325,000 to 274,000 members over past five years).

117. This is the position taken by Schleifer and Summers: namely, that the prior management had shown a career-long commitment to honoring the implicit contract and so was trusted by the unions. *See* Schleifer & Summers, *supra* note 9, at 42.

problem, and it will be analyzed further in the final section of this article. In the UAL buyout, the bid by management and the pilots union depended upon wage concessions by all employees, but the two other major unions, the machinists' and the flight attendants', each refused to participate in the buyout or accept pay cuts.[118] On one level, it is obvious that unions differ in the economic position of their members and thus in their ability to finance an ESOP with wage concessions. Not surprisingly, those unions unable to participate in the ESOP (and thus not sharing in the potential for equity appreciation) are more likely to be resistant to demands for wage concessions. Yet, more seems involved than just these differences in the economic positions of different unions, and Part V of this article will try to provide a fuller explanation of the difficulties inherent in coalition formation.

Nonetheless, union activity in takeovers seems likely to grow. Once unions learn that takeovers are a game that anyone can play and that they may have the power to scare off disfavored rival bidders, they have little reason not to use this leverage—unless they find that union-managed companies present them with more problems and conflicts than they wish to face. The factor most likely to increase stakeholder participation in takeovers is the new popularity of ESOPs as a takeover defense.[119] Given the tax advantages of ESOPs, they present a generally available and appealing strategy by which a coalition can form between management and stakeholders to block a takeover.[120] But they are not unique. Poison puts and collective bargaining agreements also permit two sides in the three-sided game of corporate governance to conspire against the third.

In overview, one difference between the responses of bondholders and unions to the threat of corporate control changes deserves special emphasis. In the wake of event risk, bondholders have been largely satisfied with new contractual protections: namely, the restoration of negative covenants and the

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118. *See* Bartlett, *United Airline Deal: A Costly Fiasco,* N.Y. Times, Oct. 25, 1989, at A1, col. 2. Eventually, the flight attendants' union agreed to participate but only after the pilots' union dropped the requirement that the attendants accept a pay cut. *Id.* at D8, col. 3.

119. For a recent case in which an ESOP was used to block a takeover bid, see Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 275-76 (Del. Ch. 1989). The holding of this case appears to be that a "shareholder neutral" ESOP (that is, one funded by employee wage concessions) is intrinsically fair and so need not be tested by the usual *Unocal* takeover standard, which asks whether the board's defensive action was "reasonable in relation to the threat." *Id.* (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985)). Also relevant to the court's decision was the ESOP's impact on the operation of the corporation, its "antitakeover effect," and its effect on diluting outstanding shares of company stock. *Id.* at 271. The court also seemed to place special emphasis on the secret pass-through voting and tendering structure of the Polaroid ESOP. *Id.* at 273-74. In its wake, many commentators have seen the ESOP emerging as a popular takeover defense. *See* Hilder & Smith, *ESOP Defenses Are Likely to Increase,* Wall St. J., Apr. 6, 1989, at A2, col. 2 (discussing popularity of ESOPs after successful defense by Polaroid Corp. to 1989 takeover attempt by Shamrock Holdings, Inc.).

120. *See infra* notes 152-153 for a discussion of ESOPs as a takeover defense.

development of the poison put. In contrast, unions have sought governance protections. Why? Possibly a partial answer is that long-term collective bargaining agreements are not feasible or, in an inflationary world, might be biased in favor of management. Possibly, they have firm-specific human capital invested in the firm, or possibly they are seeking to protect economic rents in the form of above-market wages. Whatever, unions have come to fear not just salary renegotiations, but any major change in corporate financial structure (such as a financial restructuring or a major move toward diversification) that might make it necessary for a successor management team to seek financial concessions. Thus, in the UAL bid, union directors negotiated special governance provisions that gave the unions a veto power over these matters.[121] In effect, unions seem to have sensed the failure of contracting and sought instead to form a permanent coalition by acquiring equity.

IV. THE JUDICIAL ROLE

With increasing but still sporadic frequency, courts have invalidated as a breach of fiduciary duty a broad range of antitakeover tactics, such as poison pills, lock-ups, and recapitalizations. What then is distinctive about stakeholder agreements as a takeover defense? The short answer is that these cases involve truly bargained-for consideration, and courts find it more difficult to invalidate a deal seemingly negotiated at arm's length between traditional economic adversaries. Unlike more traditional takeover defenses, these are bilateral agreements. For example, a poison *pill* is a gratuitous transfer of warrants issued by management, in theory to protect shareholders from coercive tender offers. In contrast, a poison *put* (or a similar provision in a collective bargaining agreement) is typically not gratuitous, but is bargained for between parties—the corporation and its creditors—who are normally at arms' length. With a poison put, management is in the posture of acceding to something its creditors have demanded. No such "demand" exists in the poison pill case, and the judicial task is simplified to determining whether management acted as a fiduciary for its shareholders.

Above all, this detrimental reliance factor distinguishes agreements between the firm and its stakeholders from traditional antitakeover defenses. When bondholders negotiate for a poison put, they presumably give up something in the form of higher interest rates. Similarly, when a labor union negotiates for job security or makes its collective bargaining agreement automatically terminate on the occurrence of a takeover or a defined share acquisition, it may be forgoing higher wages. No such trade-off is present when a board adopts a poison pill to block a potentially coercive takeover,

121. *See supra* text accompanying notes 101-105.

because the shareholders do not voluntarily give up anything in return. Hence, judicial review can be more searching (as Delaware's *Unocal*[122] standard certainly is) because the court only has to consider the impact of the board's action on one constituency, the shareholders. In contrast, when reviewing a bilateral agreement between unions or bondholders and management, the court cannot invalidate the agreement without causing stakeholders to suffer an uncompensated loss. Because the court cannot restore the status quo prior to the agreement, its willingness to grant relief will be predictably chilled. In general, absent proof of a conspiracy to defraud, courts do not invalidate a contract because one side gave up too much, and courts do not claim the competence to decide how much consideration is too much.

Stakeholders, as the new players in the takeover game, also have legitimate interests for which to bargain. Job security, for example, has always been a union goal in collective bargaining negotiations. On the other hand, the prospect of collusion is clearly present when stakeholders and management unite to lock free cash flow into the firm. How well can courts distinguish collusion from legitimate contractual measures to protect stakeholders? The few relevant cases to date provide mixed signals.

Perhaps the clearest illustration of a case in which management's concessions to stakeholders appear to have been deliberately excessive is *Gearhart Industries, Inc. v. Smith International, Inc.*[123] There, the target responded to a creeping open market acquisition by the bidder by issuing a package of debentures and warrants to a group of institutional investors.[124] Specifically, the target issued nearly $100 million of subordinated debentures and accompanying warrants to purchase nearly three million shares of the target's stock several days after a bidder had accumulated over thirty-three percent of its stock.[125] Under a "springing" provision in the warrants, their exercise price would decline from $33 per share to $24.60 per share if a tender offer was made without the target board's approval.[126] Because the tender offer made by the bidder in *Gearhart* was at $31 per share, the impact of these warrants, suddenly exercisable at $24.60, was basically as dilutive to the bidder as the typical "flip-in" poison pill,[127] with the one critical difference that the wind-

122. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985) (takeover defensive tactics must be reasonable in relation to threat to protect shareholders from "omnipresent spectre" of board's self-interest).

123. 592 F. Supp. 203 (N.D. Tex.), *aff'd in part, modified in part,* 741 F.2d 707 (5th Cir. 1984). The fact that the stock had recently traded below the warrant's strike price convinced the appellate court that the warrants were not issued at an irrationally low price. 741 F.2d at 722-23. Query: should irrationality be the appropriate judicial standard?

124. 741 F.2d at 722-23.

125. *Id.*

126. *Id.* at 718.

127. A "flip-in" poison pill typically involves the target granting rights to its shareholders that

fall gain would go not to the other shareholders, but to the holders of the subordinated debentures. Still, the court refused to enjoin this defense. In upholding the "springing warrants," it relied on the facts that the debentures bore interest at an effective rate that was not disproportionate to prevailing interest rates and that the target's stock had recently traded below the exercise price of the warrants.[128]

Still, *Gearhart's* analysis seems badly flawed. The springing warrants issued by the target had value only to the extent that a hostile tender offer was made for the target. The greater their value as a deterrent, the less their value as a free-standing warrant. By analogy, their operation was similar to a poison put that entitles bondholders to a call premium of one hundred percent in addition to the full principal amount of their debentures—but only if a hostile tender offer is made for the target. Both securities—the hypothetical poison put bond and the springing warrants in *Gearhart*—respond to the exposed position of the debt holders, but both respond excessively and in a manner that obviously protects management. Today, the more proportional and appropriate remedy would be the poison put that entitles the debt holder to redeem its investment only at face value (plus possibly some modest call premium).

If *Gearhart* suggests that courts will defer to the board when it offers a collusive "bribe" to bondholders, a more recent case suggests a different approach, at least when the transaction seems to reflect the board's largesse rather than hard bargaining. In *Air Line Pilots Association International v. UAL Corp.*,[129] the only case to date to deal with a "labor contract poison pill," the UAL board inserted in the machinists' collective bargaining agreement two provisions intended to deter a threatened takeover by UAL's pilots' union. The first provision entitled the machinists' union, the long-standing rival of the pilots, unilaterally to begin a new round of collective bargaining negotiations in the event of a takeover. In effect, this provision told the lenders to the pilots' buyout proposal that they would be "lending into a strike."[130] The second provision established a "most favored nation" rule for ESOPs and similar employee ownership plans, entitling all unions to equivalent treatment with respect to such equity ownership plans, but prescribing a curious rule of equality: all stock to be issued under such plans had to be allocated not on the basis of employee salaries, but on the basis of the wage concessions employees were willing to make from the "market

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entitle them to purchase target shares at a great discount in case of a hostile bid for control or an acquisition of a specified percentage of its shares by any person.

128. 741 F.2d at 722-23.

129. 699 F. Supp. 1309 (N.D. Ill. 1988), *aff'd in part, rev'd in part*, 874 F.2d 439 (7th Cir.), *on remand*, 717 F. Supp. 575 (N.D. Ill. 1989).

130. 874 F.2d at 441-42.

wages" that an arbitration panel found would prevail in a free and open (nonunion) market.[131] Although the uncertainty created by this proposal was itself a deterrent, it was clear, as Judge Posner found for the Seventh Circuit, that the effect of the provision would "be to dilute the pilots' ownership and control."[132]

The pilots' union claimed that these provisions violated Delaware corporation law, but the district court held that the Federal Railway Labor Act preempted Delaware law.[133] It then held that the same federal statute required the invalidation of the "most favored nation" clause because the pilots had not had an opportunity to collectively bargain over it.[134] On appeal, the Seventh Circuit overruled the holding that Delaware's corporation law was preempted, but upheld the holding that the "most favored nation" provision violated the federal statute.[135] On remand, the district court held that the antitakeover provisions in the collective bargaining agreement violated the *Unocal* standard and invalidated them.[136]

What distinguishes *Gearhart* from *Air Line Pilots*? A legal realist might conclude that in *Gearhart* the special provision—the "springing warrants"—was bargained for; but in the *Air Line Pilots* case it was not. In the latter case, the two provisions inserted into the collective bargaining agreement were gratuitous changes offered by the board to one union in order, ironically, to block a bid proposed by another union.

Air Line Pilots is then an easy case, but in harder cases like *Gearhart*, courts have not yet been willing to inquire if the excess protections stakeholders received were necessary. Because the case law in this area is still at a formative stage, it may be more useful to put aside the question of the appropriate judicial response for the remainder of this article and focus instead on how the parties are likely to behave in this new triangular bargaining game.

V. A GAME THEORY APPROACH

To this point, this article has deliberately oversimplified by treating stakeholders as a unified group with homogeneous preferences. Clearly this is not so, because creditors and unions can have sharply conflicting interests. Even within a class of employees, interests are not necessarily unified. The prolonged conflict between the machinists' and pilots' unions at UAL provides dramatic evidence of the difficulties employees face in achieving unity when confronted with a buyout. Initially, the machinists' union joined with man-

131. *Id.* at 442-43.
132. *Id.* at 443.
133. 699 F. Supp. at 1332-34.
134. *Id.* at 1331.
135. 874 F.2d at 439, 446-47, 448.
136. 717 F. Supp. at 588-89.

agement to attempt to block a tender offer by the pilots' union, but later, once management and the pilots' union had reached agreement on a buyout, the machinists' union sought to dissuade lenders from financing the buyout.[137] In effect, although UAL's management had originally opposed the pilots' proposed takeover, it switched sides and joined forces with the pilots' union once a hostile bidder announced a tender offer for UAL. Originally management's ally, the machinists eventually found themselves, at least for a time, out in the cold. Most recently, both unions have begun discussions with a shareholder group seeking to oust the incumbent management.[138] A union coalition was thus eventually achieved, but only with extraordinary difficulty and after all participants believed themselves to have been double-crossed at least once.

This pattern of rapidly shifting coalitions seems likely to recur with frequency. Confronted with a hostile bidder, management will predictably seek to align itself with any allies who can help it fend off the outsider's attack. Unions, in turn, may prefer the known evil to the unknown one, and thus may prefer to form a coalition with management (at least unless they are offered more by the hostile bidder). Logically, the unions could simply align themselves with the highest bidder, subject to possible problems about whether the bidder's commitments are credible. Yet if the UAL story is representative, it appears that unions may not be able to form a united front, even if it is in their rational self-interest to do so.

What could prevent rational self-interested economic actors from achieving their collective self-interest? Economic theory can supply an answer to this question, but only under certain conditions whose applicability to this context are debatable. Initially one can attempt to explain such a market failure as a collective action problem. In a well-known work, Mancur Olson has shown that collective action to produce a collective good often will fail when there is no mechanism for taxing the free riders with their proportionate share of the good's costs.[139] Olson argues that the larger the group, the greater the likelihood that its members will be unable to organize to take collective action in their mutual interest.[140]

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137. *See generally* Hyde & Livingston, *supra* note 102. This conflict is also well illustrated by the *Air Line Pilots* litigation, described *supra* text accompanying notes 129-136.

138. *See* Salpukas, *UAL Agrees to Coniston Negotiations,* N.Y. Times, Mar. 23, 1990, at D4, col. 4 (noting that Coniston Partners and three of UAL's unions formed an alliance to make a new buyout bid at an effective price between $180 to $190 per share, with the unions to acquire 75% of the stock).

139. *See* M. OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 44 (1968).

140. *Id.* at 36. He conversely argues that "[u]nless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, rational, self-interested individuals will not act to achieve their common or group interests." *Id.* at 2 (emphasis omitted). Others have challenged Olson on whether group size is

Applying Olson's logic to the takeover context, one could define the collective action problem as that of organizing the unions to share proportionately the cost of the buyout, which typically will be taxed against them in the form of reduced wages. Of course, the story may not be this simple. In the UAL case, it may instead have been the case that because the machinists' and flight attendants' unions were unable to join the buyout group, they were less willing to accept the same wage concessions as the pilots' union, which was willing to trade wage concessions for equity. Still, it is also possible that the machinists' and flight attendants' unions simply believed that the pilots would be willing to bear all, or a disproportionate share, of the concessions and so, in a rationally self-interested manner, were prepared to let them do so. In either event, if we assume all the unions would have been worse off had a hostile raider taken control and imposed even greater concessions or layoffs, we can postulate that the machinists' and flight attendants' unions were seeking to some extent to "free ride" on the pilots' union. The resulting failure of the negotiations would therefore be described as a failure of collective action. Still, viewed strictly in Olson's terms, the collective action explanation encounters a serious problem because in the context of internal bargaining within the firm in a takeover setting, the number of actors is small and agreement among them still seems possible. To have explanatory force, one must show that collective action problems apply even to relatively small groups.

A. THE PRISONER'S DILEMMA IN STAKEHOLDER NEGOTIATIONS

One way to explain the failure of small groups of rational actors to achieve a cooperative solution is to model takeover negotiations within the firm as a "Prisoner's Dilemma." In a Prisoner's Dilemma game, there are classically two players, each having two choices: to cooperate or defect. In the standard illustration of this problem, it is assumed that a prosecutor will negotiate separately with each of two prisoners to secure his cooperation against the other and that the two prisoners cannot communicate or otherwise know what the other has done. If both prisoners independently decide to cooperate, they receive a reward for cooperation in the form of a reduced sentence. If one "defects" (i.e., turns state's evidence) while the other "cooperates" (i.e., refuses to confess or implicate his colleague), the first prisoner will be dealt with very leniently, and the second prisoner very harshly. If both defect, however, both will receive more severe sentences (although not as severe as that received by the prisoner who cooperated when the other defected).

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really the relevant variable and have argued that in some circumstances small groups may be even more hobbled than large ones by collective action problems. *See* Chamberlin, *Provision of Collective Goods As A Function of Group Size*, 68 AM. POL. SCI. REV. 707, 715 (1974).

On these assumed facts,[141] one can argue that it is always rational to defect rather than to cooperate, because the individual's payoff is always higher from pretending to cooperate but then defecting. Figure One illustrates this point:

FIGURE ONE

		Prisoner B	
		Cooperate	Defect
Prisoner A	Cooperate	A=3, B=3	A=0, B=5
	Defect	A=5, B=0	A=1, B=1

Each player will recognize that a decision to defect presents him with two outcomes (5 or 1), whose payoff has a weighted average of 3, whereas a decision to cooperate can only result in two outcomes of 3 and 0, whose payoff has a weighted average of 1-1/2. Obviously each player will prefer 3 to 1-1/2 and so will defect. Yet the key point here is that what is individually rational is not collectively rational because the collective payoff to both players from cooperation is 3 plus 3, or 6, which is higher than any other collective payoff available. In short, the joint payoff from cooperation (6) is higher (or Pareto superior) to that from mutual defection (2) or any other mixed strategy, and yet it is not achieved. The Prisoner's Dilemma is an illustration of a bargaining failure caused because the players either cannot communicate with, or cannot make credible commitments to, each other.

The appeal of the Prisoner's Dilemma approach is that it does not model social behavior as a zero-sum game in which one side's winnings come exclusively at the expense of the other side. Although such games exist (poker is the standard example), corporate governance does not fit this model because clearly stockholders and stakeholders share common interests (i.e., both want the firm to remain solvent). It is generally acknowledged that Thomas Schelling reoriented game theory by forcing its students to recognize that the most important human conflicts still involve some level of, or potential for, tacit cooperation among the adversaries.[142] This focus on the circumstances

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141. The important (and somewhat artificial) aspect of this fact pattern is that the temptation to defect (or T, which is here the 5 or 1 payoff) exceeds the reward for cooperation (or R, which is here 3 or 0), which in turn exceeds the punishment for mutual defection (or P, which is here 1), which in turn exceeds the "suckers's payoff" (or S, which is here 0) if one player cooperates while the other defects. Thus, the preference rankings are T, R, P, and S. Change these rankings and the rational strategy also changes. *See* R. AXELROD, THE EVOLUTION OF COOPERATION 7-10 (1984). For a standard introduction to the Prisoner's Dilemma, see R.D. LUCE & H. RAIFFA, GAMES AND DECISIONS (1957).

142. For Schelling's seminal contribution, see *The Strategy of Conflict: Prospectus for a Reorientation of Game Theory*, 2 J. CONF. RES. 203 (1958) (applying game theory to study of interna-

under which tacit cooperation could develop among individuals pursuing their rational self-interest led social scientists back to the problem of the Prisoner's Dilemma as a basic paradigm for the problems of collective action.

Still, does this paradigm fit the world of corporate governance? To understand the potential relevance of the foregoing illustration to intrafirm bargaining, it is useful to return to Figure One and hold the payoffs constant, but substitute for the two prisoners some more familiar characters: a target management and a union, both in the setting of a UAL-like takeover. Assume now that a hostile bid has been made and that both labor and management will lose if the hostile bidder triumphs; that is, target management will be out of office very quickly and the unions will face layoffs and demands for wage concessions. If labor and management cooperate, they can structure a leveraged buyout, possibly involving an ESOP, that will defeat the hostile bidder (perhaps because of the tax subsidy underlying the ESOP or for other reasons, as in the recent *Polaroid* case).[143] Still, if either side can defect, it will be better off. Management can defect if, after it defeats the bidder and acquires equity control of the firm in an LBO, it can then renege on its implicit commitments and lay off workers or make approximately the same wage concession demands as the hostile bidder would have done. As the firm's principal equity owner, management can benefit from such a double cross because it will receive the resulting income gain. Unions and their members can also defect if they can take their new ESOP shares and vote them for the hostile bidder in return, for example, for wage or employment guarantees. Such promises to labor might be made credible if the hostile bidder promises labor adequate seats on the target's board or a board supermajority provision, such as that which UAL proposed to adopt.[144] If both players defect, the bidder will only need to give each token benefits (such as a "golden parachute" to management and some minimal employment benefits to the union). On these assumed facts, the individual payoffs can be presented in a Prisoner's Dilemma matrix, as follows:

FIGURE TWO

		Target Management	
		Cooperate	Defect
Union	Cooperate	U=3, T=3	U=0, T=5
	Defect	U=5, T=0	U=1, T=1

tional relations). For an intellectual history of the Prisoner's Dilemma and an explanation of the fascination it holds for social scientists, see Rapoport, *Prisoner's Dilemma—Recollections and Observations,* in RATIONAL MAN AND IRRATIONAL SOCIETY 72-83 (B. Barry & R. Hardin ed. 1982).

143. *See supra* note 119.

144. *See* Salpukas, *supra* note 92, at 1, col. 5.

Given this identical payoff structure, it is again better to defect than to cooperate, even though the collective payoff is higher from cooperation. In short, what is collectively rational is individually irrational.

To this point, we have considered only a two-player game. Yet clearly there are often multiple players, such as the three unions involved in the UAL negotiations. Nonetheless, Russell Hardin has shown that the results do not change when the game is expanded into an *n*-person game.[145] One can utilize the same matrix as before, but make the two players one individual versus the collective interest of all other members of the group. Thus, the Prisoner *A* player could be the pilots' union, as before, and the Prisoner *B* entries could represent the per capita payoffs to all other players (i.e., management and the other unions). Accordingly, even in a world of relatively few players, we can expect individual actors to act in a way that is not collectively rational, if the preconditions to the Prisoner's Dilemma are satisfied. In fact, Mancur Olson's "collective action" problem can be understood as simply an *n*-person Prisoner's Dilemma game.

But how realistic is the Prisoner's Dilemma to a world where the parties can and do communicate? In any example, the incentive to defect is heavily dependent on the payoff structure, and even small differences in the foregoing numbers can align the actors' self-interests and make it irrational not to cooperate. But an even more important objection to the Prisoner's Dilemma game exists: the game is by definition noncooperative. Some economists have instead sought to model corporate governance as a cooperative game.[146] If we view corporate governance in this way, a determinate solution becomes possible, which will often involve the unions and management forming a coalition to thwart the hostile bidder (and thereby also denying shareholders the takeover premium).[147] Normally, the parties to an LBO can freely communicate. Unless there is an unusual restriction (such as a court order),[148] it

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145. Hardin, *Collective Action as an Agreeable n-Prisoner's Dilemma*, 16 BEHAV. SCI. 472, 479 (1971).

146. *See* M. AOKI, *supra* note 7. Aoki sees management as basically a neutral referee, mediating the claims of other constituencies. *Id.* at 61-63. I think this view ignores management's own very real self-interests, and thus the fact that it too is an interested player in the game. Other economists, however, have used the Prisoner's Dilemma format to model cooperation within the firm under circumstances in which communication is possible but informal or implicit standards are likely to govern behavior. *See generally* Leibenstein, *supra* note 7.

147. Polaroid's successful 1989 defense against a takeover bid is an apt illustration of this pattern. *See supra* note 119. More generally, unions and management can seek antitakeover legislation and frequently have done so in the context of a specific takeover. For the most recent such effort, see Hylton, *Pennsylvania To Toughen Bill To Thwart Takeovers*, N.Y. Times, Mar. 28, 1990, at D6, col. 5 (noting alliance of corporate executives and labor behind the bill). Indeed, one Pennsylvania legislator commented: "What you have are corporate executives who need protection coming up here and saying to labor that they'll give them a piece of the action [if they help them deny shareholders their rights]." *Id.* (quoting State Senator Vincent J. Fumo).

148. *See* NWA, Inc. v. Davis, No. 4-88-298 (D. Minn. Apr. 13, 1989).

might seem that the Prisoner's Dilemma analogy is irrelevant. Yet, as the closest students of game theory have recognized, the prerequisite to the Prisoner's Dilemma's applicability is not that the parties are unable to communicate, but that they cannot make enforceable agreements with each other.[149] Thus, if the various sides in a complex negotiation over corporate control cannot make credible commitments to each other, the Prisoner's Dilemma may arise.

Still, is an inability to make credible commitments a realistic premise? Sometimes cooperation may be unlikely because the parties do not trust each other (here, the name Frank Lorenzo comes immediately to mind). But this is an atypical situation. The greater problem is that the law may forbid enforceable agreements between unions and management that effectively deny the shareholders their takeover premium. Thus, although the two sides can communicate, they may not be able to agree in a legally enforceable way. As a result, their practical ability to cooperate is likely to be determined by the degree to which they either trust each other or can develop an institutional mechanism that outflanks these legal barriers. For example, if management simply hints that there will be fewer layoffs if it remains in power, this is a nonenforceable promise from which management may later defect. If, however, management rewrites the collective bargaining agreement in the middle of a takeover to make the promise enforceable, then this is precisely the case in which the *Air Line Pilots Association* court held that Delaware corporate law should control.[150] Under Delaware law, the *Unocal* test would probably apply, making the relevant question whether the board had acted "reasonably" in relation to a perceived "threat" to corporate interests.[151] The paradox here is that the more enforceable and hence credible promise by management to the unions becomes, the more it is also likely to breach management's fiduciary duties to its shareholders under *Unocal*.

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149. *See* Harsanyi, *Rationality Postulates for Bargaining Solutions in Cooperative and Non-Cooperative Games*, 9 MANAG. SCI. 141, 143 (1952); *see also* Rapoport, *supra* note 142, at 80-81 (agreeing with Harsanyi that solution to noncooperative game is creation of enforceable agreements).

150. 874 F.2d 439, 447 (7th Cir. 1989).

151. Unocal Corp. v. Mesa Petroleum Co., 483 A.2d 946, 955 (Del. 1985). In addition, if the corporation is deemed to be up for "sale" (which term typically includes a change of control), Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986), becomes applicable. In *Revlon*, the Delaware Supreme Court held that when a corporation is "for sale," the fiduciary role of the board shifts from that of a defender to that of an auctioneer charged with obtaining the "best price" for its shareholders. *Id.* at 182. *Revlon*'s holding prevents the board from considering the interests of nonshareholder constituencies at the expense of shareholders. *Id.* at 182-84 & n.16. Some decisions, however, do permit employee interests to be considered. *See* GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985) (dictum) (as long as board acts with honest, disinterested judgment in rejecting tender offer, it may also consider interest of employer in preserving severance and pension benefits). The scope of the *Unocal* and *Revlon* rules exceeds the parameters of this article. The relevant point here is only that they will sometimes apply and thus will block coalitional agreements that come at shareholder expense.

Nonetheless, if some forms of agreement are potentially blocked by state corporate law, it does not follow that all are. One possibility is the use of an ESOP, which the *Polaroid* decision may have legitimized as a takeover defense tactic.[152] Yet here a different question surfaces about the enforceability of the implicit bargain: can management assure itself that the ESOP stock will be voted in its favor (i.e., that employees will not defect)? This question poses significant problems, particularly because federal law may require that the plan trustee vote the unallocated shares for the highest bidder.[153] If so, defection may be mandated by federal law.

Fiduciary law has, however, an asymmetric effect on the ability of the parties to form coalitions. Because fiduciary restrictions apply only to management and the board, they do not restrict the ability of third party bidders to offer a side payment to stakeholders (such as corporation's unions) to induce them to back it in a corporate control contest.[154] However, if management attempts to do the same, such conduct, if detected, will probably be viewed as a violation of *Revlon*'s rule that managers in an auction must seek to maximize share value.[155] To this extent, the outside bidder may be able to engage in a cooperative game with stakeholders, while management is restricted to a noncooperative game (or at least one in which its signals must be heavily veiled).

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152. The *Polaroid* decision is discussed in more detail *supra* at note 119.

153. The Department of Labor's customary view of ERISA's fiduciary requirements has been that the plan trustee or other applicable fiduciary must exercise tendering rights with respect to all unallocated shares and also tender all allocated shares for which tendering instructions are not received. *See* Letter from Alan D. Lebowitz, Deputy Assistant Secretary for Program Operations, U.S. Dep't of Labor (Feb. 23, 1989), *reprinted in* 2 Merg. & Acq. L. Rep. (M & A) 426-27 (1989). Although Internal Revenue Code § 409(e)(5) authorizes ESOPs to meet applicable voting requirements by authorizing the trustee to vote all plan shares in proportion to the voting instructions received from plan participants on a one-participant/one-vote basis, this language says nothing about whether plan participants may instruct the trustee as to whether to tender unallocated shares, and at least one decision has required the fiduciary to use its independent discretion under the ERISA "exclusive benefit" standard with respect to tendering the unallocated shares. *See* Danaher Corp. v. Chicago Pneumatic Tool Co., 635 F. Supp. 246, 250 (S.D.N.Y. 1986) (ESOP trustee not permitted to consider sole interests of current employee participants in tender decision). For an overview of this confused area, see Nassau, *Creating ESOPs in Leveraged Buyouts,* 1 Merg. & Acq. L. Rep. (M & A) 991, 997 (1989). In one recent case, an ESOP trustee sought and obtained a declaratory judgment that he could ignore the voting and tendering pass-through provisions of the ESOP and tender all shares owned by the ESOP, including the allocated shares. *See* Central Trust Company, N.A. v. American Avents Corp., No. C-1-88-883, slip op. at 10-12 (S.D. Ohio May 26, 1989). This opinion may be limited by the special facts of the case because the inside directors could have overturned the allocated ESOP shareholder's tender decision.

154. Although the bidder or other third parties are not subject to fiduciary duty limitations when they do not stand in a fiduciary relationship to shareholders, they may sometimes be subject to weaker limitations, such as the legal rules precluding tortious interference with contractual rights. Courts have only begun to explore what restrictions, if any, are justified on this basis. *See* NWA, Inc. v. Davis, No. 4-88-298 (D. Minn. Apr. 13, 1989).

155. *See supra* note 151.

B. SOME APPLICATIONS: HOW WILL THE GAME PLAY OUT?

The foregoing discussion has viewed corporate governance as a multiplayer game that seems located somewhere on the seam between a cooperative and noncooperative game, not fitting neatly into either category.[156] If so, what predictions, if any, can be made for the future? First, the players may avoid fiduciary problems and structure credible mutual commitments by using one technique that is clearly available: a joint buyout that cashes out the shareholders. Once shareholders are eliminated (at a competitive premium), management, the unions, and any other equity bidder can then cut up the residual equity pie in almost any way they want. Of course, this was precisely what the original UAL buyout attempted. Moreover, the insistence by the pilots' union on a supermajority voting system shows that governance provisions can be structured that do not permit subsequent defections. The pilots' union effectively negotiated a veto power over those decisions most likely to adversely affect them.[157] In this light, the Prisoner's Dilemma need not arise, because a joint buyout can involve explicit and enforceable governance provisions. Still, buyouts require the cooperation of multiple unions, whose members may be in very different economic positions (as the pilots' and machinists' unions at UAL). If only one union participates in the buyout, the others will predictably resist wage concessions that earn no equity appreciation for them. In principle, however, it is not necessary that all the free riders be "taxed" and bear their proportionate share of the costs and wage concessions. Rather, when the potential gains or losses are significant enough to a single actor, that actor should rationally be willing to bear a disproportionate share (or even all) of the costs of collective action.[158] This means that a single union (such as the pilots' union in the UAL example) might be willing to bear more than its proportionate share of wage concessions.

One more complication must be noted: both sides in this game can appeal to outside third parties to join a coalition with them. Thus, it is never certain how many players are in the game. Recent examples can be provided of both

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156. Some theorists distinguish an intermediate category of "almost noncooperative" games in which agreements are sometimes enforceable, but not when defection will yield a positive gain. *See* J. HARSANYI, RATIONAL BEHAVIOR AND BARGAINING EQUILIBRIUM IN GAMES AND SOCIAL SITUATIONS 273 (1977). Empirical research has also found that the appearance of a noncooperating outside player may cause an "implicit coalition" to form among other players. *See* Fader & Hauser, *Implicit Coalitions in a Generalized Prisoner's Dilemma*, 32 J. CONFLICT RESOLUTION 553 (1988).

157. *See supra* text accompanying notes 103-105.

158. As Olson explained, if the benefits are large enough to a single member of the group, he may be willing to bear all, or a disproportionate share, of the costs to avoid forfeiting these benefits. M. OLSON, *supra* note 139, at 48-52. Olson defined a "privileged group" as a group with a disproportionately powerful member. *Id.* at 49-50. For an overview of some of Olson's conclusions, see RATIONAL MAN AND IRRATIONAL SOCIETY 21-23 (B. Barry & R. Hardin ed. 1982).

management and stakeholders finding such a third party ally. The best example of a management coalition with an outside party is the recent three-cornered battle between Time, Warner Communications, and Paramount Communications.[159] Faced with a hostile bid from Paramount, Time's management restructured a friendly merger with Warner into a friendly tender offer for the latter at an enhanced premium. Although the Time-Warner proposed merger preceded and probably precipitated the Paramount bid, the fact remains that this conversion of an equity merger into a cash tender offer blocked Paramount and also thwarted Time's shareholders. Time's shareholders lost a lucrative premium, but Warner's shareholders effectively gained one, while Time's management avoided ouster. From a coalitional perspective, this resort to a third party (whether as a white knight or as a target) can often amount in substance to a side payment by management to the third party.[160]

A corresponding example of a coalition between stakeholders and a third party is provided by the recent agreement by UAL's unions to join with Coniston Partners, an arbitrage firm, to wage a proxy fight to oust the UAL board.[161] According to press accounts, the coalition between Coniston and the UAL unions has been effective because it frightened away other potential bidders, who feared that if they were successful in outbidding the Coniston-UAL offer, their victory would only trigger a strike by the unions.[162] If so, such a coalition benefits both sides but comes at the cost of a higher premium to shareholders.

Given that all of the major players in corporate governance can and have entered into coalitions with and against each other, what form of coalition should dominate? Employee buyouts have clearly increased and arguably represent a cooperative solution in which all participants benefit. On closer inspection, however, the issuance of shares to employees, particularly when accomplished through the use of an ESOP, may simply block a hostile takeover and involve little or no premium to shareholders.[163] In such a case, the buyout may be better viewed as a management-stakeholder coalition against shareholders.

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159. Paramount Communications, Inc. v. Time, Inc., Fed. Sec. L. Rep. (CCH) ¶ 94,938 (Del. Sup. Feb. 26, 1990).

160. Warner employees, mostly senior executives, received $677 million in settlement of their stock options and other rights as a result of the Time tender offer. *See* Hilder, *supra* note 5. This can certainly be regarded as a side payment, although not an unlawful one, which would not have accrued but for the Time tender offer.

161. *See* Salpukas, *supra* note 138.

162. *Id.* ("It is expected to be difficult for other buyers to match the offer made by Coniston and the three unions because such a group would not have the benefit of wage and benefit concessions the unions have pledged as part of the offer with Coniston.").

163. Polaroid's successful 1989 defense against a takeover bid seems to fit this pattern. *See supra* note 119.

What response will such a strategy elicit from shareholders? The ability of managers and stakeholders to collude to lock free cash flow into the firm is subject to one major caveat: because the gains to shareholders from LBOs appear to be very high (over the short-run at least), shareholders may be able to offer a higher price to either side. For example, in the UAL buyout, a prominent takeover firm allied with UAL's unions to wage a proxy fight that seeks to oust the board through a consent solicitation.[164] Conversely, one can view the RJR Nabisco buyout as an alliance between management and the shareholders to split the takeover gains at the expense of stakeholders. Although management may have a greater psychological incentive to align with stakeholders to resist a bidder, the bargaining need not logically produce such a coalition because shareholders may be able to offer greater economic incentives. Put differently, the gains and losses are asymmetric, with stockholders winning more from takeovers than bondholders and employees lose.[165] With these greater gains, stockholders can offer more to management to align with them than stakeholders can rationally bid to avoid a takeover. In a perfect Coasean world, one would expect that stakeholders and stockholders would strike a bargain to realize these net gains, but in the real world, transaction costs interfere (particularly in the case of publicly held debt).

In short, if we start with the premise that stockholders gain more than stakeholders lose in takeovers, then it follows that stockholders should be able to win any auction that develops for management's loyalty. Of course, shareholders today cannot actively organize, but they can acquiesce in (and indeed encourage) an LBO bid from management.[166] If management for some reason resists, large stockholders may pressure them (as Coniston Partners has done in the UAL episode)[167] with the threat that they will turn to outside bidders. Yet, the LBO bid should be the preferred outcome because rational shareholders should recognize that they cannot expect management's acquiescence to a third-party bid. Because management can potentially form a coalition with stakeholders to block any takeover, stockholders need essentially to preempt the formation of such a coalition by outbidding

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164. *See* Salpukas, *supra* note 107, at 33, col. 4.

165. Indeed, one study finds that even if bondholders in leveraged buyouts lost the entire book value of their claims (an obviously unrealistic assumption), their losses would account for the shareholders' gains from the same transactions in only 19 of 103 buyouts studied (or roughly 18%). These authors conclude that bondholders generally face a maximum exposure of 10% of the book value of their investments as a result of buyouts. *See* Marais, Schipper & Smith, *supra* note 65, at 182. This conclusion further supports the view that corporate governance should not be modeled as a zero-sum game. *See supra* text accompanying note 147.

166. If management for some reason resists, bidders may be able to negotiate with some stakeholders (such as the UAL unions) to oust management anyway (as Coniston Partners is threatening to do).

167. *See* Salpukas, *supra* note 101.

stakeholders in an auction for management's loyalty. Phrased differently, third-party bids do not provide management with equivalent expected gains to an LBO, and thus they are unlikely to secure management's loyalty. In other words, because the maximum amounts that might be paid in golden parachutes cannot possibly match the potential gains that the managements of UAL or RJR Nabisco anticipated from their respective buyouts, this analysis does offer one testable prediction: LBO bids should dominate hostile bids in the future, because they alone offer a feasible means for securing management's cooperation. In such a world, management has more incentive to ally with stockholders than stakeholders.

Still, once the company is put in play, management cannot easily stop the process. New bidders may surface, and management cannot know that it will be on the winning side. In fact, the law restricts management in an LBO much more than it restricts other bidders.[168] Hence, if management is risk averse, it may fear putting the company in play and prefer to side with stakeholders. Thus, while management-shareholder coalitions seem more likely than management-stakeholder coalitions (at least as long as hostile takeovers remain feasible), neither should totally dominate the other, given management's fear that it may lose control of events once it puts the company in play (as happened in the RJR Nabisco buyout).

C. THE ITERATED PRISONER'S DILEMMA AND THE EVOLUTION OF COOPERATION

In his now famous book, *The Evolution of Cooperation,*[169] Robert Axelrod concludes that in actual practice the players in Prisoner's Dilemma games quickly learn to cooperate. The strategy that he terms "TIT FOR TAT" seems regularly to dominate; that is, rational actors learn to treat others as they have been treated, cooperating if the other side has, defecting if they have not.[170] The persuasive force of Axelrod's book lies particularly in the "real world" examples he gives of reciprocity and cooperation in actual so-

168. On the other hand, management may sometimes be able to enjoin the hostile bidder from communicating with its unions. *See supra* notes 96-97 and accompanying text. For recent cases that have enjoined what were essentially LBO transactions, see City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 798-800 (Del. Ch. 1988), *appeal dismissed as moot,* 556 A.2d 1070 (Del. 1989) (enjoining board's failure to redeem poison pill when bidder made noncoercive offer posing only "mild" threat). *See also* Edelman v. Freuhauf Corp., 798 F.2d 882, 886-87 (6th Cir. 1986) (board violated fiduciary duty under Michigan law in approving and assisting management-led buyout that precluded competing bid for control through no-shop clause and other arrangements); *cf.* Hanson Trust PLC v. MLSCM Acquisition, Inc., 781 F.2d 264, 282-83 (2d Cir. 1986) (enjoining target's crown jewel lockup to LBO bidder).

169. *See* R. AXELROD, *supra* note 141.

170. *Id.* at 20.

cial settings, even when opportunism is possible.[171] In effect, his message is that cooperative behavior is efficient; rational parties will come to learn this; and through a survival-of-the-fittest type of competition, they will come to dominate the field.[172]

Does Axelrod's scenario apply to the triangular game of corporate governance that this article has been describing? The problem is that Axelrod was describing an iterated Prisoner's Dilemma, in which the same game is played over and over. In contrast, takeovers are seemingly one-shot affairs, at least for management and employees. Because the game will not likely be repeated, a policy of reciprocity is impossible, and defection will therefore always seem the superior strategy. In a one-shot game, the bidder may believe that it can break the prior implicit contract that management struck with stakeholders and then bust up the firm, quickly liquidating its assets and not having to manage them for long. Such a strategy makes sense if you are not a repeat player and do not need to be trusted in the future by others. Certainly, some bidders—the Irving Jacobs, Paul Bilzerians, and Victor Posners of this world—seem to be following just such a strategy of opportunism, by in effect violating the prior tradition of "TIT FOR TAT." On the other hand, Frank Lorenzo's current predicament shows the downside in this strategy. Lorenzo has united an alliance of stakeholders at Eastern Airlines against him.[173] The real message of Lorenzo's predicament is that if one is a repeat player, one cannot behave opportunistically without incurring reprisals.

For most players, takeovers are a recurring game in which norms of reciprocity can develop. Institutional investors, both as shareholders and bondholders, are clearly "repeat players." They do not "cut and run" with their takeover profits as do small shareholders, who often spend their gains on personal consumption, but rather they reinvest their gains in the market. Also, institutional investors need to balance their gains as equity holders with their exposure as bondholders, and they have little reason to encourage wealth transfers that merely move money from one pocket to another. Even for management, a takeover is not invariably a one-shot game. This article earlier predicted that the LBO offer should dominate the hostile bid. If this is true, an iterated game may be possible after all, because the same management will remain in place, and a defection in one period will lead to a reprisal

171. *Id.* at 73-102 (examples from human warfare and the natural world indicate that friendship and foresight are not necessary for "TIT FOR TAT" to function properly).

172. *Id.* at 22.

173. *See* Salpukas, *supra* note 98. Empirical research has found that in *n*-person games with one noncooperative player, the other players may form an "implicit coalition" against that player. *See* Fader & Hauser, *supra* note 156, at 560-62. This pattern could well describe the behavior of those dealing with Mr. Lorenzo.

by the other players in the next. To some degree, "TIT FOR TAT" may therefore continue.

What would an "evolution toward cooperation" mean in this context? Metropolitan Life's predicament in the RJR Nabisco buyout supplies an instructive example. Metropolitan Life's staff has estimated that it would have cost Kohlberg, Kravis, Roberts & Co. (KKR) only "about $4 per share to pay off bondholders" in the RJR buyout.[174] Thus, instead of paying shareholders $109 per share for stock that had been trading at $55 a share at the time of the buyout's announcement, KKR could have paid $105 to stockholders and also redeemed the bonds. Should they have done so? The usual counterargument that bondholders accepted the risk of higher leverage by not contracting against it seems particularly weak here, because purchasers of investment grade securities elect to accept a low interest rate precisely to avoid exposure to major risks. One cannot imagine Metropolitan Life rationally accepting the interest penalty on investment grade debt while also knowingly accepting a loophole through which a regiment of lawyers could march abreast to restructure the issuer. Thus, however Metropolitan Life's legal rights are defined,[175] one has to assume that as a repeat player it would consider such behavior opportunistic, and in a game of "TIT FOR TAT" would seek reprisals.

It seems clear that institutional investors are not organizing in this fashion, at least yet. Possibly, this shows that (1) takeovers are not a repeat game, (2) relevant reprisals are not possible (at least by bondholders), (3) the losses are sufficiently small that a response is not cost justified (possibly because institutional investors are sufficiently diversified so that their gains as stockholders outweigh their losses as bondholders),[176] or (4) the market regards "event risk" as an exogenous new development, which no one exploited opportunistically, and which new contractual protections (i.e., the "poison put") resolve for the future. All these interpretations are possible, but it is worth inquiring in the concluding section of this article how corporate governance would change if the principal participants—stockholders and management—did see themselves locked into a repeat game. Whether or not true today, this may prove to be a valid scenario for the future.

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174. *See* Franklin, *Met Life Looks for Help,* N.Y.L.J., May 11, 1989, at 5, col. 5.

175. *See supra* notes 37-53 and accompanying text.

176. If institutional investors were perfectly diversified between bonds and stocks, they would be indifferent to wealth transfers. This is a very unrealistic assumption, although for some institutional investors the significance of wealth transfers will be offset to the degree that they are largely diversified between bonds and stocks. Moreover, even the perfectly diversified investor would object to incurring transaction costs to produce wealth transfers that yield no real gains. In any event, the rapid appearance and use of poison puts and Standard & Poor's development of an event risk ranking system for negative covenants suggests strongly that institutional investors are not indifferent to event risk and hence not fully diversified with respect to it. For evidence of significant losses to bondholders, see *supra* text accompanying notes 79-82.

VI. CONCLUSION

This article has raised two central contentions. First, at least a modest paradigm shift is needed: we should move from viewing the public corporation as a "series of bargains" to recognizing that it is also a "series of coalitions." One need not deny that contracting within the firm is possible (and indeed will cover most contingencies) to realize that economists have tended to reify the word "contract" and use it to cover relationships in which the parties have expectations, but not enforceable rights. The truth is that long-term relational contracts, such as the corporation, are almost inevitably incomplete. Risks not perceived at the outset of the relationship grow and mature until one of the participants realizes that it is seriously exposed to loss. At this juncture, its response may be to rely not on contract, but on coalition. That is, if it cannot secure a favorable contract modification, it may seek to form an alliance with another party who is also exposed (to the same or other risks) in order to protect their mutual interests. Coalition formation is then an alternative mode of protecting expectations, and typically an *ex post* one, but it coexists with contracting, and one cannot explain the internal relationships within the firm without discussing both mechanisms.

Second, within the context in which coalitions operate, a game theory perspective has greater explanatory power than the equilibrium-oriented perspective of financial economics. The basic message of a game theory perspective on corporate governance is that the parties may make choices that yield individually rational, but collectively irrational, outcomes. Above all, what the Prisoner's Dilemma teaches is that circumstances can arise in which cooperation is unlikely and guileful defections are predictable. The difficulty experienced by the parties to the UAL buyout in reaching any consensus despite their common interests suggests that at least sometimes theory and practice can coincide.

This conclusion that rationality will not automatically prevail might seem to be a prelude to stating the case for closer regulation. But there is a flip side to this pessimistic picture: to the extent that the Prisoner's Dilemma becomes an iterated game, the likelihood of these outcomes reverses, and cooperation becomes the predictable strategy of successful repeat players.[177] Further, to the extent that a game can be converted from a noncooperative one to a cooperative one, an efficient solution is almost always possible.[178]

This analysis frames an empirical question: should takeovers be viewed as

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177. For an overview, see RATIONAL MAN AND IRRATIONAL SOCIETY, *supra* note 158, at 33-34.

178. *See* J. HARSANYI, *supra* note 156, at 289 ("[I]n a cooperative game, it is almost always possible for rational players to reach an efficient (Pareto-optimal) outcome."). If we assume that the game is cooperative, there is a rich literature on how coalition formation is likely to proceed. For an excellent overview, see H. RAIFFA, THE ART AND SCIENCE OF NEGOTIATION 257-74 (1983). Precise, determinate solutions do not, however, always result.

single-shot affairs or are they in some respects repeat player games in which cooperation can evolve? The answer must be a mixed and qualified one. For management and employees, who have by definition only one job, takeovers are indeed more likely to be one-shot affairs. But for shareholders and bondholders, the answer seems less clear. Speculative as it is to guess whether reciprocity will dominate opportunism, plausible reasons exist to believe that as share ownership becomes more "institutionalized" (that is, as institutions increasingly dominate the market and hold the majority of the stock in publicly held firms), the possibility of an "evolution toward cooperation" will grow. As recognizable repeat players, institutional investors may become more constrained than other stockholders in their ability to cooperate with opportunistic bidders. The key difference between their present position and that which they are likely to have in the near future is that they may soon lose their relative anonymity. Consider a hypothetical case in which a bidder wishes to behave opportunistically by acquiring a firm to breach implicit contracts with its stakeholders.[179] Today, such a bidder may incur some reputational loss (assuming that it has any reputational capital to lose), but the shareholders who tender to it do not, because they may do so with relative anonymity. Arguably, they have aided and abetted the bidder's opportunism, but their complicity has been masked by their anonymity.

In the future, however, that anonymity may fade, as it appears likely that eventually one hundred or fewer institutions will hold the majority of the stock in many publicly traded firms.[180] Perhaps we will soon see the day when twenty-five or so large institutional investors, each holding one to three percent, will hold de facto working control among them and will then be able easily to communicate and achieve a joint strategy.[181] Such institutionally

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179. See Shleifer & Summers, *supra* note 9, for the most complete statement of the theory that an investor could engage in a wealth-transferring takeover that profits by breaching prior implicit contracts.

180. A survey by the Investor Responsibility Research Center (IRRC) of actively traded firms on the New York Stock Exchange found that institutions hold a majority of the shares of 40% of the firms. Institutions hold more than 40% of the shares of 60% of the firms. In these institutionally dominated firms, a limited number of institutions may own a majority of the stock. In roughly 23% of the NYSE-listed firms that were majority-owned by institutions, fewer than 100 institutions held the majority, and in another 34% of these firms, between 101 and 200 institutions held the majority. *See* Conard, *Fiduciary Obligations of the Asset Manager*, in PROXY VOTING OF PENSION PLAN EQUITY SECURITIES 86, 90-93 (P. McGill ed. 1989) (copy on file at *The Georgetown Law Journal*). Hence, if these trends continue, it appears likely that there will be a significant number of publicly held corporations in which fewer than 100 institutions hold an absolute majority (and in which perhaps 20 hold de facto working control). Of course, it is also possible that institutions will seek to avoid this structure of share ownership precisely because they do not wish to lose their anonymity (and perhaps wish to behave opportunistically).

181. Recent surveys have found that institutional investors owned 42.7% of all corporate equities as of 1986, as compared with 38.5% in 1981. *See* C. BRANCATO & P. GAUGHAN, THE GROWTH OF INSTITUTIONAL INVESTORS IN U.S. CAPITAL MARKETS 13 (Columbia Law School Institutional Investor Project, Nov. 1988) (copy on file at *The Georgetown Law Journal*). Even

dominated corporations will be the most susceptible targets for takeovers, because institutions will be able effectively to resist antitakeover measures and solve the collective action problems that confound other shareholders. But, as the number of shareholders drops, so does their anonymity and thus their ability to behave opportunistically by breaching implicit contracts.

The relative loss of anonymity appears inevitable. Some estimates today place the stock ownership of the fifty largest institutional holders at twenty-seven percent of the total capitalization of the Wilshire 5000 Index (the comprehensive list of all domestic equities).[182] The thirteen largest institutions appear to hold more than half this amount. The great irony here is that the problem of collective action, upon which all pessimistic estimates of the future of corporate governance have rested since the time of Berle and Means a half-century ago, may be quietly fading in significance.

How will a small body of institutions, each owning two to three percent and sharing de facto control, behave? As they become identifiable to the stakeholders, it seems likely that they will also become more politically accountable. Indeed, to the extent that creditors are also institutions, greater direct communication among creditors and shareholders seems likely. This prediction does not imply that there will not be more takeovers, but only that their wealth-transfer aspects will become more vulnerable. "TIT FOR TAT" will become more feasible as a game, and perhaps ultimately inevitable once twenty-five shareholders or so hold control and must deal with a dozen or so large creditors and unions. Of course, at this point one is no longer describing a public corporation, but some new hybrid of public and institutional ownership. That day may be gradually dawning.

One alternative must be cautiously noted. Institutional investors could deliberately refrain from acquiring de facto control precisely to avoid visibility and political accountability. The trend toward ownership concentration may come to a halt at or about its current level because the costs of losing anonymity could exceed the benefits of reduced agency costs.

This article's focus on coalition formation inevitably requires that it face a normative issue in closing. Are not such coalitions between management and stakeholders nothing more than thinly veiled efforts at collusion that deprive shareholders of their right to management's loyalty as a fiduciary? Undoubtedly, collusion and coalition can be synonyms. But a narrow preoccupation

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these numbers understate reality because the commonly used definition of "institution" excludes many financial institutions such as investment banks and savings and loan associations.

182. According to *The Institutional Investor,* the 50 largest institutional holders of equity securities held $736 billion in stocks at the end of 1988. *See The Institutional Investor 300: Ranking America's Top Money Managers,* INSTITUTIONAL INVESTOR, July 1989, at 121, 161. This number amounts to 27% of the Wilshire 5000 level of $2,738 billion at December 31, 1988. This calculation was pointed out to me by my Columbia colleague, Professor Bernard Black.

with fiduciary duties has long been the hobgoblin of law professors. A fuller normative theory must recognize the possibility that stakeholders can also experience injury and are unable to contract so as to protect themselves from all risks. The recent experience of bondholders in takeovers illustrates this exposure. If the law were to approach all issues of corporate governance with a single-minded devotion to fiduciary duties, it would facilitate wealth transfers from stakeholders to stockholders. While these transfers are not the cause of takeovers, they are a byproduct.[183]

From what starting point should a normative theory begin? In my view, we need to recognize that takeovers are efficient only in the Kaldor/Hicks sense of that term and not in the Pareto sense.[184] The Kaldor/Hicks definition of efficiency is that the gains exceed the losses. The best evidence now available suggests that this criterion is satisfied.[185] However, Pareto efficiency requires that some be made better off, while no one is made worse off. Clearly, that standard is not satisfied. Pareto efficiency may seem an impossible standard to meet, because some losers usually result from any important economic, social, or historical transition.

Nonetheless, social policy should seek to move us from Kaldor/Hicks efficiency to Pareto efficiency with respect to the impact of takeovers. Why? The short answer is that no other position is politically tenable. Because the "losers" in takeovers—employees, managers, local communities, and suppliers—tend to be politically concentrated in the same jurisdiction as the target, while the "winners" (i.e., shareholders) are dispersed nationally, a regulatory mismatch is created. Local coalitions form between target managements and stakeholders that seek antitakeover statutes. Such coalitions are demonstrably effective, and externalities result. But this process is inevitable, because the losers outnumber the winners (both locally and nationally), as shareholders are relatively few in number in comparison to stakeholders. If takeovers are to persist, the most sensible social policy is to make them Pareto efficient, if only to keep them politically viable.

How legislation might force the winners to compensate the losers is the topic for another article, but the immediate point is that Pareto efficiency would not require the winners to sacrifice much of their gains.[186] Pending such a legislative resolution, coalitions of management and stakeholders pro-

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183. *See supra* notes 78-82 and accompanying text.

184. The Kaldor/Hicks approach to efficiency postulates that if the gains exceed the losses, the transaction is efficient because either society or the winners can compensate the losers. *See* A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7-10, 115-17 (1983); Hicks, *The Foundation of Welfare Economics*, 49 ECON. J. 696 (1939).

185. For evidence that the gains to shareholders are enormous, see the sources cited *supra* note 10. One recent study finds bondholder losses to equal only 3.3% of shareholder gains from takeovers. *See supra* note 81.

186. *See supra* notes 81 & 174 and accompanying text.

vide a mediating force that keeps opposition to takeovers from becoming even more intense. LBO's and employee takeovers yield very large gains to shareholders (although possibly somewhat less than a regime of unrestricted hostile bids would), but such a "free market" regime of unrestricted takeovers would lack political viability.

By no means do I suggest that all coalitions between management and stakeholders be accepted; nor would I even suggest a judicial rule of benign neglect. Still, coalition formation and coalition decay are facts of corporate life. For the time being, it is best that we understand them better before we decide how to regulate them.